CAN STATES TAX NATIONAL BANKS TO EDUCATE CONSUMERS ABOUT PREDATORY LENDING PRACTICES?

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Over the past quarter-century, consumer lending markets in the United States have become increasingly national in scope, with large national banks and other federally chartered institutions playing an ever more important role in many sectors, including credit card lending and home mortgages. At the same time, in a series of judicial decisions, courts have ruled that a wide range of state laws regulating abusive credit card and predatory mortgage lending practices are preempted, at least as applied to national banks and other federally-chartered institutions. Given the dominant role of such institutions in U.S. lending markets, these rulings have narrowed the capacity of states to police local lending transactions. As an alternative to direct regulation, the California Assembly recently considered legislation designed to improve consumer understanding of financial transactions through educational efforts. The measure would be financed by a new state tax on income from certain problematic loans made to California residents by financial institutions, including national banks and other federally-chartered institutions. This Article considers whether a tax of the sort proposed in California could survive a preemption challenge under recent court rulings, as well as other potential constitutional attacks. Although the States have quite limited powers to regulate federally chartered financial institutions, Congress explicitly authorizes states to tax national banks in 12 U.S.C. § 548. This Article explores the scope of state taxing authority that § 548 confers and the relationship between that authority and recent preemption rulings. After reviewing a range of legal precedent, the Article concludes that a state tax of the
sort considered in California—imposing modest levies on federally chartered entities but not preventing them from engaging in otherwise authorized activities—should qualify as a legitimate exercise of state taxing power under § 548 and should withstand scrutiny both under the Due Process and Commerce Clauses to the extent the tax is imposed on out-of-state banks.

INTRODUCTION

In February 2005, California Assemblyman Joe Nation introduced a bill proposing a novel approach to consumer protection in the financial services industry. A.B. 1375, the Consumer Protection and Anti-Interest Rate Manipulation Act, would have imposed a supplemental tax on lenders, including national banks, that include in their credit card agreements with California residents a controversial interest rate repricing mechanism known as a universal default provision. Proceeds from the levy were to be dedicated to “educating consumers regarding predatory lending practices.” Although the measure has yet to be reported out of committee, the legislation raises a number of important and unresolved questions regarding the authority of states to finance consumer education efforts through the imposition of taxes on national and out-of-state banks.

For the past several years, federal courts have faced a series of cases challenging the authority of state officials to impose a variety of consumer protection laws on national banks and other federally chartered institutions. With the Supreme Court’s recent decision in Watters v. Wachovia Bank, N.A., the battle has been resolved largely in favor of federal preemption, at least with respect to state laws purporting to regulate the manner in which national banks and other federal instrumentalities extend credit to their customers. As these federally-chartered entities play an increasingly dominant role in the nation’s lending market, the capacity of states to engage in direct regulation of the financial

2. The bill imposes the tax on any institution that “[i]ncludes a provision in its credit card agreements that allows for an increase of the interest rate, after the credit card has been issued, by any amount that is greater than the increase in the cost of the funds necessary to extend additional credit to the consumer.” Id. § 3(b)(4)(A).
3. See id. at intro.
activities of their residents has been curtailed dramatically. The decline in direct state power over consumer finance is the impetus behind proposals, such as Assemblyman Nation’s, seeking to enhance the capacity of state residents to deal with an increasingly complex array of lending opportunities through state education efforts financed with funds raised from those lending institutions deriving revenues from state residents through potentially problematic classes of lending transactions.

Whether Assemblyman Nation’s bill would survive a preemption challenge is an interesting, important, and unresolved question of law. On the one hand, the national bank activities on which the California tax would be imposed are similar to activities that the States have been denied the power to regulate directly. Taxation, however, is not the same as regulation, and—critically—Congress in § 548 expressly authorized states to impose taxes on national banks.5 Although in past preemption cases involving national bank activities the courts have had little guidance on the topic of congressional intent regarding state authority, Congress has spoken clearly with respect to taxes: States have the unambiguous authority to tax national banks. To be sure, the existence of § 548 does not wholly resolve the matter: if state taxes were blatantly designed to circumvent restrictions on direct regulation of national banks, the enactment of such taxes would raise difficult legal questions. But modest taxes imposed to finance legitimate consumer education goals—that is, taxes of the sort proposed in Assemblyman Nation’s bill—are a legitimate exercise of state authority under § 548 and should survive a federal preemption challenge, even one advanced by the Office of the Comptroller of the Currency (OCC)6 or other federal regulators under the color of Chevron deference.7

A separate, unresolved legal issue raised by Assemblyman Nation’s proposed legislation concerns the authority of states to impose income and other taxes on out-of-state banks that do not maintain a physical presence within the taxing jurisdiction. Judicial decisions are currently divided on whether alternative theories of jurisdictions—especially theories of state taxing

5. See 12 U.S.C. § 548 (2000) (establishing that “[f]or the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located”).

6. The Office of the Comptroller of the Currency is the federal agency responsible for chartering and supervising national banks.

7. See infra Part II.E.
power based on economic nexus rather than physical presence—satisfy constitutional requirements under the Due Process and Commerce Clauses. Although this aspect of the analysis turns on unresolved issues of constitutional law, this Article argues that states should be permitted to rely on an economic nexus theory of jurisdiction at least with respect to financial institutions that increasingly base their operations in a few remote jurisdictions and conduct their operations to reach borrowers throughout the nation.

This Article explores how other states might expand upon Assemblyman Nation’s original bill to establish a more comprehensive system of state consumer education financed with taxes imposed on both problematic credit card agreements and potentially predatory home mortgage transactions. The Article begins with an overview of the nationalization of U.S. lending markets in the past quarter-century and the contemporaneous legal battles over state efforts to regulate consumer lending transactions that increasingly involve national banks located in other jurisdictions. After reviewing the series of federal court cases largely curtailing the power of states to regulate in the areas of consumer credit and home mortgages, the Article considers the advantages of consumer education at the state level as an alternative to the direct regulation states can no longer effectively impose. The Article next presents a Model Act based on Assemblyman Nation’s original bill but with a number of refinements that clarify the legislation’s educational purposes, reform the terms of its tax provisions, and expand the base on which state taxes are levied to include potentially predatory home mortgages and problematic credit card arrangements. The Article then considers whether the Model Act would be authorized under 12 U.S.C. § 548, and whether the Act could withstand Due Process and Commerce Clause challenges if imposed on out-of-state financial institutions without a physical presence in the state.

I. NATIONALIZATION OF BANKING MARKETS AND FEDERAL PREEMPTION OF STATE LAWS

Over the last quarter-century, banking markets in the United States have undergone a dramatic transformation. Although banking markets were traditionally served through local institutions and segmented by legal restrictions on interstate branching and even interstate bank holding companies, the
American banking industry has become increasingly national in scope. This trend is most pronounced in the credit card industry, where a substantial proportion of credit cards are now issued by a handful of major firms located principally in South Dakota and Delaware. Home mortgage financing is also no longer a local business. Major mortgage lenders and brokers advertise nationally, and the vast majority of home mortgages originated in the United States today are immediately resold into mortgage pools financed by national and international investors. Although the U.S. banking industry still remains one of the most fragmented in the world, the trend toward consolidation is pronounced, particularly in the area of credit card lending and home mortgage finance.

The nationalization of consumer lending markets has imposed considerable pressure on the traditional structure of consumer protection laws in the United States, most significantly in the application of these laws to national banks. In the past, there was relatively little conflict between state consumer protection laws and national bank powers. Consumer protection was generally understood to be the province of state governments, and national banks routinely complied with local consumer protection rules. Indeed, federal laws often specified that national banks would be subject to local rules governing such issues as usury and bank branching.

8. See Mark Furletti, Comment, The Debate over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards, 77 TEMP. L. REV. 425, 443 (2004) (reporting that in 2003, approximately 70% of credit card debt in the United States was held by lenders based in states with 4% of the population).


10. See, e.g., Kenneth D. Jones & Tim Critchfield, Consolidation in the U.S. Banking Industry: Is the “Long Strange Trip” About to End?, FDIC BANKING REV. Jan. 2006, at 31, 32, available at http://www.fdic.gov/bank/analytical/banking/2006jan/article2/article2.pdf (noting that the years 1984–2003 were “marked by a substantial decline in the number of commercial banks and savings institutions and by a growing concentration of industry assets among a few dozen extremely large financial institutions”).


Starting in the 1970s, however, a series of legal battles forced the courts to reconsider the application of local consumer protection requirements. The disputes initially arose with respect to national banks doing business across state lines when consumer protection requirements in the states where the banks’ customers were located differed in some way from the requirements where the national bank was based. Typically, these controversies were framed as issues of federal preemption: whether the National Bank Act preempts the arguably conflicting provision of state law.\textsuperscript{13} Often acting at the instigation of the OCC, courts generally found local state consumer protection laws were preempted with respect to national banks. National banks supported preemption findings because such findings permitted national operations under a consistent set of regulatory requirements.\textsuperscript{14}

Two examples illustrate the trend toward preemption of the authority of states to protect consumers from abuses of nationally chartered banks: (1) the substantial erosion of state usury ceilings following the Supreme Court’s 1978 decision in \textit{Marquette National Bank of Minneapolis v. First of Omaha Service Corp.}\textsuperscript{15} and (2) more recent OCC rulemakings that have had the effect of preemting a broad range of state laws, including a number designed specifically to address problems of predatory mortgage lending regulations.\textsuperscript{16}

\textbf{A. State Usury Statutes}

In \textit{Marquette}, the Supreme Court faced the question of which usury rules apply when a national bank based in Nebraska makes a loan to a customer who resides in Minnesota. The case called for an interpretation of section 85 of the National Bank Act, which provides that a bank may charge in-

\textsuperscript{13} Rooted in the Supremacy Clause, U.S. Const. art. VI, cl. 2, preemption can occur in three ways: when Congress expressly declares state law preempted; when Congress has regulated so extensively as to occupy an entire field, leaving no room for state law; and when federal law conflicts with state law. See \textit{Wachovia Bank, N.A. v. Burke}, 414 F.3d 305, 313 (2d Cir. 2005). Most commonly, the preemption cases discussed here involve the third category: conflict preemption.

\textsuperscript{14} For a discussion of the costs imposed on national banks by state regulation, see Statement of Comptroller of the Currency John D. Hawke, Jr., Regarding National City Preemption Determination and Order (July 31, 2003), \url{http://www.occ.treas.gov/statementhawke.pdf}.

\textsuperscript{15} 439 U.S. 299 (1978).

\textsuperscript{16} \textit{See infra} Part I.B.
interest “at the rate allowed by the laws of the State, Territory, or District where the bank is located . . . .”17 The Court ruled in favor of the laws of the bank’s home state on the theory that the statute specified the location of the bank and not that of the customer.18 As a result of the Marquette ruling, national banks in one state could “export” their interest ceilings (or lack thereof) to other states, effectively overriding the usury limits of other jurisdictions. A number of smaller jurisdictions—notably South Dakota and Delaware—capitalized on the Marquette decision by relaxing or even eliminating their interest rate regulations and thereby encouraging national banks to locate their credit card businesses in those jurisdictions.19 In a national banking system where credit is increasingly extended across state lines, the Marquette decision, coupled with the cooperation of several state legislatures, effectively ended interest rate regulation for certain kinds of consumer credit in the United States.

