BACKGROUND AND ISSUES RELATED TO THE ADMINISTRATION'S PROPOSED TAX ON FINANCIAL INSTITUTIONS

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on April 20, 2010

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

April 16, 2010
JCX-26-10

CONTENTS

Page

INTRODUCTION 1

I. BACKGROUND 2

A. Financial Crisis 2
B. Troubled Asset Relief Program ("TARP") 3
C. Financial Institutions Background 5

II. PRESENT LAW FEDERAL INCOME TAXATION OF FINANCIAL INSTITUTIONS 9

A. Corporations Generally 9
B. Banks, Thrifts, and Credit Unions 10
C. Gains and Losses with Respect to Securities Held by Financial Institutions 11
D. Insurance Companies 13
E. Broker-Dealers 14

III. DESCRIPTION OF ADMINISTRATION'S PROPOSAL 17

IV. ANALYSIS OF BANK TAX ALTERNATIVES 18

A. Financial Institution Tax Design Issues 18
B. Administration's Proposal 21
C. Other Bank Tax Alternatives 24
1. Income tax 24
2. Excess profits tax 24
3. Risk-based assessments 25
4. Tax linked to benefits received under the TARP 27
5. International approaches 27
6. Proposed financial regulatory reform legislation 28

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on April 20, 2010, on the Administration's proposed tax on financial institutions regarding the Troubled Assets Relief Program ("TARP"). This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of Federal income tax issues related to the Administration's financial crisis responsibility fee and, more generally, sector-specific taxes on financial institutions. Except as otherwise noted, all references to sections in this document are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

Part One provides general background related to the recent financial crisis, the Federal government's response, and an overview of financial institutions. Part Two describes present law related to the Federal income taxation of financial institutions including banks, thrifts, bank and thrift holding companies, credit unions, insurance companies, securities broker-dealers, and certain other financial institutions. Part Three describes the Administration's proposed financial crisis responsibility fee. Part Four provides a discussion of the basic design considerations for crafting a sector-specific tax on financial institutions and a description and analysis of possible bank tax alternatives.

[1] This document may be cited as follows: Joint Committee on Taxation, *Background and Issues Related to the Administration's Proposed Tax on Financial Institutions* (JCX-26-10), April 16, 2010. This document can be found on the Joint Committee on Taxation's website at www.jct.gov.

I. BACKGROUND

A. Financial Crisis

Beginning in 2007, the credit markets began to tighten as issues surfaced with respect to subprime mortgage lending to risky borrowers.[2] As mortgage defaults and delinquencies accelerated, investors, including financial institutions, realized losses on loans and mortgage-backed securities. Investors, including financial institutions, withdrew debt and equity contracting the lending base. Credit became difficult to obtain, even for potential borrowers who would ordinarily have been considered good credit risks for institutions. By September 2008, several large financial firms failed or nearly failed, resulting in severely constricted credit and financial markets.[3] Stock prices fell sharply as investors lost confidence in the financial markets and as uncertainty about the risk exposure of financial institutions led investors to question and discount their future profitability.

The lack of available credit and overall bearish investor sentiment resulted in a rapid and deep global economic contraction that persisted through at least early 2009. Job losses, foreclosures, and falling consumer confidence continued. In addition, financial institutions experienced significant losses and numerous banks failed, each of which contributed to a continuation of tight credit policies. As a result of the crisis in the capital markets, the ability of businesses and individuals to borrow money was severely restricted. Businesses, limited in their ability to borrow, continued to reduce costs through employment cuts and inventory reductions.

Lack of information exacerbated problems along various dimensions. Lack of information about the true credit quality underlying mortgage backed securities led rating agencies and investors to assess the value of such securities improperly. Lack of information prevented firms from credibly signaling their true exposure to credit losses. Lack of information about whether, and the terms under which, the government would intervene to resolve those institutions with greater exposure to credit losses contributed to uncertainty about whether creditors would be repaid, increasing short-term borrowing costs and encouraging firms to increase their cash reserves. Lack of information prevented potential borrowers from credibly signaling their creditworthiness, restricting opportunities for financial institutions to generate profits to ease concerns. In the absence of information, the capital markets ceased to function normally.[4]

---

[2] Congressional Research Service, *Government Interventions in Response to Financial Turmoil (R41073)*, February 1, 2010, by Baird Webel and Marc Labonte, available at http://www.crs.gov/ReportPDF/R41073.pdf.

[3] Including the filing for Chapter 11 bankruptcy by Lehman Brothers at http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf.

[4] For a canonical examination of the impact of uncertainty on markets, see George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics*, August 1970, pp. 488-500.

In late 2008 and early 2009, the Federal government took several unprecedented steps to provide liquidity in the credit and financial markets and to restore confidence in the financial sector.[5]

B. Troubled Asset Relief Program ("TARP")

The Emergency Economic Stabilization Act of 2008[6] ("the Act") established the Office of Financial Stability ("Treasury-OFS") within the Department of the Treasury ("Treasury") to implement the Troubled Asset Relief Program ("TARP"). The Act authorized the Secretary of the Treasury to "purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on terms and conditions as are determined by the Secretary."[7] The TARP primarily consists of eight programs, each of which is briefly described below.[8]

The Capital Purchase Program ("CPP") was created to bolster the capital position of various financial institutions. Treasury-OFS provided capital to more than 600 financial institutions and received senior preferred shares and warrants in exchange.[9] Most financial institutions participating in the CPP are required to pay Treasury-OFS a dividend rate of five percent per year on the preferred stock sold to Treasury-OFS, with the rate increasing to nine percent after the first five years.[10]

---

[5] In addition to the creation of the Troubled Asset Relief Program ("TARP"), the Federal Reserve provided access to cash and readily-tradable assets through direct lending facilities and the Commercial Paper Funding Facility. The Federal Deposit Insurance Corporation ("FDIC") provided liquidity through its Temporary Liquidity Guaranty Program. The government also used public funds to prevent the failure of certain institutions (such as Fannie Mae, Freddie Mac, and American International Group) determined to be "too big to fail." For a detailed discussion of the U.S. government's response to the financial crisis see, Congressional Research Service, *Government Interventions in Response to Financial Turmoil (R41073)*, February 1, 2010, by Baird Webel and Marc Labonte, available at http://www.crs.gov/ReportPDF/R41073.pdf.

[6] Pub. L. No. 110-343.

[7] Sec. 101 of the Act.

[8] For a detailed description of these programs see Government Accountability Office, *Financial Audit - Office of Financial Stability (Troubled Asset Relief Program) Fiscal 2009 Financial Statements,* December 2009, GAO-10-301, pp. 45-65.

Although not funded through the TARP, Treasury has also provided financial assistance to Fannie Mae and Freddie Mac. As of December 2009, total cash payments and guarantees of approximately $151 billion have been provided to Fannie Mae and Freddie Mac. See, Congressional Budget Office, *Budgetary Treatment of Fannie Mae and Freddie Mac, January 2010,* and Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010-2020*, January 2010.

[9] For a detailed description of the terms of the senior preferred shares and warrants, see TARP Capital Purchase Program, Senior Preferred Stock and Warrants, Summary of Senior Preferred Terms at http://www.ustreas.gov/press/releases/reports/document5hp1207.pdf .

[10] By comparison as of April 16, 2010, five-year Treasury securities are yielding 2.49 percent while ten-year Treasury securities are yielding 3.79 percent. U.S. Department of the Treasury, *Daily Treasury Yield Curve Rates,* available at http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield.shtml.

Under the Targeted Investment Program ("TIP"), Treasury-OFS invested $20 billion in each of Bank of America and Citigroup. These preferred stock investments provide for an annual dividend rate of eight percent. Recipients of TIP funds are considered to have received "exceptional assistance" and, as a result, are subject to special rules governing executive compensation. All funds advanced under the TIP had been repaid as of December 2009.

The Asset Guarantee Program ("AGP") is designed to maintain stability in the financial markets by helping to limit a financial institution's exposure to losses on distressed assets. The AGP has been used in connection with a potential guarantee of certain Bank of America losses and with respect to an agreement to guarantee potential loan losses of Citigroup. In each case, Treasury-OFS received compensation for its guarantee. No amounts are currently outstanding with respect to the AGP.

The Automotive Industry Financing Program ("AIFP") provides emergency loans and a path for orderly restructuring to General Motors Corporation and Chrysler LLC. Financial assistance under the AIFP has also been provided to financing companies affiliated with GM and Chrysler, respectively, as well as certain automotive suppliers.

Treasury-OFS purchased preferred shares and received warrants to purchase common shares in American International Group, Inc ("AIG"). This is considered "exceptional assistance" with the result that AIG is subject to the special executive compensation rules.

The objective of the Term Asset-Backed Securities Loan Facility ("TALF") is to stimulate investor demand for securities backed by certain eligible consumer and small business loans to lower the cost and increase the availability of credit to consumers and small businesses. Under the program, Treasury-OFS provides up to $20 billion in credit protection to the Federal Reserve for losses on TALF loans. Treasury-OFS also has committed up to $15 billion to purchase securities backed by the Small Business Administration ("Unlocking Credit for Small Businesses Program").

Under the Public-Private Investment Program ("PPIP"), Treasury-OFS provides debt and equity financing to newly-formed public-private investment funds established by private sector investors to acquire so-called "legacy assets" from financial institutions to improve the financial institutions' balance sheets. These legacy assets include real estate loans and securities backed by non-agency residential and commercial real estate loans.

The Home Affordable Modification Program ("HAMP") provides funding and assistance enabling home mortgage modifications for qualifying homeowners.

As of April 12, 2010, the amounts disbursed, repaid, outstanding, and received on the disposition of warrants with respect to the programs were as follows (in billions):[11]

	Disbursed	Repaid	Other	Outstanding	Warrants
CPP	$204.9	$135.8	$-2.3	$66.8	$4.4
TIP	40	40	0	0	1.3
AGP	0	0	0	0	0
AIFP	81.3	4.2	0	77.1	0
AIG Investment	69.8	0	0	69.8	0
TALF	20	0	0	20	0
Small Business Lending	0.2	0	0	0.2	0
PPIP	30	0	0	n/a	0
HAMP	39.9	0	0	n/a	0
Totals	$486.1	$180	$-2.3	$233.9	$5.7

The Act requires that on October 4, 2013, the Director of the Office of Management and Budget, in consultation with the Congressional Budget Office, submit to Congress a report on the net amount within the TARP. The statute provides that in case of a shortfall, "the President shall submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall."[12]

C. Financial Institutions Background

In general

To the extent that they perform the function of financial intermediation, banks, thrifts,[13] bank and thrift holding companies, securities brokers and dealers, nonbank financial entities, and insurance companies may all be viewed as financial institutions. The definitions of these entities are not consistent for Federal tax, Federal or State regulatory, or State law purposes. For example, the Code defines a bank in terms of its place of incorporation, its business operations and its status as an entity subject to State or Federal regulatory authority.[14] The definition, however, is for the limited purpose of determining the applicability of certain special tax rules.[15]

[11] See http://www.financialstability.gov/docs/transaction-reports/4-12-10%20Transactions%20Report%20as%20of%204-8-10.pdf. In addition, as of February 28, 2010, Treasury-OFS had received dividend, interest, and distribution payments totaling $13.7 billion.

[12] 12 U.S.C. Sec. 5239.

[13] A thrift institution is not separately defined in the Federal tax law, but is generally understood to include domestic building and loan associations (sec. 7701(a)(19)), mutual or stock savings banks (sec. 591(b)), and certain cooperative banks (sec. 7701(a)(32)).

[14] Sec. 581.

[15] Secs. 582 and 584.

Even within the Federal banking regulatory regime, the definition of bank or financial institution is not uniform.[16] An entity that qualifies as a bank under State law might not satisfy the Federal tax definition and vice versa. In addition, nonbank entities might engage in activities, or be exposed to liabilities traditionally considered within the banking sphere. For example, in recent years nonbank entities gained increasing exposure to home mortgage loans,[17] but did not thereby satisfy the Federal tax definition of a bank.

Financial institution regulation

Regulatory responsibility for financial institution in the United States is divided among multiple regulators with overlapping jurisdictions.[18] In general, a depository institution is subject to regulation by its chartering authority (either State or Federal) and, if Federally insured, by at least one primary Federal regulator responsible for the safety and soundness of the institution. The Office of the Comptroller of the Currency (the "OCC") is the primary Federal regulator for national banks. State-chartered banks that are members of the Federal Reserve System are overseen by the Board of Governors of the Federal Reserve System. State-chartered banks that are not members of the Federal Reserve System are primarily regulated by the FDIC. Thrifts, whether State or Federally chartered, have the Office of Thrift Supervision (the "OTS") as their primary regulator, but are also subject to FDIC regulatory authority. Credit unions are regulated by the National Credit Union Administration (the "NCUA"). The Federal Reserve also has regulatory authority over bank holding companies, financial holding companies, U.S. branches of foreign banks, and foreign branches of U.S. banks.

Nonbank entities that sell securities to the public (e.g., publicly-traded companies), certain financial market intermediaries (e.g., securities broker-dealers), and other financial entities (e.g., mutual funds, auditors, investment advisors) generally must register with the Securities and Exchange Commission (the "SEC"). Unlike the various bank regulators, the SEC is not responsible for insuring the financial soundness of the firms it regulates, but rather is concerned with maintaining fair and orderly markets and protecting investors from fraud.[19] While the FDIC has resolution authority over the banks it regulates,[20] the SEC has no authority

[16] The lack of an accepted definition within the Code and the lack of uniformity within banking led to amending the exceptions the definition of U.S. property in 956(c)(2) in 2004. Formerly, it referred to deposits with a "person carrying on the banking business." It now instead requires that the deposits be placed with an entity that satisfies the definition of section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)). See, Pub. L. No. 108-357, sec. 837(a).

[17] See, e.g., Congressional Research Service, *Bear Stearns: Crisis and "Rescue" for a Major Provider of Mortgage-Related Products (Report RL34420)*, April 9, 2008 by Gary Shorter, available at http://www.crs.gov/ReportPDF/RL34420.pdf.

[18] Some have suggested that regulatory coverage is incomplete despite overlapping regulatory jurisdiction. See, Congressional Research Service, *Who Regulates Whom? An Overview of U.S. Financial Supervision (R40249),* December 14, 2009, by M. Jickling and E. Murphy, available at http://www.crs.gov/ReportPDF/R40249.pdf.

[19] *Ibid*.

[20] That is, generally, the FDIC has authority to place a regulated bank into receivership and liquidate its assets.

to intervene in a registrant's business regardless of its risk exposure and the SEC cannot preemptively seize a troubled registrant.[21]

Insurance companies are regulated by insurance regulatory bodies at the State level in each State. The National Association of Insurance Commissioners ("NAIC") standardizes forms for reporting financial information to the various States.

Federal Deposit Insurance Corporation

The FDIC is an independent agency created by Congress[22] to maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising certain financial institutions for safety and soundness and consumer protection, and managing receiverships. The FDIC is funded through a risk-based assessment system of premiums paid by banks and thrift institutions for deposit insurance and from earnings on investments in U.S. Treasury securities. The risk-based assessment system calculates a depository institution's assessment based on the probability that the Deposit Insurance Fund ("DIF") will incur a loss with respect to the institution due to the composition and concentration of the institution's assets and liabilities (or any other factor relevant to such probability), the likely amount of any such loss, and the revenue needs of the DIF.