Over the years, the Marquette holding has been expanded to cover other aspects of credit card operations. Not only are local interest rate ceilings preempted, but so too are restrictions on late fees and other financing charges, on the grounds—endorsed by the OCC and accepted by the Supreme Court in Smiley v. Citibank20—that late fees are an element of interest for purposes of section 85.21 More recently, state attempts to protect consumers by regulating disclosures in credit agreements

18. Id. at 310.
19. For an overview of the aftermath of Marquette and other preemption decisions, see generally Schiltz, supra note 11.
21. To prevent state banks from being too severely disadvantaged by Marquette, Congress enacted section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified at 12 U.S.C. § 1831d (2000)), granting state banks the power to export local interest rates. In Greenwood Trust Co. v. Massachusetts, 971 F.2d 818 (1st Cir. 1992), the First Circuit, in a ruling that prefigured Smiley, held that section 521 preempted a Massachusetts statute prohibiting late fees, as applied to a Delaware state bank’s charging of late fees to Massachusetts customers. Accordingly, the capacity of state banks to export interest rates is now quite similar to the power of national banks. In other areas of preemption analysis, state banks do not enjoy such broad preemptive protections, although the FDIC has proposed a preemption regulation that, if adopted, could partially redress the imbalance. FDIC Notice of Proposed Rulemaking, 70 Fed. Reg. 60,019 (proposed Oct. 14, 2005) (to be codified at 12 C.F.R. pts. 331, 362).
have also been preempted with respect to national banks.\textsuperscript{22} Even claims only indirectly related to usury violations by national banks have been held to arise exclusively under federal law.\textsuperscript{23}

B. Preemption Rulings of the Comptroller of the Currency

Over the past few years, controversies over the preemption of state consumer protection laws typically have involved preemption decisions, including a number of rulings designed to restrict the application of state predatory lending legislation to national banks. The OCC’s actions prompted much academic criticism and a series of court cases.\textsuperscript{24} Responding in part to concerns about a Georgia statute designed to prevent predatory lending practices against residents of that state, the Comptroller in early 2004 adopted a series of regulations defining the application of state laws to national banks.\textsuperscript{25} The rules cover a number of specific areas including real estate lending,\textsuperscript{26} deposit taking,\textsuperscript{27} non-interest charges and fees,\textsuperscript{28} and general bank operations.\textsuperscript{29} In addition to identifying specific state laws preempted in certain areas,\textsuperscript{30} the regulations include the following:

\textsuperscript{22} See Am. Bankers Ass’n v. Lockyer, 239 F. Supp. 2d 1000 (E.D. Cal. 2002) (holding that a California statute requiring warnings about the ramifications of making only minimum payments was preempted).

\textsuperscript{23} See Beneficial Nat’l Bank v. Anderson, 539 U.S. 1, 3–4 (2003). As a result of the Beneficial ruling, banks can now remove to federal court a wide variety of lawsuits challenging various forms of fees charged on lending transactions. See, e.g., Phipps v. FDIC, 417 F.3d 1006 (8th Cir. 2005).


\textsuperscript{26} 12 C.F.R. § 34.4 (2006).

\textsuperscript{27} Id. § 7.4007.

\textsuperscript{28} Id. § 7.4002.

\textsuperscript{29} Id. § 7.4009.

\textsuperscript{30} For example, 12 C.F.R § 34.4(a), which addresses state laws governing national bank real estate lending, provides:
general formulation: “Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank’s ability to fully exercise its powers to conduct activities authorized under Federal law do not apply to national banks.”31 The preemption provisions are supplemented with a further “visitorial powers” provision that severely constrains the authority of a state official to examine, investigate, or impose licensing requirements on the activities of national banks.32

The overwhelming weight of judicial authority to date has affirmed the broad scope of the OCC’s preemption rules. Federal district court decisions have accepted preemption of additional state disclosure requirements on national bank lending

Specifically, a national bank may make real estate loans… without regard to state law limitations concerning:

1. Licensing, registration (except for purposes of service of process), filings, or reports by creditors;
2. The ability of a creditor to require or obtain private mortgage insurance, insurance for other collateral, or other credit enhancements or risk mitigants, in furtherance of safe and sound banking practices;
3. Loan-to-value ratios;
4. The terms of credit, including schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan;
5. The aggregate amount of funds that may be loaned upon the security of real estate;
6. Escrow accounts, impound accounts, and similar accounts;
7. Security property, including leaseholds;
8. Access to, and use of, credit reports;
9. Disclosure and advertising, including laws requiring specific statements, information, or other content to be included in credit application forms, credit solicitations, billing statements, credit contracts, or other credit-related documents;
10. Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages;
11. Disbursements and repayments;
12. Rates of interest on loans;
13. Due-on-sale clauses except to the extent [expressly] provided;… and
14. Covenants and restrictions that must be contained in a lease to qualify the leasehold as acceptable security for a real estate loan.

(footnote omitted).


practices, state rules assigning liability on loans sold by national banks into secondary mortgage markets, and even state tort claims that turn on fees charged on national bank loans. Furthermore, a string of federal appellate courts have affirmed the OCC’s visitorial-powers regulation denying state officials any supervisory functions with respect to most activities of national banks. And, in its recent decision in Watters, the Supreme Court endorsed the OCC’s extension of it visitorial powers to operating subdivisions of national banks.

In light of these precedents, the only open question remaining is the residual scope of state authority to maintain local rules that have some indirect impact on the operations of national banks. Once again, OCC regulations include a standard formulation:

State laws on the following subjects are not inconsistent with the powers of national banks and apply to national banks to the extent that they only incidentally affect the exercise of national bank powers: (i) Contracts; (ii) Torts; (iii) Criminal law; (iv) Rights to collect debts; (v) Acquisition and transfer of property; (vi) Taxation; (vii) Zoning; and (viii) Any other law the effect of which the OCC determines to be incidental to the exercise of national bank powers or otherwise consistent with the powers set out in . . . this section.

Although the courts have not yet had an opportunity to provide definitive interpretations of this formulation, the OCC

37. 127 S.Ct. 1559 (2007). While the Watters case did not concern a field of law in which Congress had explicitly authorized state law to govern the activities of national banks, the majority opinion recognized that, where Congress has explicitly chosen to subject national banks to state laws, national banks are subject to conditions set in state law. See id. at 1569 n.7.
38. 12 C.F.R. § 7.4009(c)(2) (2005) (applicability of state law to particular national bank activities) (footnote omitted) (emphasis added); see also id. § 7.4008(e) (lending); id. § 7.4007(c) (deposit taking); id. § 34.4(b) (real estate activities).
39. A few lower courts—typically ruling in the context of requests to remove to federal court, see supra note 23—have issued opinions suggesting that national banks may be subject to some state law legal requirements that only peripherally affect their operations. See, e.g., Johnson v. Wachovia Bank, N.A., No. Civ. JFM-05-
position does seem to suggest that national banks are subject to some state law requirements in areas traditionally left to local control: those that are “not inconsistent” with national bank powers. Part II of this Article considers, in some detail, the authority of state governments to impose taxes on national banks, an area that is addressed specifically in a federal statute and not just in the OCC’s standard formulation above. A key question will be whether the OCC’s “not inconsistent” standard is appropriate in the area of state taxation where Congress has expressly authorized states to tax national banks.

C. The Dilemma for States and the Appeal of Consumer Education

Faced with a dramatic diminution of their traditional authority to protect their residents from financial abuses, the States today confront a serious dilemma. 40 Although recent developments in financial markets and judicial decisions have effectively limited the regulatory powers of states, problems of consumer protections have become more severe in many respects.

The rise of national consumer lending markets has undoubtedly expanded consumer access to credit. 41 Moreover, several authors have linked rapidly rising bankruptcy filings with the *Marquette* decision’s deregulatory effect. 42 For example, Diane Ellis of


40. To be sure, states do retain the power to impose restrictions on their own state banks, as opposed to national banks and other federally chartered firms. National banks, however, control a dominant share of many consumer lending markets, aided no doubt by the preemptive force of the federal law. Although a state could in many cases impose restrictions on state banks, there is understandable political resistance in state legislatures to disadvantage local banks as compared with national banks. Moreover, the efficacy of such restrictions is doubtful, as state banks can always convert to national charters if the costs of maintaining state charters become too severe. Competitive equality concerns of this sort are evident in Georgia’s reaction to preemption. The Georgia act now has a parity provision to ensure that, where preempted from applying to national banks, the GFLA does not apply to state banks (although the GFLA remains in effect for other institutions). GA. CODE ANN § 7-6A-12 (2006).


42. See, e.g., David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L.J. 311 (1999); see also Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs*,
the Federal Deposit Insurance Corporation (FDIC) argues that “deregulation altered the consumer credit markets and triggered a substantial increase in consumer credit availability, charge-off rates, and personal bankruptcies.”43 A recent study by Professor Ronald Mann corroborates the relationship between rising consumer debt and personal bankruptcies in the United States and the substantial costs that the financial distress imposes on families, local communities, and the public more generally.44 Other analysts have explored the negative impact on consumers of particular lending practices, such as credit cards with the universal default provisions targeted in Assemblyman Nation’s bill.45

Predatory lending practices impose similar social costs and are increasingly perceived as a major concern for state legislatures.46 Although Congress has adopted some legislation designed to constrain predatory lending practices, lenders still have considerable latitude to structure home mortgages as they wish. There is also evidence that some lenders have exploited this latitude to induce consumers to enter into lending transactions that they will not be able to afford and that will ultimately cause them to lose their homes through foreclosure.47 Elderly low-income borrowers are often the target

43. Ellis, supra note 42, at 6–7.
of such abusive lending practices. Although the Comptroller of the Currency has made some effort to police predatory lending activities of national banks, the agency has dedicated limited resources and brought only a handful of enforcement actions against national banks for such matters in recent years.

In response to lending practices that states cannot directly regulate but that impose potentially substantial costs on state residents and state social welfare networks, consumer education initiatives of the sort proposed in Assemblyman Nation’s bill have substantial appeal. A growing body of academic research suggests that Americans have a relatively low level of financial literacy. Faced with a vast array of choices for consumer credit and home mortgages, many Americans are ill-equipped to determine which products provide the most advantageous terms and which include provisions, like a universal default clause, that many experts consider unfair and abusive. More complicated questions, such as whether a borrower can afford to repay a high-cost home equity loan or an interest-only mortgage with monthly payments that may rise substantially in a few years, are also beyond the ken of many consumers. Viewed in this light, many of the problems associated with abusive credit card and predatory lending practices are simply a byproduct of financial illiteracy: if consumers had a better understanding of the consequences of certain financial transactions and the capacity to investigate more attractive alternative arrangements, the magnitude of the problems for consumers, and their communities and states, could be greatly reduced.


Although the Federal Reserve Board has researched the problem of consumer financial literacy in the United States, federal banking authorities, unlike national regulators in some other countries, have never viewed consumer financial education as a principal responsibility. Because education traditionally has been a core function of state and local governments, state level initiatives to improve financial literacy would also be consistent with traditional divisions of governmental responsibility in the United States.

Programs to educate consumers about financial literacy necessarily entails the expenditure of public resources. The adoption of any such programs thus requires some consideration of issues of public finance. Although states might use general revenues for such programs, in many ways a more sensible approach would be to raise funds from the activities—here, problematic lending practices—that give rise to the need for the education in the first place. After all, the public concerns with credit abuses and predatory lending practices—whether excessive foreclosures and rising bankruptcies or even just the costs imposed by consumers entering into less advantageous credit arrangements—entail forms of negative externalities borne by local communities and by the states more broadly. A standard public finance solution to negative externalities is to impose a tax on the activity that generates the externality. Although the tax is inevitably borne by the provider and user of the services or goods taxed, the imposition of the levy on those parties has at least as strong a justification as the raising of taxes on the general population.

52. For an example of and introduction to the Federal Reserve Board’s efforts to research consumer financial literacy, see Marianne A. Hilgert et al., Household Financial Management: The Connection Between Knowledge and Behavior, 89 FED. RES. BULL. 309 (2003).