Institutions are placed in risk categories based on capital adequacy and supervisory ratings.[23] Assessments are set to maintain a certain reserve ratio of the net worth of the DIF to the value of the aggregate estimated insured deposits. Current assessment rates on domestic deposits range from seven basis points for the lowest-risk institutions to 77.5 basis points for the highest-risk institutions.[24] From January 1, 1997 through December 31, 2006, the highest rated

---

[21] Congressional Research Service, *Who Regulates Whom? An Overview of U.S. Financial Supervision (R40249),* December 14, 2009, by M. Jickling and E. Murphy, available at http://www.crs.gov/ReportPDF/R40249.pdf.

[22] The Banking Act of 1933 (Pub. L. No. 73-66), commonly referred to as the Glass-Steagall Act, established the FDIC as a temporary agency. The Banking Act of 1935 (Pub. L. No. 74-305) made the FDIC permanent.

[23] Supervisory ratings are based on an institution's composite CAMELS rating, a rating assigned by the institution's supervisor at the end of a bank examination. CAMELS is an acronym for component ratings as follows: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Assessments are also adjusted for unsecured debt, secured liabilities, and brokered deposits. See 12 CFR Part 327 for details.

[24] On May 22, 2009, the FDIC imposed a special assessment on each depository institution's assets minus Tier 1 capital as of June 30, 2009, as part of a plan to restore the DIF reserve ratio to 1.15 over a period of eight years. The FDIC plans to maintain assessment rates at their current levels through the end of 2010, to adopt a uniform three basis point increase in assessment rates effective January 1, 2011, and to require institutions to prepay assessments for all of 2010, 2011, and 2012.

institutions (approximately 95 percent of all institutions during this period) were assessed zero basis points for deposit insurance.[25]

As of December 31, 2009, the FDIC insured more than 8,000 institutions with $5.4 trillion of insured deposits, $7.7 trillion of domestic deposits and total assets of $13.1 trillion. The FDIC earned $17.8 billion in assessments in 2009 ($3.0 billion in 2008) for an average annual assessment rate of 23 basis points on domestic deposits.[26]

Securities Investor Protection Corporation

The Securities Investor Protection Corporation ("SIPC") is a nonprofit corporation created by Congress[27] to recover assets held by a brokerage firm on behalf of customers, should the firm fail.[28] Commodity futures contracts, fixed annuity contracts, and currency, as well as investment contracts (such as interests in limited partnerships) that are not registered with the SEC are ineligible for SIPC protections. When a brokerage firm fails, customers receive all securities held by the firm that are registered in customers' names or are in the process of being registered. To the extent that a sale of the firm's remaining assets cannot satisfy customer claims, SIPC protects up to $500,000 per customer, including up to $100,000 for missing cash, through payments from its reserve fund. SIPC does not provide insurance against investment losses or stock fraud.

SIPC is funded by assessments on securities broker-dealers, and a backup line of credit from the Treasury. SIPC assesses each registered member broker-dealer an amount necessary to maintain sufficient reserves to carry out its mission. Assessments on members may be based on the amount of their gross revenues from the securities business, the amount or composition of their gross revenues from the securities business, the number or dollar volume of transactions effected by them, the number of customer accounts maintained by them or the amounts of cash and securities in such accounts, their net capital, the nature of their activities and the consequent risks, or other relevant factors.[29] As of April 1, 2009, SIPC assessments are based on one quarter of one percent of the net operating revenue of member firms. Prior to this 25 basis point assessment, member firms were assessed a flat $150 per year.[30]

---

[25] Federal Deposit Insurance Corporation, FDIC Assessment Rates, http://www.fdic.gov/deposit/insurance/assessments/proposed.html, accessed March 17, 2010.

[26] FDIC, *Quarterly Banking Profile*, Fourth Quarter 2009, volume 4, no. 1, 2010, available at http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP.

[27] Securities Investor Protection Act of 1970, Pub. L. No. 91-598, as amended, codified at 15 U.S.C. 78aaa et. seq.

[28] See Securities Investor Protection Corporation, "How SIPC Protects *You*," 2009, available at http://www.sipc.org/pdf/SIPC%20English%202009.pdf.

[29] 15 U.S.C. 78ddd(c)(2).

[30] Securities Investor Protection Corporation, "SIPC to Reinstitute Assessments of Member Firms' Operating Revenues," Press Release, March 2, 2009, available at http://www.sipc.org/media/release02Mar09.cfm.

II. PRESENT LAW FEDERAL INCOME TAXATION OF FINANCIAL INSTITUTIONS

A. Corporations Generally

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[31] generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Corporations that make a valid election pursuant to section 1362 of Subchapter S of Chapter 1 of the Code, referred to as S corporations, are taxed differently. In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns. To prevent double taxation of these items upon a subsequent disposition of S corporation stock, each shareholder's basis in such stock is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

To qualify for S corporation status, a corporation must be a small business corporation as defined in section 1361(b)(1) and not be an ineligible corporation as defined in section 1361(b)(2). A corporation qualifies as a small business corporation if it has 100 or fewer shareholders, has only individuals or certain trusts and estates as shareholders, has no nonresident aliens as shareholders, and has only one class of stock. Ineligible corporations include any financial institution using the reserve method of accounting for bad debts (discussed below) and any insurance company subject to Subchapter L of the Code.

[31] Corporations subject to tax are commonly referred to as C corporations after Subchapter C of the Code, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (Real Estate Investment Trusts) or in stock and securities (Regulated Investment Companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to Subchapter C.

B. Banks, Thrifts, and Credit Unions

In general

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with certain specified exceptions. There is no sector-specific Federal income tax currently applied to financial institutions, and there are currently no corporate taxes assessed on the balance sheet liabilities of an entity.

Certain special rules and exceptions that are applicable to determining the Federal income tax liability of banks and thrifts, certain other financial institutions, insurance companies, and broker dealers are discussed below.

C corporation banks and thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.[32] A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.[33] Prior to 1951, thrifts were exempt from Federal taxation. In 1951, mutual savings banks and savings and loan associations lost their tax exemption because they were viewed as being "in active competition with commercial banks and life insurance companies for the public savings."[34]

S corporation banks

A bank is generally eligible to elect S corporation status under section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in section 585.

Special bad debt loss rules for small banks

Section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. For taxable years beginning before 1987, section 166(c) allowed taxpayers to deduct annual reasonable additions to a reserve established for bad debts (in lieu of deducting specific debts as worthless in the year in which the bank determined the debt was worthless). The reserve method of accounting for bad debts was repealed in 1986[35] for most

[32] Sec. 581.

[33] See Treas. Reg. sec. 1.581-1("in order to be a bank as defined in section 581, an institution must be a corporation for Federal tax purposes") and Treas. Reg. sec. 1.581-(2)(a) ("While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, or a cooperative bank…there are certain exceptions and special rules [for such institutions]").

[34] S. Rep. No. 82-781, Revenue Act of 1951, at 25.

[35] Tax Reform Act of 1986, Pub. L. No. 99-514.

taxpayers, but is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if for the taxable year (or for any preceding taxable year after 1986) the average adjusted basis of all its assets (or the assets of the controlled group of which it was a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that looks to the ratio of (1) total bad debts sustained during a taxable year to (2) the total bad debts over the five preceding taxable years. A large bank is allowed a deduction for specific bad debts charged off during a taxable year.

Prior to 1996, thrifts (mutual savings banks, domestic savings and loan associations and cooperative banks) had separate bad debt reserve rules under section 593. The special rules for thrifts were repealed for tax years beginning on or after January 1, 1996.

Credit unions

Credit unions are exempt from Federal income taxation.[36] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of common bond has been expanded to permit greater utilization of credit unions.[37] While significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.[38]

C. Gains and Losses with Respect to Securities Held by Financial Institutions

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain of a corporation is currently taxed at a rate not to exceed 35 percent, which is also the maximum corporate income tax rate. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

---

[36] Sec. 501(c)(14). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, available at http://www.ustreas.gov/press/releases/report3070.htm.

[37] The Credit Union Membership Access Act, Pub. L. No. 105-219, allows multiple-common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.*, 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.

[38] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, p. 2, available at http://www.ustreas.gov/press/releases/report3070.htm.

Capital losses generally are deductible in full against capital gains. Individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Section 1211 provides that, in the case of a corporation, losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges. Thus, in taxable years in which a corporation does not recognize gain from the sale of capital assets, its capital losses do not reduce its income. However, in general, corporations (other than S corporations) may carry capital losses back to each of the three taxable years preceding the loss year and forward to each of the five taxable years succeeding the loss year.

In the case of an S corporation, net capital losses flow through to the corporation's shareholders and could be considered losses attributable to a banking business in such shareholders' hands. Banks hold a wide range of financial assets in the ordinary course of their banking business. For convenience, those assets often are described as "loans" or "investments," but both serve the same overall purpose (to earn a return on the bank's capital and borrowings consistent with prudent banking practices). A bank's investments are subject to the same regulatory capital adequacy supervision as are its loans, and a bank may acquire only certain types of financial assets as permitted investments. Banks determine how much of their assets to hold as loans or as investments based on the exercise of their commercial and financial judgment, taking into account such factors as return on the assets, liabilities, relative liquidity, and diversification objectives. As a result, for Federal income tax purposes, gains and losses on a bank's investment portfolio would be considered an integral part of the business operations of the bank, and ordinary losses that pass through to the shareholder of a bank that is an S corporation therefore could comprise part of such shareholder's net operating loss for the year attributable to that banking business. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) specified literary or artistic property; (4) business accounts or notes receivable; (5) certain U.S. publications; (6) certain commodity derivative financial instruments; (7) hedging transactions; and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Under section 582(c)(1), the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution described in section 582(c)(2) is not considered a sale or exchange of a capital asset. Thus, generally, as a manufacturer receives ordinary income treatment on sale of its inventory, so does a financial institution on the sale or exchange of its loans under section 582. A financial institution described in section 582(c)(2) includes: (1) any bank (including any corporation which would be a bank except for the fact that it is a foreign corporation); (2) any financial institution referred to in section 591, which includes mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under

Federal or State law; (3) any small business investment company operating under the Small Business Investment Act of 1958; and (4) any business development corporation, defined as a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or State in the ordinary course of their business (except on the basis of a partial participation) and which is operated primarily for such purposes. In the case of a foreign corporation, section 582(c)(1) applies only with respect to gains or losses that are effectively connected with the conduct of a banking business in the United States.

Stock (including preferred stock) is not considered indebtedness for tax purposes and therefore is not treated as an asset entitled to ordinary gain or loss treatment under section 582.[39] However, under section 301 of Division A of EESA, gain or loss recognized by an "applicable financial institution" from the sale or exchange of "applicable preferred stock" is treated as ordinary income or loss. An applicable financial institution is a financial institution referred to in section 582(c)(2) or a depository institution holding company, as defined in the Federal Deposit Insurance Act.[40] Applicable preferred stock is preferred stock of Fannie Mae or Freddie Mac that was (1) held by the applicable financial institution on September 6, 2008, or (2) was sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.[41]

D. Insurance Companies

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. An insurance company is subject to tax as a life insurance company if its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves.[42] All other taxable insurance companies are treated as property and casualty insurance companies for Federal income tax purposes. Insurance companies are subject to tax at regular corporate income tax rates.

A life insurance company is subject to tax on its life insurance company taxable income.[43] Life insurance company taxable income is the sum of premiums and other

---

[39] Under section 306 of the Code, the sale of certain preferred stock can produce ordinary income to any taxpayer (without regard to section 582).

[40] 12 U.S.C. 1813(w)(1).

[41] On September 7, 2008, the Federal Housing Finance Agency ("FHFA") placed both Fannie Mae and Freddie Mac in a conservatorship. Also on September 7, 2008, FHFA and the Treasury Department entered into Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, the Treasury Department received senior preferred stock in the two companies and warrants to buy 79.9 percent of the common stock of such companies.

[42] Sec. 816.

[43] Sec. 801.

consideration on insurance and annuity contracts, decreases in certain reserves, and other amounts includible in gross income, reduced by allowable deductions for all claims and benefits accrued and all losses incurred during the taxable year, increases in certain reserves, policyholder dividends, dividends received, operations losses, certain reinsurance payments, and other deductions allowable for purposes of computing taxable income.[44]

The taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[45] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

Certain special rules apply to both life insurance and property and casualty companies. These rules relate to foreign tax credits, foreign companies carrying on insurance business within the United States, annual accounting period, special loss carryovers, certain reinsurance agreements, discounted unpaid losses, special estimated tax payments, and capitalization of certain policy acquisition expenses.[46]

E. Broker-Dealers

For Federal income tax purposes, a person is a securities dealer if such person is regularly engaged in the purchase and resale of securities to customers.[47] The determination of dealer status is made based on all facts and circumstances. The courts and the IRS have considered the following factors in evaluating dealer status: (1) being licensed as a dealer;[48] (2) holding oneself out to the public as a dealer;[49] (3) selling inventoried securities to customers;[50] (4) the frequency, extent, and regularity of securities transactions;[51] (5) profiting from commissions as opposed to

---

[44] Secs. 801-818.

[45] Sec. 832.

[46] Secs. 841-848.

[47] Treas. Reg. sec. 1.471-5 (as amended in 1993). In *Bielfeldt v. Commissioner*, 231 F.3d 1035 (7th Cir. 2000), the Seventh Circuit described the difference between a trader and a dealer noting that "the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely fluctuations in the market value of the securities or other assets that he transacts in."

[48] *Polachek v. Commissioner,* 22 T.C. 858, 859 (1954).

[49] *Verito v. Commissioner,* 43 T.C. 429, 441-442 (1965), *acq.* 1965-2 C.B. 7.

[50] *United States v. Chinook Investment Co.,* 136 F.2d 984 (9th Cir. 1943).

[51] *Purvis v. Commissioner,* 530 F.2d 1332, 1334 (9th Cir. 1976).

appreciation in the value of securities;[52] and (6) ownership of a securities exchange membership.[53]

Securities dealers must account for their securities inventory using the mark-to-market accounting method.[54] In general, under that method, securities held by a dealer in its inventory are marked to fair market value at the close of the taxable year, with any resulting difference between value and basis included as ordinary income or loss in computing taxable income for such year. For this purpose a security is defined as any share of stock in a corporation, partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, note, bond, debenture, or other evidence of indebtedness, interest rate, currency, or equity notional principal contract, and evidence of an interest in, or a derivative financial instrument in any of the foregoing, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency.[55] Additionally, a security includes a position that is not one of the foregoing, but is a hedge with respect to such security, and is clearly identified in the dealer's records as a security before the close of the day on which it was acquired.[56]

Special rules apply to gains and losses of a securities dealer with respect to "section 1256 contracts."[57] Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss.[58] Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.[59]

---

[52] *Kemon v. Commissioner*, 16 T.C. 1026, 1033 (1951).

[53] *Securities Allied Corp. v. Commissioner*, 95 F.2d 284, 286 (2d Cir. 1938), *aff'g* 36 B.T.A 168 (1937), *cert denied*, 305 U.S. 617 (1938).

[54] Sec. 475. Section 475(c)(1) defines a securities dealer for purposes of section 475 as "a taxpayer who- (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business; or (B) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business."

[55] Sec. 475(c)(2). The definition of securities under section 475 excludes section 1256 contracts, which include futures contracts and certain exchange-traded options.

[56] Sec. 475(c)(2)(F).

[57] Section 1256(b) provides that a "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract.

[58] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

[59] Sec. 1256(c)(1). Additionally, section 1212(c) provides that a taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.

A securities dealer may also hold securities for investment rather than as inventory (such securities are not subject to mark-to-market accounting, and any gains or losses with respect thereto treated as capital rather than ordinary).[60] Additionally, a dealer is not subject to mark-to-market accounting for debt securities originated or entered into in the ordinary course of its trade or business that are not held for sale.[61] For either of these exceptions to apply, the dealer must clearly identify that the security is either held for investment or not held for sale by the close of the day the security is acquired and the security may not at any time thereafter be held primarily for sale to customers.[62]

[60] Secs. 1236 and 475(b)(1).