54. For a discussion of taxation as a technique for dealing with negative externalities, see J. Fred Giertz, Excise Taxes, in THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 125 (Joseph Cordes et al. eds., 2d ed. 2005).
D. A Model Act

The sample Model Act reproduced in the Appendix provides a more specific legislative structure to focus the following discussion. Titled "A Model Act for the Provision and Public Financing of Consumer Financial Education," the bill is modeled on Assemblyman Nation's bill but expands upon that legislation in various respects.

Following the analytical framework just outlined, the Model Act begins with a series of declarations of legislative findings justifying the enactment of the Act as necessary to assist state residents to understand more completely the range of financial products now offered by the financial services industry. Noting the significant adverse public consequences of inappropriate financial transactions and increasing levels of financial distress and bankruptcy, the Model Act establishes a Consumer Financial Education Program to be administered by a joint task force of the State Departments of Banking and Education. Details of program implementation are left to the discretion of agency officials.

The cost of administering the Act's education program is to be financed by a modest tax of 1.5 basis points (0.015%) of total interest income earned on two categories of loans: credit card arrangements with universal default provisions of the sort targeted in Assemblyman Nation's bill\textsuperscript{55} and potentially predatory mortgage loans, using a definition of predatory lending adapted from recently proposed federal legislation.\textsuperscript{56} As explained in the Act's preamble, the choice of these loans is based on legislative findings that these categories of loans

\textsuperscript{55} The Model Act defines "universal default" as an increase in the interest rate as a result of borrowers' late payment to a different creditor. States should examine the credit card practices that generate a need for consumer education within the state to determine how best to define predatory practices to which the tax shall apply, considering factors such as the practices of concern in that state, the difficulty of administering a tax on practices of concern, and the clarity of tax provisions so that institutions can reliably predict which practices will be subject to the tax.

\textsuperscript{56} The Model Act uses the provisions of the Prohibit Predatory Lending Act, H.R. 1182, 109th Cong. § 2(a) (2005), to define high-cost mortgage loans. As with universal default provisions, states enacting a tax should consider which aspects of predatory lending generate the greatest need for consumer education within the state and target those activities, balancing refinements in the definition of tax practices with the need for organizations to predict which practices will be subject to the tax. For example, while loan flipping may be a predatory practice of concern, states may find it too difficult to define loan flipping ex ante, making it difficult to tax.
are particularly difficult for consumers to understand and evaluate. Additionally, imposing the cost of the state’s Consumer Financial Education Program on these transactions is consistent with sound principles of public finance.\footnote{57} The tax would apply to all financial institutions doing business in the state but only to interest income from specified classes of loans to state residents.\footnote{58} To ensure full transparency of the tax, the Banking Commissioner would be required to publish from time to time the names of all financial institutions subject to the tax. This periodic report would inform state residents of the institutions and lending transactions subject to the taxation and its associated costs. Finally, the Model Act includes a severability provision that would preserve the balance of the Act should the courts subsequently rule some provision or application of the Act invalid or unauthorized.

II. THE TAXING POWER OF STATES

This Article now turns to the question of whether states are authorized to finance a consumer education program through the imposition of taxes on all financial institutions, including national banks and other federally-chartered firms making certain kinds of loans to state residents.\footnote{59} As 12 U.S.C. § 548 bears directly on this inquiry, the analysis begins with a review of the history of that provision. Next, this Part considers how the courts have treated similar congressional grants of authority to the States and the special interpretation issues that arise from the fact that the state taxes at issue here arguably have a regulatory impact on national banks and other fed-

\footnote{57. For analytical purposes, these two categories of loans should be considered mere placeholders, and actual legislation could specify different classes of loans or perhaps even delegate to state officials the task of periodically updating the categories of loans subject to the taxation, pursuant to some legislative guidance specifying the criteria to be used for classification, such as likelihood of engendering consumer confusion or of precipitating misinformed and ill-advised financial transactions.}

\footnote{58. Under the terms of the Model Act, a billing address within a state creates a rebuttable presumption of state residency, unless the lender has reason to know that the borrower is not a state resident.}

\footnote{59. Our analysis throughout the balance of this Article focuses on national banks but is fully applicable to federally-chartered thrifts over which Congress has also authorized non-discriminatory state taxes. See Home Owners’ Loan Act, 12 U.S.C. § 1464(h) (2000), construe in First Fed. Sav. & Loan Ass’n of Boston v. State Tax Comm’n, 437 U.S. 255 (1978).}
erally chartered entities. This Part then considers whether the courts should defer to the OCC or other federal banking agencies if the agencies were to interpret § 548 in a manner that severely limited states’ authority to impose any taxes on national banks. Finally, this Part examines the specific provisions of the Model Act included in the Appendix, and offers an assessment of whether legislation of this sort would withstand judicial review.


Since 1819, when the Supreme Court decided M’Culloch v. Maryland, national banks have enjoyed a limited immunity from state taxation; states cannot tax national banks absent express congressional authorization.60 Beginning in 1864, Congress waived that immunity and permitted certain forms of state taxation.61 In 1926, Congress amended the statute to provide that states could tax national banks by: (1) taxing bank shares; (2) including bank-share dividends in the taxable income of a shareholder; (3) taxing national banks on their net income; and (4) levying a franchise tax on national banks measured by their net income.62 States could only tax banks whose principal offices were located within the state.63 The statute retained this form until 1968, when the Supreme Court held in First Agricultural National Bank v. State Tax Commission64 that § 548 did not permit states to impose sales and use taxes on national banks for their purchase of personal property. The Court held that, “if a change is to be made in state taxation of national banks, it must come from the Congress.”65

In response to the Court’s decision in the First Agricultural National Bank, Congress revisited the issue of state taxation of national banks and adopted a temporary amendment authorizing states to impose any nondiscriminatory tax on a bank with its principal office within the state, but not allowing such taxes on an out-of-state bank doing business within the taxing state’s jurisdiction.66 Congress simultaneously adopted a permanent

60. 17 U.S. (4 Wheat.) 316 (1819).
63. Id. at 224.
64. 392 U.S. 339 (1968).
65. Id. at 346.
amendment terminating all congressionally-granted immunity of national banks from state taxation (that is, ending the temporary amendment’s moratorium on “doing business” taxes for out-of-state banks), allowing all national banks to be taxed in the same manner as state banks.\(^67\) Congress postponed effectiveness of the permanent amendment pending a Federal Reserve Board study of the impact of local taxes on out-of-state banks,\(^68\) but after the study was completed,\(^69\) Congress enacted no additional federal legislation. As a result, since 1976, Congress has expressly authorized states to tax national banks in the same manner as state banks, including the power to tax out-of-state banks, subject to otherwise applicable constitutional limits.\(^70\)

B. **Plain Meaning of the Statute**

Starting with the text of the statute, one might view the authority of states to tax national banks as a fairly straightforward issue of statutory interpretation. Both the plain language and the history of § 548 counsel in favor of a broad construction of state taxing powers. The language of the permanent amendment granting states the authority to tax national banks is clear and suggests Congress meant for states to have a wide range of power. Under § 548, the only limitation on these taxes should be the nondiscrimination norm (that is, states may not tax national banks in a discriminatory fashion as compared to state banks).\(^71\)

Not only is the language of § 548 clear, but the legislative history contains clear evidence of congressional intent to authorize broad state power in taxing national banks. One court interpreting the statute noted that the legislative history of the statute reflects the sentiment “that there is no longer any justification for Congress continuing to grant national banks immunities from State taxation which are not afforded State

\(^{67}\) Id. § 2.


\(^{69}\) See infra note 137.

\(^{70}\) The statute provides that “[f]or the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located.” 12 U.S.C. § 548 (2000).

\(^{71}\) Id.
banks.” The same court explained that § 548 reflects an intent to provide for parity between state and national banks in the application of state taxes, animated by the principle that every state government should be allowed the “greatest possible degree of autonomy with regard to the formulation of its tax structure.”

This principle of enhanced state autonomy in taxation is also reflected in the conference reports. The legislative history of § 548 envisions that, as a result of the statute:

States will become free to impose intangible property taxes on national banks just as they have always been free to impose such taxes on State-chartered banks. Likewise, any State will be free to impose taxes on income derived within its borders by the operations of a bank having its principal office in a different State, regardless of whether the foreign bank is State or National.

The taxing power granted to states is virtually unqualified; other than the nondiscrimination requirement, there is no limitation suggested by either the statutory language or by the legislative history. Thus, both the plain language of § 548 and its legislative history indicate that Congress clearly granted states wide power to tax national banks subject only to the limitation that the tax should not discriminate between national and state banks.

This interpretation of § 548 is consistent with the approach courts have adopted in dealing with other congressional assignments of authority to state legislatures. As a leading constitutional scholar explains, “In those rare cases where Congress has expressly granted or withheld regulatory or tax immunity to or from certain of its instrumentalities, agents, or contractors, the validity or invalidity of state action is definitively settled by such federal legislation.” Consistent with this deference to congressional decisions, the Supreme Court has held that because

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Congress has the power to protect the instrumentalities which it has constitutionally created...[it] is not our function to speculate whether the immunity from one type of tax as contrasted with another is wise. That is a question solely for Congress, acting within its constitutional sphere, to determine.76

In the case of § 548, the only limit Congress has placed on states’ authority to tax is the nondiscrimination criteria. For federal courts to impose an additional test to determine whether the tax unduly interferes with federal instrumentalities is inappropriate given Congress’s decision that taxes are permissible so long as they are nondiscriminatory.

C. Judicial Precedents in Analogous Contexts

Further support for judicial deference to state taxation can be found in judicial precedent in two analogous contexts. The first area involves situations in which states have been granted authority to tax federal instrumentalities, and the second concerns congressional delegations to state legislatures allowing them to control some aspect of the business of national banks. In both areas, the courts have consistently granted the States wide latitude to exercise their powers, often over the strenuous objections of federal instrumentalities and even federal regulators.

Consider the state taxation cases. The starting point for analysis here is the fact that taxation is a core sovereign power. As the Supreme Court emphasized in Wisconsin v. J.C. Penney Co.,

Nothing can be less helpful than for courts to go beyond the extremely limited restrictions that the Constitution places upon the states and to inject themselves in a merely negative way into the delicate processes of fiscal policy-making. We must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to summarize.77

More recently, in Lunding v. New York Tax Appeals Tribunal, the Supreme Court echoed the deference accorded to state leg-

77. 311 U.S. 435, 445 (1940).
islatures in their development of tax schemes, despite invalidating the denial of an alimony deduction to nonresidents under the Privileges and Immunities Clause. In dicta, the Court noted that “[b]ecause state legislatures must draw some distinctions in light of ‘local needs,’ they have considerable discretion in formulating tax policy.” While *Lunding* underscores the need for states to exercise discretion within constitutional bounds, the need to adhere to constitutional limits does not negate the initial conclusion that states have broad discretion in wielding their taxing power.

Given the status of taxation as a core sovereign power of states, courts have been reluctant to impose stringent limits when Congress has expressly authorized states to tax federal instrumentalities. For example, in *Reconstruction Finance Corp. v. Beaver County*, the Supreme Court upheld a state imposition of a real property tax on machinery of the Reconstruction Finance Corporation despite the government’s claim that the local definition of real property conflicted with the federal act. In affirming the application of the local definition, the Court reasoned that it could not “see how application of a local rule governing what is ‘real property’ for tax purposes would impair the Congressional program for the production of war materials any more than the program would be impaired by the action of Congress in leaving the fixing of rates of taxation to local communities.”

The Court continued:

> We think the Congressional purpose can best be accomplished by application of settled state rules as to what constitutes ‘real property’ so long as it is plain, as it is here, that the state rules do not effect a discrimination against the government, or patently run counter to the terms of the Act. Concepts of real property are deeply rooted in state traditions, customs, habits, and laws . . . . To permit the states to

78. 522 U.S. 287, 297 (1998) (citing Madden v. Kentucky, 309 U.S. 83, 88 (1940)). Noting that the discretion granted to states in taxing does not empower them to act outside constitutional bounds, the Court held that New York’s denial of deductions to non-residents violated the Privileges and Immunities Clause because it imposed “discriminatory treatment on nonresident individuals . . . [that was not] reasonable in effect and based on a substantial justification other than the fact of nonresidence.” *Id.* at 314.

79. Section 10 of the Reconstruction Finance Corporation Act provided that “any real property” would be “subject to State, Territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed.” Reconstr. Fin. Corp. v. Beaver County, 328 U.S. 204, 206 (1946) (quoting Reconstruction Finance Corporation Act, ch. 8, § 10, 47 Stat. 5, 9 (1932)).

80. *Beaver County*, 328 U.S. at 209–10 (emphasis added).
tax, and yet to require them to alter their long-standing practice of assessments and collections, would create the kind of confusion and resultant hampering of local tax machinery, which we are certain Congress did not intend.81

*Beaver County* demonstrates the Court’s unwillingness to restrict taxation power extended by Congress, even in the face of a challenge that the local definition impaired federal objectives. This suggests that a court faced with an argument that a state’s tax impairs the National Bank Act should apply a stringent test of whether the tax “patently runs counter” to the activities permitted under the Act. To “patently run counter” to permissible activities, a tax must do more than merely impair the activities (for all taxes will necessarily be accompanied by some level of impairment).

The Fourth Circuit applied similar reasoning in *Federal Reserve Bank v. City of Richmond* when it applied state law to determine whether charging interest and collecting late payment fees violated 12 U.S.C. § 531, which provides that Federal Reserve banks are “exempt from Federal, State, and local taxation, except taxes upon real estate.”82 The court reasoned that “applying state law . . . would not impair the federal interest any more than that interest is impaired by Congress’ decision to leave the fixing of tax rates and assessment procedures to localities.”83 Like *Beaver County*, this case demonstrates courts’ deference to state practices in light of broad congressional authorization of the taxing power. Courts recognize that Congress, in authorizing the power to tax, has consented to state taxation and, as an unavoidable consequence, to some degree of impairment of federal programs. As a result, courts have been reluctant to accept claims that states exercising those authorized powers are interfering with federal programs to a greater extent than Congress anticipated.

The courts have been similarly deferential to state legislatures when the state law in question involves the exercise of state authority over a sphere of national bank activities that Congress has expressly assigned to state law. A fine example is state regulation of national bank branching. In the 1920s,

81. *Id.* at 210.
82. 957 F.2d 134, 135 (4th Cir. 1992).
83. *Id.* at 136–137 (holding that congressional grant of power to tax real property of federal reserve banks includes permission to levy interest and late payment charges).
when banks were first starting to develop extensive branching networks, Congress adopted the McFadden Act, authorizing national banks to establish branches to the extent permitted by state laws.\textsuperscript{84} Animated by Congress’s desire to maintain competitive equality between state and national banks,\textsuperscript{85} the McFadden Act delegated decisions about the appropriateness of branches within a state’s borders to that state. Over the years, the various states adopted a number of different rules governing branching: some allowed state-wide branching, others permitted only county-wide branching, and some prohibited all branches. Utah, at one point, adopted a rule that permitted branching in some locations only if the branching bank took over an existing bank. The Comptroller of the Currency, taking the view that the McFadden Act only authorized states to set geographic boundaries for national bank branching and not the manner in which the branches were established, authorized the First National Bank of Logan to establish a branch without complying with Utah’s additional requirements. The case went up to the Supreme Court, which overruled the Comptroller’s position. In \textit{First National Bank v. Walker Bank & Trust Co.}, the Court interpreted the McFadden Act as evincing Congress’s intent “to leave the question of the desirability of branch banking up to the States . . . .”\textsuperscript{86} Courts relied on this case’s articulation of legislative policy to establish that states had authority not only to determine whether branch banking would occur, but also to control the circumstances under which branching was allowed.\textsuperscript{87} Rejecting the Comptroller’s alternative interpretation, the Supreme Court also emphasized that the congressional policy was not open to judicial review, “[n]or is the congressional policy of competitive


\textsuperscript{86} 385 U.S. 252, 258 (1966) (upholding application of a Utah statute allowing branching only by taking over an existing bank).

\textsuperscript{87} See, e.g., First Nat’l Bank v. Dickinson, 396 U.S. 122, 130 (1969) (affirming states’ latitude under the Act to determine “when, where, and how” a bank may establish and operate a branch). The Court emphasized the legislative policy behind the Act, noting that “Congress has deliberately settled upon a policy intended to foster ‘competitive equality.’ State law has been utilized by Congress to provide certain guidelines to implement its legislative policy.” \textit{Id.} at 131 (citation omitted).
equality with its deference to state standards open to modification by the Comptroller of the Currency.”

In numerous other contexts, courts tend to grant states wide latitude when operating under powers delegated by Congress, even if the powers infringe upon the activities of national banks. For example, under the old Douglas Amendment, which until the mid-1990s governed the ability of bank holding companies to own banking subsidiaries in more than one state, the Supreme Court allowed the States to impose a wide variety of restrictions on permissible forms of multi-state bank holding companies. The conditions often imposed extraordinary burdens on the activities of national banks. For example, South Dakota used its authority to force national bank affiliates of out-of-state holding companies to organize their operations to focus on out-of-state credit card customers and to avoid competition with South Dakota banks. Nevertheless, the courts upheld the restrictions from legal challenges, finding that such restrictions did not unduly impair the activities of national banks.

Collectively, these banking precedents from analogous contexts reflect the principle that where Congress has clearly delegated authority to impose equivalent rules on national banks and state-chartered institutions, courts allow states broad lati-

88. Id. at 138.
90. See Ne. Bancorp, Inc. v. Bd. of Governors of the Fed. Reserve Sys., 472 U.S. 159 (1985). Analogizing state authority in holding companies to delegated power in branching, the Court held that states had latitude to configure a solution along a wide spectrum of options, which included allowing acquisitions in limited circumstances. Id. at 171–72. The Court found this latitude consistent with the purposes underlying the Douglas Amendment, noting in particular the intent to “retain local, community-based control over banking.” Id. at 172.
91. See In re Citicorp, 67 FED. RES. BULL. 181 (1981); see also JACkSON & SYMOnS, supra note 85, at 75–77.
92. The issue of the legality of these restrictions was most sharply joined in two federal appellate cases of the late 1980s; both decisions found that, in the context of inter-state mergers, national banks could be subject to operational limitations set under state law as long as those limitations did not conflict with or frustrate federal law. The second case, however, found those limitations to be a violation of the Commerce Clause. See Indep. Cmty. Bankers Ass’n of S.D., Inc. v. Bd. of Governors of the Fed. Reserve Sys. (First City), 820 F.2d 428 (D.C. Cir. 1987); Indep. Cmty. Bankers Ass’n of S.D., Inc. v. Bd. of Governors of the Fed. Reserve Sys. (Mich. Nat’l), 838 F.2d 969 (6th Cir. 1988); see also Citicorp v. Bd. of Governors of the Fed. Reserve Sys., 936 F.2d 66 (2d Cir. 1991) (denying Federal Reserve Board authority under the Bank Holding Company Act to override powers granted to state-chartered banks to engage in insurance activities).
tude in exercising that power. Like the McFadden Act and the old Douglas Amendment, 12 U.S.C. § 548 advances the goal of competitive equality by ensuring that states can tax national banks to the same extent as state banks. In considering arguments about whether this unqualified power to tax should be preempted, courts should evaluate preemption arguments with deference to congressional policies of competitive equality and to the wide latitude that judicial precedents have granted states in other contexts.

D. The Regulatory Dimension of State Taxation

Although the foregoing analysis counsels strongly for judicial deference to nondiscriminatory state taxes imposed on national banks, the recent line of judicial rulings preempting state efforts to impose direct regulations on national banks makes the analysis more complex. States are not free to prohibit a national bank from engaging in the kinds of loans that Assemblyman Nation’s bill or the Model Act would tax. Indeed, states cannot even impose disclosure requirements or licensing procedures on national banks that extend credits of this sort.75 To the extent that any tax has a marginal regulatory impact—by raising the cost of whatever behavior is subject to the levy—how should the courts approach taxes of the sort at issue here?

At the outset, one must acknowledge that the line dividing regulation and taxation is often blurred. Many taxes have a marginal regulatory impact of the sort noted above,94 and many regulations effect some form of taxation.95 The courts, however, have dealt with such distinctions before and developed reasonably administrable rules for distinguishing the legitimate scope of a sovereign’s taxing power in situations where the sovereign happens to have more limited regulatory powers. As explained below, these rules provide practical guidance for how a court might distinguish legitimate exercises of state taxing power under 12 U.S.C. § 548 from impermissible ones. A more constraining test, this Article argues, would be inconsistent with the statute itself and the many lines of judicial precedent discussed above. A stricter test would also be wholly impractical to administer.

In the early years of the twentieth century—when Congress’s powers under the Commerce Clause were much narrower—the federal courts often faced the question of whether federal taxes with regulatory overtones were authorized under Congress’s taxing powers if Congress lacked Commerce Clause power to regulate the activity directly. Summarizing a line of Supreme Court precedents, Professor Laurence Tribe explains that the federal power to tax is considered “an independent source of federal authority: Congress may tax subjects that it may not be authorized to regulate directly under any of its enumerated regulatory powers.” 96 A federal tax is valid “if it achieves its regulatory effect through its rate structure” 97 (for example by imposing a higher tax on one good as compared to a substitute good) 98 or “if its regulatory provisions bear a ‘reasonable relation’ to its enforcement as a tax measure.” 99 On the other hand, a tax may be an invalid regulatory tax (if not authorized under another provision) if “[i]ts prohibitory and regulatory effect and purpose are palpable” 100 or where it “is a penalty and not a tax.” 101

Although the more expansive New Deal interpretation of the Commerce Clause made these distinctions anachronistic as applied to the federal government, similar analysis can be applied to state taxing power with respect to national banks. Just as the federal government’s taxing power is distinct from its regulatory power, a state’s sovereign taxing power as authorized under § 548 is distinct from its constrained power to regulate national banks. Just as the federal government’s power to tax can be broader than its power to regulate, a state’s power to tax can be broader than its power to regulate, particularly where that taxing power has been expressly granted by Congress. As suggested in the Supreme Court’s interpretations, authority under

96. 1 Tribe, supra note 75, § 5-7.
97. Id. “A tax is a regulatory tax—and hence invalid if not otherwise authorized—if its very application presupposes taxpayer violation of a series of specified conditions promulgated along with the tax.” Id.
98. Id. (citing McCray v. United States, 195 U.S. 27 (1904) (upholding tax rate on yellow oleomargarine that was forty times the tax rate on white oleomargarine)).
99. Id. (quoting United States v. Doremus, 249 U.S. 86, 93 (1919) (upholding the Narcotics Drugs Act of 1914 and noting that “[i]f the legislation enacted has some reasonable relation to the exercise of the taxing authority conferred by the Constitution, it cannot be invalidated because of the supposed motives which induced it”)).
101. E.g., Carter v. Carter Coal Co., 298 U.S. 238, 289 (1936) (holding that a statute imposing a 15% tax subject to a 13.5% rollback for those who submitted to regulatory price-fixing and labor provisions was a penalty).
§ 548, however, need not be interpreted so broadly as to countenance state levies that are palpably punitive and prohibitive. Thus, blatant attempts to circumvent restrictions on state regulatory powers may indeed be problematic, although marginal regulatory effects achieved through differences in rate structure or provisions reasonably related to the purpose of the tax measure should withstand judicial scrutiny.