[61] Sec. 475(b)(1).

[62] Secs. 1236(a) and (d)(1). See also, section 475(b)(2).

III. DESCRIPTION OF ADMINISTRATION'S PROPOSAL

On January 14, 2010 the President announced his intention to propose a financial crisis responsibility fee.[63] A version of the fee is included in the Administration's Fiscal Year 2011 Budget.[64]

As described in the 2011 Budget, the proposal contemplates an annual financial crisis responsibility fee levied on certain liabilities of banks, thrifts, bank and thrift holding companies, brokers and securities dealers, as well as on U.S. companies owning or controlling such entities as of January 14, 2010. The proposed rate is not set, but is expected to be approximately 0.15 percent of an applicable financial firm's covered liabilities. Covered liabilities are defined as total balance sheet liabilities less deposits subject to assessments by the FDIC (in the case of banks), certain insurance policy-related liabilities (in the case of insurance companies) and other (unspecified) exceptions. The fee is assessed on the worldwide consolidated liabilities of firms headquartered in the United States, and the consolidated liabilities of U.S. subsidiaries of non-U.S. financial firms. The fee only applies to firms with consolidated assets in excess of $50 billion. Firms with consolidated assets of less than $50 billion would not be subject to the fee for the period when their assets are below the threshold.

The Act provides that on October 4, 2013, the Director of the Office of Management and Budget, in consultation with the Congressional Budget Office, shall submit to Congress a report on the net amount within the TARP. The statute requires that in any case where there is a shortfall, "the President shall submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall."[65] The proposed fee is intended to fulfill the commitment three years early.[66] Other stated goals of the proposal are to "require the largest and most highly leveraged Wall Street firms to pay back taxpayers for the extraordinary assistance provided" by TARP and to provide a deterrent against excessive leverage for the largest financial firms.

According to the January 14th press release, the fee would be in place for at least 10 years, but longer if necessary to recoup the costs of TARP. The 2011 Budget does not specify a sunset date. The fact sheet suggests that the fee would be reported by regulators but collected by the Internal Revenue Service. In contrast, the 2011 Budget description suggests that entities subject to the fee would report it on their annual Federal income tax return, and make estimated payments on the same schedule as estimated income tax payments.

---

[63] See http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-fee-recoup-every-last-penn and http://www.whitehouse.gov/sites/default/files/financial_responsibility_fee_fact_sheet.pdf.

[64] A description is provided in the U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, pp. 29-30.

[65] 12 U.S.C. sec. 5239.

[66] http://www.whitehouse.gov/sites/default/files/financial_responsibility_fee_fact_sheet.pdf.

IV. ANALYSIS OF BANK TAX ALTERNATIVES

A. Financial Institution Tax Design Issues

Response to the financial crisis

There has been interest in possible Federal responses both to address the most recent financial crisis and to prevent a recurrence. Proposals have ranged from reforming the current regulatory structure for financial institutions to various tax changes applicable to financial institutions. The goals of any policy response generally determine whether a tax law change is warranted (or whether a nontax policy might better achieve the desired goals), and, in the event a tax policy response is warranted, inform the design of any specific tax proposal. These goals could involve simply raising revenue as efficiently as possible or attempting to alter behavior to discourage or encourage certain activity. Whatever the goal, certain considerations will influence the design of any tax policy response. The incidence of the tax, that is, who bears the ultimate burden, indicates whether a tax is targeted in the intended manner. Administrability of the tax affects compliance and the efficiency of revenue collection.

One possible goal may be simply to raise revenue efficiently. A significant aspect of this approach is to avoid influencing taxpayer behavior at all by maintaining tax neutrality. Such an approach may focus on taxpayers unlikely to alter their behavior in response to the imposition of the tax, whether or not they are related to the financial industry. A lump-sum tax that is unrelated to a taxpayer's income would be an example of such a tax, but might not be desirable for other reasons, including fairness. A variant of a lump-sum tax that also would not alter behavior would be a tax based on some characteristics of the taxpayer at some point of time in the past. Since future taxpayer behavior could not alter the amount of tax due, such a tax would not create incentives to alter behavior. As with a lump-sum tax, however, such an alternative may raise other issues that would make it undesirable. To minimize the economic distortions created by a tax other than a lump-sum tax, another alternative might be a tax with a broad base and a relatively low rate.[67] From an efficiency and compliance standpoint, a tax that can utilize existing administrative systems may be preferable to one requiring the establishment of new collection mechanisms, which may require time and money to design and implement.

Another possible goal of a tax response may be to alter the incentives for certain behaviors. A tax may achieve this objective even if it raises very little or no revenue. For example, if the goal is to create disincentives for financial institutions to take excessive risk or to pay excessive bonuses, the tax may need to be targeted at the particular activities deemed undesirable, rather than broad-based in its application.

Another possible goal may be to fund an insurance program against failure of institutions. The coverage and burden of the tax might correspond to the coverage and benefits of the insurance provided. That is, the tax could equal the premium on a hypothetical insurance policy

---

[67] The efficiency loss of tax is proportional to the square of the tax rate. Thus, it will increase more than proportionately as the tax rate increases. See, e.g., Alan Auerbach. "The Theory of Excess Burden and Optimal Taxation" in *Handbook of Public Economics*, ed. Alan Auerbach and Martin Feldstein, 1985.

that fairly reflects the probability that an institution's transactions will result in a loss to the fund, as well as the size of the loss. The burden of the tax might be designed to fall on those entities that contribute to the risk of loss. Such a tax raises issues about incentives to undertake risky behavior if those undertaking such behavior are protected from the losses they might incur, that is, a moral hazard. In this way, an insurance program could be viewed as increasing risky behavior, particularly if the positive returns from risk accrue to the institution undertaking the risk, while any loss accrues to other parties.

Incidence

In general

The economic incidence of any tax on financial institutions depends on the details of the proposal. The ultimate cost of any tax is not necessarily borne by the entity with the statutory obligation to make the payment to the government. The cost is ultimately borne to varying degrees by an institution's customers, employees, and investors, depending on the competitiveness of each of those markets; but the precise incidence among those groups is uncertain. Also, the incidence of the tax may be different in the short-run than the long-run, after markets adjust to the tax.

Administration's proposal

Customers would probably absorb some of the cost of a tax on certain financial institutions in the form of higher borrowing rates and other charges, although competition from financial institutions not subject to the tax would limit the extent to which the cost could be passed through to borrowers. Within the banking industry, a large fraction of assets are attributable to institutions that are members of affiliated groups with assets over $50 billion. For example, among depository institutions regulated by the FDIC as of December 31, 2009, at least 70 percent of all assets, including 64 percent of loans, are attributable to institutions that are members of affiliated groups with assets over $50 billion.[68] This may suggest that competition from institutions may not be able to prevent pass-through of the tax. If firms could not pass on the cost of the tax directly to consumers, certain services with low profit margins may no longer be profitable. If firms no longer offered these services, customers would bear the cost of the tax by no longer having access to products for which they would be willing to pay in the absence of the tax or if more costly smaller providers pick up the service.

Employees might bear some of the tax burden in the form of reduced compensation. This will depend on the conditions of the labor market for the employees of affected institutions. If employees have competitive employment opportunities available to them from firms not subject to the tax, such as smaller financial institutions, those firms subject to the tax will be required to pay employees according to their productivity and will not be able to pass on the burden of the

---

[68] Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, http://www2.fdic.gov/sdi/index.asp and staff calculations. Preliminary discussions with regulators of depository institutions suggest that more than 90 percent of assets of all depository institutions are held by institutions that are members of affiliated groups with assets in excess of $50 billion.

tax. The effects on different types of employees may vary depending on the transferability of their skills. For example, the earnings of secretaries or accountants are likely to be unaffected as their skills are transferable to many other firms who compete in the market for their labor. However, there may be employees whose skills are more firm-specific. The labor market for these employees may be less competitive, making it more likely that they could bear some of the tax burden through reduced compensation.