Aside from hewing to doctrinal distinctions articulated through a series of Supreme Court precedents, the foregoing approach, grounded in presumptive deference to state legislative actions, has a number of advantages. To begin with, it is consistent with the several lines of judicial precedent reviewed earlier, where the courts have nearly unanimously acceded to state legislation enacted under express congressional authorizations to exert authority over federal instrumentalities, including national banks.

Another advantage is one of administrability. How exactly would the courts impose a more stringent review of state taxes on national banks? Imagine, for example, a doctrinal requirement under which, notwithstanding the express language of § 548, states are denied the authority to impose any tax on national banks that has even a marginal regulatory impact—that is, any state tax imposing an incremental burden on the activities of a national bank or favoring one kind of national bank lending over another. Such a rule precluding any regulatory impact would make a mockery of § 548. All taxes impose some incremental burden, and a tax on any particular kind of activity disadvantages that activity with respect to other permissible activities. Consider, for example, a tax on real property—the kind of tax that the Supreme Court endorsed for states to impose on the Reconstruction Finance Corporation in the Beaver County case: if states were precluded from taxing federal instrumentalities in a manner that disfavored owning real property as opposed to other kinds of property, then Beaver County was wrongly decided. If the precedents, however, suggest (as they do) that states can establish some classifications in imposing taxes on national banks, are narrower classifications of the sort imposed in Assemblyman Nation’s bill or our Model Act more or less problematic than broader classifications, when narrow classifications subject fewer national bank activities to state taxation? Is it plausible that Congress intended for the

102. Reconstr. Fin. Corp. v. Beaver County, 328 U.S. 204 (1946),
courts to micro-manage the classification systems written into state taxation rules on the basis of some kind of marginal analysis of economic impact? We think not.

In short, there are a host of practical problems in any interpretation of § 548 that requires courts to inspect state taxation systems for marginal or incremental effects on national banks. Supreme Court precedents articulating the permissible scope of Congress’s powers under the Taxation and Spending Clauses offer a workable mechanism for distinguishing the vast majority of legitimate state taxes from those rare cases that are palpably punitive or blatant attempts to subvert restrictions on regulatory power. Prior interpretations of § 548 and analogous statutes granting states authority over federal instrumentalities, including national banks, counsel for broad deference to state legislation in these areas and support the very limited constraints on state taxing powers reflected in a narrow exception for precluding only blatant attempts to evade restrictions on regulatory activities.


A final issue to consider is whether the foregoing preemption analysis would be altered if the Comptroller of the Currency or some other federal banking agencies were to propound a different interpretation of § 548. For example, imagine that the OCC issued an interpretive release suggesting that state taxes should be evaluated under the same standard as state contract claims or zoning rules and be preempted if the OCC determines that they have more than an incidental effect on the exercise of any national bank powers. Imagine further that the agency claimed its interpretation of § 548 was entitled to Chevron deference.

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103. See supra text accompanying notes 38–39. Of course, it is not at all clear that the OCC or any other banking agency would propose such an interpretation. In its preemption regulations, the OCC has identified taxation as a state power not generally preempted, see supra note 38 and accompanying text, and also acknowledged that, “where made applicable by federal law,” state laws will not be preempted. See supra text accompanying note 31. Arguably, the language of these regulations suggests that federal regulators would not find the Model Act or similar state legislation to be problematic.

This issue, at least, appears quite easy to resolve. Although much about *Chevron* doctrine is confused and confusing, one thing that is clear is that *Chevron* deference is only warranted for matters that Congress entrusts to the discretion of a federal agency.\textsuperscript{105} With § 548, no such delegation has occurred.\textsuperscript{106} The provision is an authorization extended to state legislatures. If deference is due in any direction, it is due to the state legislatures that establish the system of taxation with respect to national banks.\textsuperscript{107} Indeed, the cases discussed earlier show that

\begin{footnotesize}
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\item[105] *Chevron* deference applies only to regulations within an agency’s authority. *See*, e.g., *Kelley v. EPA*, 25 F.3d 1088 (D.C. Cir. 1994) (holding that an EPA rule interpreting liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) is not entitled to deference where the statute delegates no role to EPA in determining liability).
\item[106] Within the academic literature, there is currently a debate over whether an agency is entitled to *Chevron* deference for ruling on issues related to its own jurisdiction. Although the Supreme Court has yet to resolve the issue, much academic writing argues against deference on jurisdictional issues. *See* JOHN F. DUFFY & MICHAEL HERZ, A GUIDE TO JUDICIAL AND POLITICAL REVIEW OF FEDERAL AGENCIES § 4.042 (2005). The current issue does not, however, implicate this debate. Section 548 is not within the jurisdiction of any federal agency any more than the setting of state branching rules under the McFadden Act or inter-state banking provisions under the old Douglas Amendment were within the jurisdiction of state banking agencies. *See supra* text accompanying notes 84–92.
\item[107] Further evidence that federal bank regulators have no role in interpreting § 548 lies in the manner in which the provision came into being. In the 1960s when Congress was considering whether to liberalize the rules governing state taxation of national banks, opponents of the legislation expressed concern that states could use taxes to impair national banks’ activities. Mindful of these concerns, Congress postponed full implementation of the act while the Federal Reserve Board conducted a study “to determine the probable impact on the banking systems and other economic effects of the changes in existing law to be made by section 2 of this Act . . . .” *Pub. L.* No. 91-156, § 4, 83 Stat. 434, 435 (1969). The report was timed so that Congress would have the opportunity to act if the Board staff—that is, federal banking regulators—raised substantial concerns. After the study was released, Congress chose not to act and allowed the permanent amendment to take effect in 1976. *See supra* text accompanying notes 69–70. Thus, rather than delegate authority to a federal agency for ex post implementation (as is the case when *Chevron* deference obtains), Congress in the case of § 548 requested agency input before implementation of the statute, and ultimately chose to disregard the recommendations of the Federal Reserve Board study. *See infra* note 137. Notably absent from the legislation as enacted was further delegation of interpretative authority to any federal agency. *See* First Agric. Nat’l Bank v. State Tax Comm’n, 392 U.S. 339, 346 (1968) (analyzing prior version of statute and concluding that “[b]ecause of § 548 and its legislative history, we are convinced that if a change is to be made in state taxation of national banks, it must come from the Congress, which has established the present limits”). Through their work with Congress several decades ago, the federal banking agencies had their chance to influence the structure of § 548. They have no further role to play now.
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the federal courts have been consistent in deferring to state interpretations of § 548 and analogous statutes.\textsuperscript{108}

To be sure, the Comptroller of the Currency does have expertise with respect to national banks, and so one might be tempted to look to the OCC for guidance regarding the impact of state taxation regimes on national banks. The courts, however, have not followed such an approach in prior cases. For example, in \textit{First National Bank}, the Supreme Court expressly rejected the OCC’s view that Utah branching rules impermissibly burdened national banks.\textsuperscript{109} Similarly, in the line of federal cases upholding state taxes on the Reconstruction Finance Corporation and other federal instrumentalities, there was always a federal entity arguing against the state action. In none of these cases did the courts—including the Supreme Court—defer to the federal parties’ interpretation of the statutory provision at issue. Quite sensibly, in our view, the courts have recognized that the federal parties in these disputes are parties in interest: they have a vested interest in escaping the application of state laws. Although instances may arise when state legislatures overstep their authorized sphere of activity, it is the role of the courts to make that determination. Again, to the extent that deference is to be shown—where the power involves the core sovereign function of taxation and Congress has expressly authorized state action—the party deserving deference is clearly the state.

In short, neither the OCC nor any other federal agency or instrumentality is entitled to deference in the interpretation of § 548.

\textbf{F. Judicial Review of the Model Act}

Applying the framework developed above, we now examine whether a court would consider this Article’s Model Act a legitimate exercise of state authority under § 548. Judicial review should, according to this Article, entail two distinct inquiries. First, do the Act’s financing provisions comply with the nondiscrimination requirements of § 548. Second, do the Act and its financing provisions represent a reasonable application of the state’s taxing powers, imposing incremental costs as a result of ordinary differentials in rate structure, or do they reflect

\textsuperscript{108} See \textit{supra} text accompanying notes 77–92.

\textsuperscript{109} See \textit{supra} text accompanying notes 86–88.
a blatant effort to circumvent regulatory restrictions through the imposition of palpably punitive taxes.

1. Does the Act Discriminate Between National Banks and State Institutions?

The one requirement that Congress has imposed under § 548 is that state taxes not discriminate between national bank and state institutions. Accordingly, it is possible that affected banks could raise a claim of discrimination. On its face, the preceding line of argument is implausible as applied to the Model Act because the Act applies equally to all financial institutions doing business in the jurisdiction, whether national banks or state-chartered firms.

In theory, national banks might attempt to argue that § 548 also prohibits state taxes that fall disproportionately on national banks as opposed to state-chartered banks (although this line of argument would be a bit brazen as it would rest on the premise that national banks do more problematic lending than state-chartered institutions). The courts, however, have been reluctant to accept such as-applied challenges in similar contests. So long as state banks are authorized to engage in the taxed activity, courts are not likely to require an examination of the distribution of taxes between state and national banks. For example, in First Federal Savings & Loan Association of Boston v. State Tax Commission, the Supreme Court examined whether a state tax on federal thrifts was barred by section 5(h) of Home Owner’s Loan Act (the analog of § 548 for federal thrifts). The petitioners asserted that a Massachusetts tax, which granted deductions for reserves, discriminated against federally-chartered thrifts because state regulations imposed higher reserves than federal regulations required (resulting in a greater deduction for state institutions). The Supreme Court rejected the challenge. The Court recognized that the Home Owners’ Loan Act was designed to protect federal thrifts from unequal competition by state tax laws favoring state-chartered institutions. The Court found that:

110. 437 U.S. 255 (1978). Section 5(h) of the Home Owners’ Loan Act of 1933 provided, “No State, county, municipal, or local taxing authority shall impose any tax on [Federal savings] associations or their franchise, capital, reserves, surplus, loans, or income greater than that imposed by such authority on other similar local mutual or cooperative thrift and home financing institutions.” Id. at 256–57.

111. Id. at 256. Petitioners also challenged the tax on the grounds that it effected discrimination because it did not apply to state credit unions. The Court rejected this challenge as well, reasoning that credit unions were not similar to savings associations within the meaning of section 5(h). See id. at 261.
On its face, however, Massachusetts’ tax scheme is not unfriendly or discriminatory. It applies a single neutral standard to state and federal institutions alike. The amount of the deduction depends on varying regulatory practices, but a tax is not invalid because it recognizes that state and federal regulations may differ. There is no reason to believe that § 5(h) was intended to force state and federal regulation into the same mold.112

The Supreme Court has established a high bar for discriminatory practices; “manifest discrimination” is the test for compliance with statutes delegating non-discriminatory taxing power.113 Provided state banks in the enabling jurisdictions are not prohibited from engaging in the activities targeted by the tax,114 courts should find that the Model Act meets § 548’s non-discrimination requirement.115

2. **Is the Act a Reasonable Exercise of State Taxing Powers?**

There are two ways in which a court could approach the question of whether the Model Act’s financing provisions rep-

112. *Id.* at 258. Rather than require exact equality in tax impacts, the Court followed a long line of precedent that examined whether the “practical operation” of the tax effected a manifest discrimination that placed national banks at a disadvantage. *Id.* at 259 (quoting Michigan Nat’l Bank v. Michigan, 365 U.S. 467, 476 (1961)). In *Michigan Nat’l Bank*, the Court looked to whether it was “manifest that . . . national bank shares [were] placed at a disadvantage by the practical operation of the State’s law.” 365 U.S. at 476.