Investors could bear some of the cost of the tax in the form of lower stock prices if the tax reduced the future profitability of institutions. A tax applied to covered liabilities, as in the Administration's proposal, could increase an institution's cost of capital. To the extent that insured deposits are exempt, this could increase the attractiveness of raising capital by attracting deposits. Competition for deposits by institutions subject to the tax could drive up deposit rates. This could benefit depositors, but may raise the cost of attracting deposits for institutions not subject to the tax, implying profitability of the banking sector falls or borrowing costs rise.

The ultimate burden of the tax may vary by industry. To the extent that fewer participants in a particular industry are subject to the tax relative to participants in another industry, a firm subject to the tax will face more competition from firms not subject to the tax. The firm that faces more competition from firms not subject to the tax would be more likely to bear the burden of the tax. For example, a very large fraction of assets of the banking industry is held by institutions that are members of affiliated groups with assets over $50 billion. However, large insurance companies that own depository institutions represent a smaller segment of the insurance industry. This suggests that an insurance company subject to the tax may have less of an ability to pass the burden of the tax on to consumers, resulting in a bigger burden for the employees or shareholders of the affected institutions in that industry.

Administrability

The administrability of any tax depends, in part, on the number and sophistication of the parties upon which the tax is assessed and the complexity of the tax. As a general rule, the fewer and more sophisticated the affected taxpayers and the simpler the tax, the easier and less costly to administer.

If a tax on financial institutions applied only to institutions with more than $50 billion in assets, relatively few institutions would be subject to it. These institutions are also likely to be among the most sophisticated taxpayers.

The complexity of a tax generally relates to: (1) computational complexity (calculations required to determine tax liability), (2) transactional complexity (extent to which planning and execution of transactions are complicated) and (3) drafting complexity (clarity of promulgated rules and regulations).

Although complexity of tax laws may be problematic, trade-offs are often necessary between complexity and other policy goals. Moreover, tax law complexity often is a necessary consequence of the complexity of the economy or the underlying business transactions. In a voluntary self-assessment tax system, the need for simplification may be less warranted in

circumstances that either (1) do not affect the majority of taxpayers or (2) affect only the most sophisticated taxpayers.[69]

A tax computed based upon an existing complex calculation that a firm undertakes for nontax reasons would add little incremental complexity. Tax administrators would need to have access to and an understanding of the underlying data to ensure compliance. For example, depository institutions must undertake many complex calculations to report data to various regulatory entities, including risk-weighted assets for capital adequacy purposes. Such reports are publicly available. A tax on depository institutions that used this reported measure of assets as a base would add little complexity. However, modifications to adjust regulatory measures for tax purposes could add significant complexity. Additionally, the degree of complexity could be considerable to the extent that some institutions subject to the tax do not currently undertake such calculations, or such concepts would need to be modified to be meaningful. For example, nondepository institutions do not have a concept of insured deposits or Tier 1 capital.[70] Specifying equivalent concepts for other financial institutions may be complicated and adversely affect the ease and cost of administration.

B. Administration's Proposal

In general

Significant details of the Administration's proposal are not specified in detail, including both the firms subject to the tax and the intended tax base. The uncertainty makes evaluating the technical details of the proposal difficult, but may also be used to highlight issues in need of further consideration.

Covered institutions

The extent to which the proposal applies to insurance companies is not entirely clear. One possibility may be that the proposal only applies to insurance companies that own insured depository institutions or other types of financial institutions. Some argue that it is arbitrary to apply the fee to an insurance company that happens to have a small bank subsidiary, but to exempt an otherwise similarly situated insurance company that does not have a bank subsidiary, or to exempt an insurance company with less than $50 billion in assets but with a larger banking

[69] For example, tax rules relating to corporate mergers and acquisitions are among the most complex in the Federal tax system, but (1) do not add complexity for individual taxpayers, and (2) are generally understood by the tax practitioners employed by the limited number of sophisticated taxpayers who typically use such rules.

[70] Tier 1 capital consists primarily of common stock and certain types of preferred stock and is generally defined as capital for accounting purposes less (1) investments and advances to non-includable subsidiaries, (2) goodwill and other intangibles, (3) non-qualified equity (e.g., cumulative preferred stock), (4) certain servicing assets and purchased credit card relationships, (5) disallowed deferred tax assets, (6) credit enhancing interest-only strips in excess of 25 percent of Tier 1 capital, (7) accumulated gains on certain available-for-sale debt and equity securities and qualifying cash-flow hedges plus (A) minority interests in equity accounts of fully consolidated includable subsidiaries, (B) mutual thrift nonwithdrawable and pledged deposit accounts and (C) accumulated losses on certain available-for-sale debt securities and accumulated losses on qualifying cash-flow hedges. See, e.g., OTS Examination Handbook, Section 120 "Capital Adequacy" available at http://www.ots.treas.gov/_files/422017.pdf).

subsidiary than an insurance company with assets exceeding $50 billion. It is also possible that defining a covered institution as any company owning any of these other entities could qualify unintended entities. For example, unless otherwise exempted, mutual fund groups owning captive securities broker-dealers to service fund trading requirements would appear to be subject to the fee.

Another ambiguity is presented by the $50 billion consolidated asset threshold. The fee applies to firms with more than $50 billion in consolidated assets and would not apply to otherwise eligible entities for the period when their assets are below this threshold. It is not clear what is intended by "consolidated." The meaning of, and requirements for, consolidation differs in the financial reporting and U.S. Federal income tax contexts. Further, it is uncertain whether the proposal intends a more comprehensive definition which might, for instance, look through to the assets and liabilities of entities owned or controlled by the affected entities but which are not typically consolidated Federal income tax purposes, but the assets of which might be included for financial statement purposes.

Tax base

The base of the tax is similarly unclear. The fee applies to the "worldwide consolidated liabilities" of covered firms, but as described above, the meaning of "consolidated" is not clear and could vary significantly in scope. Moreover, the proposal contemplates exceptions to the tax, including FDIC-assessed deposits and "certain policy-related liabilities." It is not clear from the proposal which liabilities would be subject to the fee, which would be excluded, or the method for determining inclusion or exclusion.

Assessment of rationales for the proposal

One rationale for the fee is that it would provide a deterrent against excessive leverage for the largest firms. Risk in this context has various meanings.[71] Financial institutions face systemic risk commonly described as either (1) risk an institution faces as a market participant against which it cannot diversify or (2) risk that the linkages between institutions in the financial system might affect the system as a whole. Various risks may also be identified on both sides of a financial institution's balance sheet. On the asset side, for example, each originated or held loan involves credit risk (e.g., whether the borrower pays) and interest rate risk (e.g., whether interest rates increase generally and the value of the loan drops, or rates decrease and borrowers accelerate repayment). Bank regulatory capital requirements are generally intended to address solvency risk.

With respect to the liabilities side of the balance sheet, liquidity risk includes the sudden withdrawal or unavailability of funds. A financial institution commonly faces varying degrees of durational risk, that is, a mismatch in the terms of its assets and its obligations. Banks typically raise money for long-term loans, such as 30-year residential mortgages, by borrowing short-term

[71] Congressional Research Service, *Who Regulates Whom? An Overview of U.S. Financial Supervision (R40249),* December 14, 2009, by M. Jickling and E. Murphy, available at http://www.crs.gov/ReportPDF/R40249.pdf.

from depositors who can withdraw their money at any time. Thus, a sudden withdrawal of capital (e.g., a run on a bank) could result in an insolvent bank regardless of the quality of its assets if such assets cannot be liquidated quickly enough. A nondepository institution that relies on other forms of short-term capital with long-term assets faces a similar risk. Managing these risks is the principal business of financial intermediaries, and for which investors in these institutions are compensated.

Arguably, the Administration's proposal contributes to the stability of the financial system to the extent it provides a disincentive to raise funds using certain types of risky leverage. Others might counter that the proposal, in effect, imposes a fee on all leverage other than FDIC assessed deposits (or certain policy reserve related assets) which may or may not be particularly risky or even possible to avoid. For example, general trade liabilities such as accounts payable would be subject to the fee. The fee would also be applied without regard to duration of the liability. For certain nonbank entities, short-term wholesale liabilities drove a liquidity crunch when the short-term lenders lost confidence in the institution's credit worthiness. However, the fee would apply to such potentially risky short-term debt and to long-term corporate debt issuances equally.

Others may argue the proposal has, in practice, little effect on risk insofar as it taxes all liabilities other than a narrowly identified group, and does nothing to address risk taken on the asset side of the balance sheet. Proponents of this critique would point out that exceedingly risky positions can be financed with liabilities that the proposal would exclude from the tax base. Banking regulations attempt to address the risks to a bank's creditors posed by holding risky assets by requiring institutions with riskier assets to hold more Tier 1 capital. To the extent banks only hold capital sufficient to comply with regulations, the exemption of Tier 1 capital from the tax (as in the Administration's proposal) could have the effect of imposing a lower tax burden on riskier institutions. This may result because a bank holding riskier assets must hold more Tier 1 capital than an otherwise similarly situated bank with less risky assets. Therefore, removing Tier 1 capital from the tax base effectively imposes a greater tax liability on bank with less risky assets.[72]

Some have argued that a tax measured as a fixed percentage of assets or liabilities may actually encourage institutions to undertake riskier investments in pursuit of higher returns to offset the cost of the tax. However, those higher risk and higher return investments were also available in the absence of the tax. Having rejected a higher risk/higher return portfolio when its costs were lower, it is not clear why a profit maximizing firm would choose such a portfolio in the face of the tax. A firm must choose a level of risk consistent with the risk-return profile of its investors. On the other hand, if the tax increased the likelihood that the firm would become insolvent given its current investment choices, a firm may be willing to increase the risk of its portfolio in pursuit of higher returns to stave off bankruptcy.

---

[72] See discussion below regarding risk-based assessments.

C. Other Bank Tax Alternatives

1. Income tax

An alternative to a liability-based assessment on financial firms might be an income-based tax on financial firms. Arguably an income-based tax implicitly takes into account a firm's ability to pay the tax. Proponents of an income-based tax might argue that such a tax would be less complicated than a liability-based tax and would be relatively easy to administer, because it could be superimposed on the existing income tax framework.

Opponents of an income-based tax on financial firms might argue that such a tax would be assessed on firms that did not receive TARP funds or have repaid TARP funds. An income tax on financial firms could effectively obligate such firms to pay for the losses in the automotive, insurance, and mortgage industries, because companies in such industries have significant current losses and losses that will be carried over into future taxable years, and likely will not be subject to a tax on income. Opponents also might point out that an income tax would not reduce financial firms' risky investment practices. Instead, an additional income tax could serve to incentivize such firms to strive for higher returns on capital investments to recoup the additional tax, thus encouraging riskier, higher-yielding investments. Moreover, administration of a special income tax is complicated where, as is nearly always the case, the financial firm is a member of a consolidated group, with taxable income determined on a consolidated group (not separate entity) basis. Administration of the tax would require allocation of items of income and expense between the financial and non-financial members of the group; allocation issues would tend to increase avoidance opportunities as well as require more complex rules.

In response to concerns about excessive risk-taking, an income-based tax could be structured to increase taxable income through the disallowance of all or a portion of the deduction for commissions and other performance-based compensation. This adjustment could serve to reduce the incentive for risky investment behaviors at least in the case of financial intermediaries where compensation is determined on a performance basis. On the other hand, this approach could be criticized as overbroad in penalizing compensation for high performance unrelated to risk.

2. Excess profits tax

An excess profits tax typically is a tax levied on a firm that makes extraordinarily large profits. Historically, excess profits taxes have been imposed in times during which certain industries' profits escalated due to unusual circumstances, such as wartime production.[73] In

[73] An excess profits tax was imposed in the United States during World Wars I and II and the Korean War primarily as a mechanism to capture wartime profits that exceeded normal peacetime profits.

general, an excess profits tax is levied on profits in excess of a pre-established normal amount.[74] An excess profits tax generally is treated in the same manner as an income tax.

Advocates of an excess profits tax may contend that such a tax is the most efficient way to raise money from financial firms. To the extent that higher rates of return are associated with high levels of risk, an excess profits tax could be structured as a levy with respect to excess profits derived from the investment of Tier 1 capital. An excessive return on Tier 1 capital suggests that a bank may be underestimating its investment risk and that more capital should be set aside to offset such risk. The tax would complement the regulatory insurance scheme by requiring the bank to pay for the risk arguably underestimated by the regulators.[75]

Opponents may argue that an excess profits tax creates a disincentive to capital investment because it dampens the rewards to higher investment risks. Moreover, normal and excessive profits are terms that cannot be accurately determined. Poor experiences with prior excess profits taxes could demonstrate that such taxes are unsound.[76] An excess profits tax could also be criticized for the difficulties in administering the tax (such as documenting the amount subject to tax).

3. Risk-based assessments

U.S. bank regulatory capital requirement standards are generally based on the Basel Accords,[77] the guiding principle of which is that capital standards should be risk-based. In effect, riskier assets require more capital to be held to absorb potential losses.[78] Specific capital requirements are subject to minor variation among the OCC, FDIC, Federal Reserve, OTS and NCUA, but generally, banks are required to hold some minimum level of Tier 1 capital (e.g., three percent of adjusted total assets) and satisfy a minimum risk-based capital ratio (e.g., a ratio of total capital to risk-weighted assets of eight percent).[79] The minimum risk-based capital ratio

---

[74] An excess profits tax can be contrasted with the windfall profits tax imposed on crude oil in the 1980s. The windfall profits tax was an excise tax on each barrel of oil produced, without reference to the amount of profit earned on the sale of the oil.

[75] See, e.g., Lee A. Sheppard, *Alternatives to the Obama Banking Fee,* 126 *Tax Notes* 898 (Feb. 22, 2010). The author suggests that in computing the return on Tier 1 capital, the numerator could be taxable income with an add-back for excessive compensation as a way to effectively impose a tax on excessive compensation. However, it is not clear how, among other things, taxable income would be computed for members of a consolidated group or why taxable income is an appropriate economic measure of return on Tier 1 capital.

[76] See e.g., The Tax Foundation, *Financing Defense: Is an Excess Profits Tax the Solution?* Dec. 1, 1950 available at http://www.taxfoundation.org/news/printer/1450.html.

[77] See Congressional Research Service, *The Basel Accords: The Implementation of II and the Modification of I (RL 33278)*, February 21, 2006, by Walter W. Eubanks, available at http://www.crs.gov/ReportPDF/RL33278.pdf.

[78] See Congressional Research Service, *Who Regulates Whom? An Overview of U.S. Financial Supervision (R40249),* December 14, 2009, by M. Jickling and E. Murphy, available at http://www.crs.gov/ReportPDF/R40249.pdf.

[79] *Ibid.*

applies to the value of each asset, and a risk-weighting determines what percentage of the base ratio will apply. Thus, for example, under the Basel Accords, very safe assets (such as AAA-rated sovereign debt, and cash) are assigned a risk-weighting of zero percent. Thus, the amount of capital held against $10,000 of U.S. Treasury bills is $10,000 * 0.08 * 0 = 0. In contrast, a $10,000 loan to a private entity receives a risk-weighting of 100 percent, requiring an amount equal to eight percent of the value of the asset (in this case $800 = $10,000 * (0.08 * 1.0)) to be held as capital against it.