114. While the above question is an empirical one that cannot be resolved with respect to a Model Act, it is clear that as a general matter state banks across the country are engaging in the kinds of practices subject to taxation under the Model Act’s financing provisions. Recent enforcement efforts of the FDIC, which only supervises state-chartered banks, provide evidence for the proposition that state banks engage in these practices. For a discussion of FDIC enforcement efforts, see FDIC OFFICE OF INSPECTOR GENERAL, CHALLENGES AND FDIC EFFORTS RELATED TO PREDATORY LENDING, Rep. No. 06-011 (2006), available at http://www.fdic.gov/reports/06%5C06-011-508.shtml.

115. If a state did not permit state banks to engage in the taxed activity, national banks would have an argument that the tax fails the non-discriminatory test. *See United States v. State Tax Comm’n*, 481 F.2d. 963 (1st Cir. 1973). In that case, the First Circuit held that a state tax on deposits, which allowed a deduction for unpaid balances on loans secured by real estate located within a 50-mile radius of the main bank office, violated section 5(h) by discriminating against national savings and loan associations. *Id.* at 970. State regulations limited state associations to the 50-mile radius for real estate loans, and federal associations faced no such limit. As a result, the federal associations were ineligible for the deduction. Upholding the challenge, the court noted that it “perceived no reason—other than the impermissible one of sheltering local institutions—for adoption [of the 50-mile limitation].” *Id.*
resent an exercise of state authority under § 548. First, a court could consider whether the legislation is roughly comparable to other kinds of state taxes with a reasonable rate structure and sensible public purpose. Alternatively, the court could approach the matter from the other side, asking whether the overall operation of the tax is palpably punitive and a blatant attempt to subvert limitations on direct state regulations.

Starting with the first of these approaches, courts should have relatively little problem concluding that overall goals of the Act—to improve consumer education about financial matters—present a sensible, even laudatory public policy. Financing the costs of such an education program about certain lending activities, identified by many experts as problematic and associated by empirical research with less financially-sophisticated consumers, is consistent with standard principles of public finance.116 Designating a relatively small number of activities as subject to the taxation is not unusual, as many state levies (such as luxury taxes or sin taxes) are limited to a relatively narrow range of activities. Thus, the basic structure of the public financing provisions of the Model Act is unexceptional.

A disproportionate rate structure could, of course, transform a superficially innocent tax into one that is, in fact, palpably punitive. The rate restructure of the Model Act’s public financing provisions, however, is modest. A tax rate of 1.5 basis points (or 0.015%) of total interest income on specified loans is demonstrably a low rate. By way of comparison, the average return on assets for all commercial banks in the United States was 131 basis points in 2005.117 Thus the Model Act’s tax would represent slightly more than one percent of the average profits on commercial banking lending in 2005, hardly a punitive rate. Moreover, compared to other state taxes on bank lending activities, the Model Act’s charges are modest. For example, Indiana imposes a tax of 8.5% of net income,118 while Kentucky imposes a rate of 1.1% of net capital.119 The rate of 1.5 basis points on interest income from a select category of loans is certainly within the range of modest, reasonable tax rates, particularly

116. See supra text accompanying notes 50–54.
117. Elizabeth C. Klee & Gretchen C. Weinbach, Profits and Balance Sheet Developments at U.S. Commercial Banks in 2005, FED. RES. BULL., June 2006, at A77, A87. Return on credit card loans was substantially higher. Id. at A89.
118. IND. CODE § 6-5.5-2-1 (2006).
119. KY. REV. STAT. ANN. § 136.510 (West 2006).
given that it is targeted toward loans that impose additional costs on the state (through a need for additional education).

Of course, taxes may be punitive in ways other than imposing high rates. Excessive administrative burdens could conceivably convert a taxing system into a disguised, prohibitive regulation. The Model Act’s financing provisions, however, are carefully structured to minimize administrative costs. To begin with, unlike a traditional income tax that requires taxpayers to associate expenses with income, the Model Act imposes its small charge on total interest payments. Financial firms must routinely calculate total interest payments for their own purposes, and, indeed, they often report the figure to their customers at the end of each calendar year for federal income tax purposes. The Model Act also makes it easy for financial institutions to determine on which loans the levy is to be charged: only those loans to borrowers who reside in the state. To facilitate compliance further, the Act permits banks to presume the residency of its customers from the mailing address on their billing statements. It is difficult to imagine a simpler system of tax administration.

Finally, a court might consider other incidental effects of the Model Act. For example, consumers may become educated about financial matters and change the way in which they do business with national banks, or the State Banking Department will periodically publish lists of financial institutions subject to the tax. Although both of these effects could conceivably be said to have a marginal impact on national banks, they are by no means palpably punitive nor do they appear to rise to the level of a blatant circumvention of direct regulation. After all, much of the education in state school systems would have similar kinds of effects on bank activities and all sorts of state taxing regimes—like local records of real estate holdings—including periodic reporting of bank assets and tax payments. No reasonable interpretation of state authority in the fields of education or taxation under § 548 could allow preemption of state legislation with such ephemeral effects on national banks.

120. Courts analyzing whether preemption applies have considered administrative burden. See, e.g., Am. Bankers Ass’n v. Lockyer, 239 F. Supp. 2d 1000, 1016–18 (E.D. Cal. 2002). A tax would likely have to impose a significantly greater administrative burden than a comparable regulation, given the congressional authorization to tax national banks.
Thus, being neither discriminatory with respect to state banks nor disguised regulation with respect to national banks, the Model Act and its financing provisions should withstand judicial review and be deemed to be consistent with the authority that Congress granted states under § 548.

III. LEGAL BARRIERS TO THE TAXATION OF OUT-OF-STATE BANKS

Both Assemblyman Nation’s original bill and our Model Act structure their financing provisions to apply to all banks, in-state or out-of-state, that provide certain kinds of loans to state residents. As a matter of policy, the coverage of out-of-state banks is entirely sensible. The consumer education program that these bills establish would benefit state residents entering into lending transactions with all financial institutions, regardless of their place of organization. In addition, the negative externalities generated by problematic loan transactions have an impact on state residents and the state itself irrespective of where the lending institution’s home office is located. The role of out-of-state banks is also not a trivial issue. Much of the consumer financing business in the United States now operates on a national basis,\(^{121}\) and if the financing provisions of these bills applied only to local institutions, the burden of supporting the program would fall on only a small fraction of the market and put them at a further disadvantage to out-of-state lenders.

Although the extra-territorial application of the financing decisions is sound as a matter of public policy, it raises important and unresolved legal questions in its application to out-of-state banks that do not maintain some sort of physical presence with the taxing jurisdiction. The critical question—and one that has received considerable attention in state taxation circles\(^ {122} \)—is whether states have authority to tax out-of-state lenders that lack a physical presence in a state but possess some other “economic nexus” as a result of the manner in which the lender markets its products or provides services to state residents. Economic nexus is a theory of taxing jurisdiction based on a threshold of economic activity within a state—such as expanding into a state to reach its consumer credit market and taking the many steps necessary to affect lending transactions and enforce their terms—regardless of

\(^{121}\) See supra text accompanying notes 8–10.

whether the out-of-state firm has a physical presence within the taxing jurisdiction. The availability of taxing authority based on economic nexus is particularly important in the area of credit card lending, as many institutions are located in states like South Dakota and Delaware (which have liberal usury rules), and many of these institutions maintain physical operations in few other states. In the case of mortgage loans, out-of-state lenders will often have more contact with a taxing state due to requirements associated with perfecting liens, such as recording requirements, or the use of other state procedures associated with foreclosures. However, because institutions may accomplish many of these activities through the use of mail, local affiliates, and local contractors, nexus for out-of-state mortgage lenders can also be questioned and may turn on a fact specific assessment of the entities’ contact with the state.

There are several ways a state tax could be structured to extend to banks located outside the state. First, and most conservatively, the state could extend a “doing business” tax to those banks that extend credit to state residents and that also maintain a physical presence in the taxing state. This would allow a state to tax out-

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123. See id. ¶ 6.30 (explaining that “[u]nder an economic nexus theory, jurisdiction to tax exists if an out-of-state corporation avails itself of the benefits of the economic market of a state and without regard to that corporation’s physical presence in the state”).
124. See Furletti, supra note 8, at 443.
125. HELLERSTEIN & HELLERSTEIN, supra note 122, ¶ 6.31.
126. Id.
127. Using a fact-specific inquiry to determine the constitutionality of taxing based on affiliates’ presence in the taxing state, courts have come to different conclusions depending on the extent of the affiliate company’s activities on behalf of the taxed entity. Compare J.C. Penney Nat’l Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999) (finding no nexus despite parent company’s presence in state where the parent company did not conduct business related to taxed entity’s credit card lending), with W. Acceptance Co. v. Dep’t of Revenue, 472 So. 2d 497 (Fla. Dist. Ct. App. 1985) (finding nexus based on parent company’s presence in state where taxed entity carried out its business through the in-state parent company, including by accepting payments from customers).
128. Of course, the drawback of this approach is that the financing provisions will not affect a large portion of creditors (the proportion of creditors with a physical presence in the state will likely depend on the taxing jurisdiction and the sources of consumer credit for that state’s citizens). If the legislation were structured in accordance with the requirements of 12 U.S.C. § 548 (that is, being neither palpably punitive nor a blatant effort to circumvent restrictions on direct regulation), its financing provisions would likely not impose a high cost on the affected institutions. Banks might be unlikely to make decisions about whether to have a physical presence in a particular state based on the tax. Although the tax would marginally increase the cost of targeted practices for taxed institutions as com-
of-state banks that extend credit to the taxing state’s residents and have a physical presence in the taxing state (for example, through branch operations). Thus, a bank chartered in state A that operates a branch in state Y could be taxed in state Y based on the physical presence of the branch in that state. State corporate income and franchise taxes with jurisdictional provisions of this sort are common: forty-six states impose corporate income or franchise taxes. But many of these states also assert nexus over entities without a physical presence. For example, a recent survey found that issuing credit cards to residents creates nexus in 18 states, while 20 states report finding nexus over companies to whom in-state companies make royalty payments.

Though not limited to a narrow range of loans in the manner of Assemblyman Nation’s bill or our Model Act, several states have enacted taxes that extend to out-of-state financial institutions that lack physical presence in the state. Six states (Indiana (franchise tax), Kentucky (franchise tax), Massachusetts (excise tax), Minnesota (franchise tax), Tennessee (excise tax), and West Virginia (corporate net income tax)) have established economic nexus as the basis for jurisdiction to tax out-of-state banks that lack the traditional jurisdictional hook of physical presence within the state.

A summary of the economic bases for these taxes follows:

- Sale of products or services received in the state (IN, MA, MN, TN)
- Solicitation of business in the state (IN, TN)

pared to those without a physical presence, the economic impact might be trivial. So long as a reasonable number of institutions continued to engage in the activity and pay tax to the state, the tax could succeed in raising sufficient revenue to fund consumer education initiatives and raise awareness of predatory lending practices.


131. See HELLERSTEIN & HELLERSTEIN, supra note 122, ¶ 6.30 (summarizing taxes on out-of-state financial institutions); see also IND. CODE §§ 6-5.5-3-1, 6-5.5-3-4 (2006); KY. REV. STAT. ANN. § 136.520 (West 2006); MASS. GEN. LAWS ch. 63, § 1 (2006); MINN. STAT. § 290.015 (2006); TENN. CODE ANN. § 67-4-2004 (2006); W. VA. CODE § 11-24-7b (2006).