An alternative to a liability-based tax might be a tax on risk-weighted assets. Under this approach a tax might be applied to a financial institution on the relative riskiness of its assets. Such an approach would impose a greater tax on institutions that assume greater risk on the asset side of the balance sheet. Standards of riskiness could be based on bank regulatory measures of risk-weighted assets. Some might argue such an approach would cede too much authority to bank regulators (who define and modify the risk-weighting scheme) and accounting standards boards (who may modify accounting standards defining on- and off-balance sheet assets). It would also be necessary to establish risk-weighting guidelines for institutions not subject to the Basel-based standards. Moreover, different methods for calculating risk-weighted assets will apply to certain very large banks in the U.S.[80]

Some might argue that the Administration's liability-based tax might reward investment in risky assets, an undesirable result that might be avoided with a risk-weighted asset based tax. The Administration's proposal is a tax on covered liabilities defined as total assets less Tier 1 capital, less FDIC-assessed deposits and/or certain insurance policy reserves. A given bank's Tier 1 capital amount is, however, a function of risk inherent in its assets. That is, the more risky a bank's assets the greater amount of Tier 1 capital it must hold. As a result, a bank with riskier assets would tend to hold more Tier 1 capital and could therefore pay less tax under the Administration's proposal than a similarly situated bank with less risky assets.

A risk-based tax, however, has the effect of taxing more heavily certain lending activities some seek to encourage. Because commercial loans are assigned the highest risk-weight of 100 percent, a tax on risk-based assets could prove a disincentive for an institution to make such loans (including loans to small businesses). Some might also argue that the risk weighting scheme as applied in the banking industry would be ill-suited for use in other industries which could be subject to such a tax. The fundamental business models and risks faced by a depository institution and an insurance company are quite different.

---

[80] In December 2007, Federal banking regulators issued a final rule for implementation of the Basel II Capital Accord in the U.S. It is expected that only banks with at least $250 billion in consolidated total assets or at least $10 billion of on-balance sheet foreign exposure will be subject to Basel II's advanced rating-based approach for calculating risk-based capital requirements. See Congressional Research Service, *Basel II in the United States: Progress Toward a Workable Framework (RL34485)*, May 18, 2008 by Walter W. Eubanks, available at http://www.crs.gov/ReportPDF/RL34485.pdf.

4. Tax linked to benefits received under the TARP

Some have criticized the Administration's proposal for not directly linking the tax due to the benefits received. They suggest that responsibility for recovering TARP losses (if any) should be borne proportionately (in some fashion) by TARP beneficiaries. One such proposal suggests levying a tax on the difference between a covered entity's assets at the end of August 2008 (i.e., before the bankruptcy of Lehman Brothers) and its current level of capital.[81] Such a tax would, arguably, require a firm to pay an amount proportionate to the support received, assuming such support was linked to the size of assets prior to the financial crisis. Another proposal in a similar vein suggests a tax linked to the value of an implicit government guarantee of large financial institutions.[82] Such a tax might be linked to the difference in the cost of capital of small and large institutions pre- and post-financial crisis. The argument is that adopting a "too big to fail" approach to large institutions results in an implicit subsidy to large financial institutions measurable by the relative cost of funds for large institutions relative to other banks before and after the crisis.[83]

The Administration and others argue that a tax focused only on direct TARP recipients overlooks the benefit of a functioning financial system enjoyed by all financial institutions and by the public more broadly. If the pool of TARP beneficiaries is defined broadly, then some might argue that a tax on beneficiaries should similarly be applied broadly. Opponents of levying a tax only on TARP recipients also note that the entities requiring the most support may be the least capable of repaying it, and attempting to recover a greater share of funds from still struggling entities would be counterproductive.

5. International approaches

Certain European governments have enacted bank taxes (or fees) or are considering enacting one in some form or another. Sweden was the first European country to create a bank stability fund, intended to provide direct support to Swedish financial institutions in the event of another financial crisis. In 2008, the Swedish Parliament enacted the Act on Government Support to Credit Institutions.[84] Generally, the Act establishes a fund to equal approximately 2.5 percent of Sweden's GDP within 15 years which would be available to the Swedish National Debt Office in the event of severe economic distress. To capitalize the fund, the Swedish government provided an initial SEK 15 billion. The act provides for additional payments to the

---

[81] Douglas W. Diamond and Anil K. Kashyap, *Return Our Investment*, Jan. 19, 2010, available at http://www.nytimes.com/2010/01/20/opinion/20diamond.html.

[82] Cornelius Hurley, Banks Need to Return Subsidy, Jan. 27, 2010, available at http://www.boston.com/bostonglobe/editorial_opinion/oped/articles/2010/01/27/banks_need_to_return_subsidy/

[83] Dean Baker and Travis McArthur, "The Value of the 'Too Big to Fail' Big Bank Subsidy," Center for Economic and Policy Research Issue Brief, September 2009, available at http://www.cepr.net/documents/publications/too-big-to-fail-2009-09.pdf/

[84] See http://www.sweden.gov.se/sb/d/5825/a/115368 and http://www.sweden.gov.se/content/1/c6/12/06/01/429ac020.pdf.

fund from, among other sources, a "stability fee" levied on certain financial institution liabilities at a rate of 0.036 percent.

Other European countries considering a levy on banks include the United Kingdom,[85] Austria,[86] France, and Germany. Similar to the Swedish law, a German proposal, approved by the German Cabinet on March 31, 2010, would establish a common fund, funded by a financial institution levy, which would be used in the event of a future financial crisis.[87]

The International Monetary Fund is studying a tax on financial institutions, among other options, as a mechanism to create a global insurance fund for banks.[88] Among the taxes under consideration by the IMF are a transaction-based tax (so-called "Tobin Tax") under which a tax would be assessed on each financial transaction,[89] a balance sheet tax (similar to the Administration's Proposal), and an excess profits tax.

6. Proposed financial regulatory reform legislation

The Administration's proposal is designed to cover the cost of support already provided to financial and other institutions. Some argue that such a scheme represents an implicit, but unfunded, guarantee of large financial institutions by the Federal government. Another approach, taken by two financial regulatory reform bills in Congress, would make such a guarantee explicit in the form of a pre-funded dissolution or support fund.

On December 11, 2009, the House of Representatives passed the Wall Street Reform and Protection Act of 2009[90] which would, among other things, establish a new dissolution authority for the Treasury and the FDIC with respect to bank holding companies, systemically important financial firms, and insurance companies.[91] The bill would create a Systemic Dissolution Fund pre-funded, up to a maximum of $150 million, by FDIC assessments on large companies.

---

[85] See *Wall Street Journal*, "Moves to Tax Banks to Pay for Bailouts Gain Steam," March 29, 2010.

[86] See Federal Chancellery of Austria 3/01/2010 press release "Federal government calls for bank tax" available here: http://www.bka.gv.at/site/infodate__01.03.2010/6892/default.aspx#id38670.

[87] http://www.thelocal.de/money/20100331-26245.html; http://dealbook.blogs.nytimes.com/2010/03/31/germany-readies-bank-tax-for-future-bailouts/

[88] http://www.imf.org/external/pubs/ft/survey/so/2010/int011110a.htm.

[89] A transaction tax has been criticized for its lack of administrability and negative effect on liquidity, among other issues. See e.g., http://aswathdamodaran.blogspot.com/2009/11/tax-on-financial-transactions-good-or.html.

[90] H.R. 4173.

[91] See, Congressional Research Service, *Financial Regulatory Reform and the 111th Congress (R40975),* December 30, 2009, by E. Murphy, et al., available at http://www.crs.gov/ReportPDF/R40975.pdf.

On April 15, 2010 the Senate Committee on Banking, Housing and Urban Affairs reported the "Restoring American Financial Stability Act of 2010."[92] Section 210 of the bill provides for the creation of an Orderly Liquidation Fund within the Treasury which would be funded in advance by "graduated assessments" on "eligible financial companies." The bill contemplates graduated, risk-based assessments by the FDIC over a five to ten year period to capitalize the Orderly Liquidation Fund with $50 billion (adjusted for inflation).

[92] S. 3217.