• Sale of products or services consumed in the state (IN, MN)
• Transactions with customers in the state involving intangible property located in the state (IN, MA, MN)
• Loans secured by property in the state, leases for property in the state (MA, MN)
• Solicitation of business from 20–100 persons in the state (KY, MA, MN, WV)
• Receipts of $100,000–$500,000 or assets of $5–$10 million attributable to the state (KY, MY, MN, TN, WV)
• Deposits attributable to the state in excess of threshold (MA, MN)

Jurisdictions seeking to extend financing provisions to a broader range of out-of-state lenders could—following the proposed Model Act—assert jurisdiction over those entities with some combination of this list of economic nexi with the taxing jurisdiction.

Because states considering financing provisions similar to the ones included in the Model Act would likely at least consider applying an economic nexus criterion to reach out-of-state banks, this Part analyzes the statutory and constitutional challenges such financing provisions would face. It then examines the likelihood that the proposed Model Act would survive challenges to its applicability to out-of-state financial institutions.

A. Statutory Challenge to Economic Nexus

One potential basis for a challenge to an economic nexus tax would be the absence of federal statutory authority. To be applicable to out-of-state national banks, the tax must be authorized under 12 U.S.C. § 548. Because state taxes on national banks must be authorized by statute, courts must first establish whether a state tax on out-of-state national banks is consistent with the congressional authority. The question therefore arises: Does § 548 authorize a state to tax national banks located outside the state?

The statute declares that “a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located.”133 So long as a state’s tax on out-of-state banks applied to state-chartered institutions that met the jurisdictional requirements, including state

banks in the same location as the national bank, the tax would not contravene the language of § 548. Nothing in the language of § 548 bars state taxes on out-of-state banks with national charters, so long as out-of-state banks with state charters are subject to the tax under the same conditions. In fact, although the original version of the statute prohibited states from taxing out-of-state banks, when Congress revised the statute it only included a temporary moratorium on out-of-state taxation. As a result of this revision and the lack of a limitation on out-of-state banks, the statute clearly authorizes out-of-state taxation of national banks, at least to the extent permissible under the relevant constitutional provisions.

Legal scholars have interpreted § 548 to authorize “doing business” taxes on nationally-chartered financial institutions whose principal office is located in another state for activity in the taxing state. For example, one leading treatise on state and location taxation notes that the permanent amendment was postponed due to

sharp conflicts between and among commercial banks, savings banks, savings and loan associations, and the states as to how far Congress should permit the states to tax out-of-state depository institutions. Legislation further restricting the states’ power to tax national banks was never enacted.

134. Act of Mar. 25, 1926, ch. 88, 44 Stat. 223, 223 (“The legislature of each State may determine and direct, subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits.”) (emphasis added)).


The Congress finds that the national goals of fostering an efficient banking system and the free flow of commerce among the States will be furthered by clarifying the principles governing State taxation of interstate transactions of banks and other depositories. Application of taxes measured by income or receipts, or other “doing business” taxes, in States other than the States in which depositories have their principal offices should be deferred until such time as uniform and equitable methods are developed for determining jurisdiction to tax and for dividing the tax base among the States . . . . With respect to any taxable year or other taxable period beginning on or after the date of enactment of this section and before September 12, 1976, no State or political division thereof may impose any tax measured by income or receipts or any other “doing business” tax on any insured depository not having its principal office within such State.

No further amendments were enacted after September 12, 1976.
Accordingly, since 1976 states have been free to tax national banks just as they tax state banks.\footnote{136. Hellerstein & Hellerstein, supra note 122, ¶ 6.29 (citations omitted).}

Although Congress delayed the amendment to consider limitations on “doing business” taxes, and despite the recommendations of federal agencies that they adopt such limitations,\footnote{137. See Advisory Comm’n on Intergovernmental Relations, State and Local “Doing Business” Taxes on Out-of-State Financial Depositories: Report of a Study Under Public Law 93-100, Report for the S. Comm. on Banking, Housing and Urban Affairs 48–51 (Comm. Print 1975) (proposing a prohibition on “doing business” taxes on banks without a “substantial physical presence” in the taxing state); see also Bd. of Governors of the Fed. Reserve Sys., State and Local Taxation of Banks, Pts. I, II, III and IV: Report of a Study Under Public Law 91-156, Report for the S. Comm. on Banking, Housing and Urban Affairs 4 (Comm. Print 1972) (recommending a limitation on “the circumstances in which national banks, State banks, and other depository institutions may be subject to State or local government taxes on or measured by net income . . . or to other ‘doing business’ taxes in a State other than the State of the principal office . . .”).} Congress refused to limit state power to tax out-of-state institutions. The statute thus places no limits on the imposition of taxes on out-of-state institutions, provided that the taxes comply with the non-discrimination norm.

\[\text{**B. Constitutional Challenges to Economic Nexus**}\]

Even if statutorily authorized under § 548, a state tax on out-of-state financial institutions must meet constitutional requirements. A tax based on economic nexus would almost certainly face both Due Process and dormant Commerce Clause challenges, particularly as applied to out-of-state lenders with no physical presence in the state but who lend to state residents.

Although the Supreme Court has not always distinguished between Due Process Clause and dormant Commerce Clause requirements for interstate taxation, the Court has made clear that the two tests are distinct.\footnote{138. See Quill Corp. v. North Dakota, 504 U.S. 298, 305 (1992) (noting that “although we have not always been precise in distinguishing between the two, the Due Process Clause and the Commerce Clause are analytically distinct”).} The touchstone for nexus in the Due Process context is fair warning.\footnote{139. Id. at 312.} The test for Due Process compliance requires that an institution “purposefully avail[ ] itself of the benefits of an economic market in the forum
State.” Taxes imposed on financial institutions without a physical presence based on economic nexus can likely meet the purposeful availsment standard. Given that out-of-state banks rely on a state’s legal institutions for contracts, collections, and other background protections, an out-of-state bank with an economic nexus with the state is likely to be taxable for Due Process purposes. Thus, so long as the tax is limited to out-of-state institutions that reach into the taxing state, the tax should meet Due Process requirements.

The dormant Commerce Clause presents the more difficult constitutional challenge for taxes on out-of-state financial institutions whose nexus with the state is exclusively economic. The Constitution vests Congress with the power “[t]o regulate commerce with foreign nations, and among the several states.” “[T]he Commerce Clause is more than an affirmative grant of power; it has a negative sweep as well . . . ‘[B]y its own force’ [it] prohibits certain state actions that interfere with interstate commerce.” This “negative sweep” is the dormant Commerce Clause, and it imposes an additional limitation on a state’s power to tax.

In Complete Auto Transit, Inc. v. Brady, the Supreme Court announced a four-part test for state taxes faced with dormant Commerce Clause challenges. Taxes would be upheld where they were: (1) applied to an activity with substantial nexus with the taxing state; (2) fairly apportioned; (3) not discriminating against interstate commerce; and (4) fairly related to the services provided by the state.

In the case of a tax on out-of-state financial institutions under an economic nexus theory, the substantial nexus prong is the most vulnerable to a Commerce Clause challenge. In Quill

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140. Id. at 307 (quoting Miller Bros. Co. v. Maryland, 347 U.S. 340, 344–45 (1954)). In Quill, the court struck a North Dakota use tax collection requirement on mail order sales requiring out-of-state retailers who solicit customers in the state to collect the tax. The tax collection requirement met due process requirements but violated the dormant Commerce Clause.
141. See HELLERSTEIN & HELLERSTEIN, supra note 122, ¶ 6.31.
142. U.S. CONST. art. I, § 8, cl. 3.
143. Quill, 504 U.S. at 309 (internal citation omitted).
144. Id.
146. Id. at 279.
147. Regardless of its nexus basis, the tax should also be structured to avoid allegations of protectionism. Taxes designed to protect in-state interests against out-of-state competition will be invalid under the dormant Commerce Clause. A tax that extends to all providers of financial services (including thrifts and other entities making loans, in addition to banks) best avoids this charge of protectionism.
Corp. v. North Dakota, the Supreme Court explained that substantial nexus in the Commerce Clause context is animated by “structural concerns about the effects of state regulation on the national economy” and functions as a “means for limiting state burdens on interstate commerce.” The Court applied a bright-line physical presence test for determining substantial nexus for sales tax applied to mail order companies. The Court justified its use of the bright-line test for sales tax based on precedent, noting that settled expectations had arisen as a result of the physical presence requirement announced for mail order companies in National Bellas Hess, Inc. v. Department of Revenue of Illinois.

It remains an open question whether the physical presence test that governs nexus for sales tax applies in the context of income or franchise taxes. The issue of nexus in corporate taxation generally is currently a hotly contested issue; U.S. Congressmen Goodlatte and Boucher recently introduced legislation to require physical presence for imposition of a business activity tax (BAT) on out-of-state corporations. But even in the absence of federal legislation requiring physical presence, some argue that economic nexus should be insufficient to establish constitutional nexus in the income tax context, just as it was in the sales tax context of Quill. This argument is based on several considerations. First, as in the sales tax context, proponents of physical presence contend that economic nexus could lead to over-taxation. Second, bright-line rules of physical presence are arguably more easily administered, as

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148. 504 U.S. 298, 312–13 (1992) (finding that use tax on an out of state mail catalog company that solicited business in state but had no property and no employees in the state violated the dormant Commerce Clause because the tax lacked substantial nexus).

149. See id.

150. See id. at 316; see also Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill., 386 U.S. 753 (1967).


153. For an example of this argument’s application to sales tax, see Quill Corp. v. North Dakota, 504 U.S. 298, 313 (1992).
both states and the entities they tax are more likely to be able to clearly delineate when there is a physical presence.\footnote{154. See id. at 315 (noting that “[s]uch a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes”).}

On the other hand, there are several factors that suggest a court might allow a more flexible economic nexus test for states imposing “doing business” taxes, such as income or franchise taxes. First, the Court in Quill clearly felt bound by \textit{stare decisis}, citing settled expectations relative to the physical presence requirement for sales tax in the mail order industry as a result of \textit{Bellas Hess}.\footnote{155. See id. at 316–17.} No such settled expectations have arisen in the income or franchise tax context, perhaps leaving the Court more free to adopt a more flexible economic nexus standard in that arena.\footnote{156. \textit{Quill}, 504 U.S. at 317.} In fact, the Court in \textit{Quill} noted that “concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement . . . .”\footnote{157. \textit{Quill}, 504 U.S. at 317.}

Second, as the Court noted in \textit{Quill}, sales taxes present considerably greater compliance burdens given that there are six thousand jurisdictions with sales tax.\footnote{158. Id. at 313 n.6.} The dangers of multiple taxation and concerns about administrative burdens are reduced in the area of income tax, where there are far fewer jurisdictions with taxing authority.

Though no federal court has yet considered the issue of economic nexus for income tax as applied to out-of-state financial institutions, state courts have considered the issue. A Tennessee appellate court, for example, ruled that economic nexus was an insufficient basis for taxation of out-of-state financial institutions.\footnote{159. J.C. Penney Nat’l Bank \textit{v.} Johnson, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999).} In \textit{J.C. Penney National Bank \textit{v.} Johnson}, the Tennessee Court of Appeals rejected the imposition of franchise and excise taxes on an out-of-state bank with no physical presence in the state.\footnote{160. Id.} The Tennessee court held that the application violated the Commerce Clause’s substantial nexus requirement where the only business that occurred within the state was solicitation by mail, where that solicitation was done by a formerly wholly owned subsidiary that was not an independent organization and that was

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154. See id. at 315 (noting that “[s]uch a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes”).

155. See id. at 316–17.

156. \textit{Hellerstein} \& \textit{Hellerstein}, supra note 122, ¶ 6.31[5].


158. \textit{Id.} at 313 n.6.


160. \textit{Id.}
not targeted to Tennessee residents but sent throughout the country.161

In contrast, the Circuit Court of West Virginia upheld application of the state’s corporate income and franchise tax against a credit card bank domiciled outside the state with no physical presence within the state.162 The court found that the “bright-line physical presence test” of Bellas Hess and Quill did not apply outside the sales and use tax context.163

Though not in the context of financial institutions, other state courts faced with the question of economic nexus have also answered the question differently from the Tennessee Appeals Court in J.C. Penney National Bank.164 For example, the New Jersey Supreme Court recently affirmed a Superior Court holding that application of corporate income tax to a taxpayer with no physical presence within the state did not violate the Commerce Clause.165

Where a taxpayer has intangible property within the state, several courts have upheld application of franchise taxes despite a lack of physical presence. For example, the North Carolina Court of Appeals found sufficient nexus for assessment of corporate franchise and income taxes against non-domiciliary subsidiaries of The Limited, Inc. (a retail sales company with nine stores in North Carolina).166 The Limited incorporated the subsidiaries (“taxpayers”) in Delaware as trademark-holding companies; the taxpayers had no physical presence within the state. The court reasoned that the presence of intangible property was sufficient to establish sufficient nexus for income and franchise tax, distinguishing the taxes in Quill as based on “the

161. See id. at 839.
163. See id. at *6 (basing a finding of substantial nexus on substantial revenue generated from state residents, the extension of credit to state residents, and the state’s provision of banking and consumer credit laws).
164. Before Quill was decided, the Alabama Supreme Court considered the issue of whether the state’s financial institution excise tax applied to the national banks located outside Alabama that extended credit to state residents but had no physical presence in the state. See Siegelman v. Chase Manhattan Bank, 575 So. 2d 1041 (Ala. 1991). As a matter of statutory interpretation, however, the court concluded that because the state tax was enacted when federal law prohibited taxation of out-of-state banks, the tax did not extend to out-of-state banks. Id. at 1051.
vendor’s activities in the state,” as opposed to the use of intangible property by the taxpayer’s licensees.167

Similarly, the South Carolina Supreme Court found sufficient nexus over Geoffrey, Inc., a foreign corporation with no physical presence in the state.168 Because Geoffrey licensed its trademark to Toys “R” Us stores within the state, the court found that Geoffrey had intangible property with taxable situs within the state, and found sufficient presence to meet the dormant Commerce Clause substantial nexus requirement.169 Both Geoffrey and A&F Trademark are important for the substantial nexus analysis as applied to financial institutions. Regardless whether credit card receivables would acquire taxable situs in the debtor’s state sufficient to qualify as intangible property, Geoffrey and A&F are significant in their refusal to limit the application of state corporate income and franchise taxes to out-of-state entities based on a bright-line physical presence test.

In the end, however, state courts are split between those accepting broader theories of state taxing jurisdiction, following Geoffrey and A&F Trademark, and those following the Tennessee Court of Appeals in J.C. Penney, maintaining a strict physical presence requirement in all contexts.170 This split, coupled with the Supreme Court’s failure to consider whether income taxes based on economic nexus violate the dormant Commerce Clause, places the constitutionality of economic nexus as applied to all corporations in doubt.

Despite this uncertainty, the dormant Commerce Clause as applied to financial institution taxes is slightly different from its application in the general corporate tax arena. The dormant Commerce Clause applies where Congress has not acted. If § 548 authorizes the power to levy taxes based on economic nexus, states should arguably be immune from dormant Commerce Clause challenges against these taxes as applied to national banks. The legislative history of the statute demonstrates that Congress considered limiting “doing

167. Id. at 195.
169. Id. at 18.
business” taxes on out-of-state banks. Instead, Congress allowed the permanent amendment to take effect, authorizing “doing business” taxes against national banks through its removal of the prohibition. Though courts may be reluctant to read authorization of taxing of power into congressional silence, particularly in the context of the dormant Commerce Clause, § 548 is not a typical case of congressional silence. Although the statute in its current form does not explicitly authorize taxes based on economic nexus, the history of the statute and its removal of restrictions carry perhaps some degree of implicit congressional endorsement of deference to the States in such matters. To be sure, one must be circumspect in asserting what was foreseeable to Congress back in the last 1960s when § 548 was enacted. At that time, the States had not imposed doing-business taxes of the sort at issue here. It is, moreover, unlikely that many in Congress at the time could have envisioned the modern credit market or the innovations in the securitization of mortgages. It is undeniable, however, that Congress was aware of the problem of inter-state lending, and was informed by a Federal Reserve Board study in 1975 that 29% of all loans made by Federal Reserve Board member banks were extended to out-of-state borrowers. As discussed earlier, the courts have traditionally been deferential to states in their adoption of taxes under grants of congressional authority such as § 548. Arguably, the considerations that counsel for that deference also justify relaxation of the strictures of the dormant Commerce Clause to accommodate fiscal experimentation of state taxes to reaching out-of-state banks that increasingly dominate our national lending markets.

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171. See supra notes 136–37 and accompanying text.
173. One slight complexity of the line of argument suggested in the text: even if § 548 could be construed to entail implicit congressional authorization of economic nexus as applied to national banks, the dormant Commerce Clause might still apply to out-of-state state banks. This imbalance would be untenable, given that § 548 requires that national banks be taxed in the same manner as state banks domiciled in the same state. Accordingly, to remain faithful with the logic of the statute, the implicit congressional authorization of economic nexus taxes in § 548 would also have to extend to out-of-state state banks and other out-of-state lenders.
C. Constitutional Challenges to the Model Act

In examining Due Process Clause and Commerce Clause challenges, courts will examine the structure of the financing provisions of the Model Act. To whom do the financing provisions apply? What threshold of activity does the Act require before imposing the tax? In the case of the Model Act, the proposed tax applies to income of entities "doing business" in the state. "[D]oing business" is defined as having physical presence within the state, or having established an economic nexus with the State of Ames, including but not limited to actively engaging (whether directly, through its affiliates, or through other parties) in any transaction for the purpose of financial or pecuniary gain or profit. To the extent that these financing provisions would sometimes be based solely on an economic nexus theory, the Act would likely face constitutional challenge. Given the looser standard for Due Process Clause than dormant Commerce Clause challenges under Quill, a tax based on economic nexus would likely survive a Due Process challenge, as any creditor reaching into a state and relying on its laws for enforcement of credit obligations will likely meet the purposeful availed test.

As indicated above, it is less clear whether the tax using economic nexus would survive a dormant Commerce Clause challenge. That the tax is imposed on income makes it more likely to survive such a challenge, given settled expectations around the imposition of income-based taxes have not developed as they did for sales tax. In addition, that the Model Act’s financing provisions are comparable to a limited-purpose franchise tax and that forty-six jurisdictions impose franchise taxes suggest that it would be less burdensome to allow such taxes to apply to out-of-state institutions than it would be to extend sales taxes, which can be imposed by over six thousand jurisdictions. Moreover, to the extent that ease of administration reduces dormant Commerce Clause concerns, the simple structure of the Model Act’s financing provisions would increase the likelihood that the Act’s application to all out-of-state banks would withstand constitutional chal-

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174. See infra Appendix, Model Act § 3(c)(2).
175. See supra note 129 and accompanying text.
176. See Quill Corp. v. North Dakota, 504 U.S. 298, 313 n.6 (1992) (noting the more than six thousand jurisdictions that impose sales tax).
While there is support for an economic nexus test as a matter of public policy and in some state court rulings as well as additional grounds for accepting economic nexus for a state tax expressly authorized by Congress under § 548, the ultimate constitutionality of economic nexus for income taxes on out-of-state entities with local physical presence remains unsettled. Conceivably, practical differences between credit card and mortgage lending markets may make it easier for courts to accept economic nexus as a jurisdictional basis in one case rather than the other. In particular, with mortgage lending, where lenders must obtain local security for each loan (a property interest of sorts), jurisdiction may more easily be found to satisfy constitutional standards. Of course, foreclosure and debt collection procedures used by credit card lenders and their assignees also create fairly strong claims on state residents, again arguably rising to the level of a form of property interest. Still, it is possible that the economic nexus standard of the Act’s financing provisions may be constitutional in some but not all applications. In that case, the Model Act’s severability provision would call for the Act to be applied to the extent constitutionally permitted.178

In the end, however, it remains an unsettled question whether those applications of the Model Act’s financing provisions that depend on a theory of economic nexus standard would survive a dormant Commerce Clause challenge. In our view, the better result would be for the courts to resolve the issue in favor of the economic nexus theory at least in the context of out-of-state financial institutions that systematically and self-consciously develop national distribution systems for their financial products, interact extensively with state residents and state legal institutions from marketing through servicing and collection or foreclosure, and impose substantial costs on state residents and state governments when some borrowers enter into financing transactions that they do not fully understand and that may not be appropriate to their circumstances. This remains, however, an issue that the courts must ultimately resolve.

177. See text accompanying note 120 (discussing administrability issues in considering whether the Model Act imposed an impermissible burden on national banks).
178. See infra Appendix, Model Act § 7.
IV. CONCLUSION

A state-sponsored consumer education program financed through a targeted levy on certain loans could be a valuable tool for dealing with the serious problems that many borrowers face in understanding loan terms and obtaining the most appropriate kinds of credits. If carefully structured along the lines of our Model Act, such legislation would, in our view, be consistent with the taxing authority granted to the States under § 548. Ideally, the financing provisions of such a state-sponsored education program should reach all lenders extending certain loans to state residents, and states should consider tying the financing provisions of such legislation to an economic nexus test. While the constitutional status of an economic nexus for state income taxes has yet to be resolved, there are strong reasons to hope and believe that the Supreme Court will endorse this approach for financing provisions of the sort included in the Model Act.

APPENDIX: A MODEL ACT FOR THE PROVISION AND PUBLIC FINANCING OF CONSUMER FINANCIAL EDUCATION

THE PEOPLE OF THE STATE OF AMES DO ENACT AS FOLLOWS:

SECTION 1. Short Title.

This Act shall be known and may be cited as the Ames Act for the Provision and Public Financing of Consumer Financial Education

SEC. 2. Findings.

The Legislature finds and declares all of the following:

(a) The Legislature has determined that many residents of the State of Ames lack sufficient financial education to understand and compare the terms of many financial products and that, as a result of this lack of education, consumers sometimes enter into financial transactions that they do not adequately understand, that may be less advantageous than other products available in the marketplace, and that may, in some circumstances, cause consumers to suffer unnecessary and unwarranted financial distress, including foreclosures and personal bankruptcies.
(b) The Legislature has further determined that the lack of consumer financial education and the associated problems noted in Declaration (A) are imposing significant costs—both emotional and financial—on state residents, local communities, and the government of the State of Ames.

(c) The Legislature has further determined that it would be in the best interest of the State of Ames to undertake a consumer education program to educate all residents of the state about basic principles of consumer finance and about practical strategies for comparing financial services of different providers, finding the most advantageous products, and avoiding financial transactions that may expose consumers to foreclosure, bankruptcy, or other forms of financial distress.

(d) Finally, the Legislature has determined that the most equitable and efficacious manner in which to finance the costs of this new education program is to impose a modest tax on banks and financial corporations that lend to state residents on terms that create a need for additional consumer education, and has further determined that proceeds from this tax should be used exclusively to promote consumer financial education as provided by this Act.

SEC. 3. Definitions.

(a) For purposes of this Act, “credit card” means a credit card as defined in the Civil Code Section ____.

(b) For purposes of this Act, “home loan” means a home loan as defined in Civil Code Section ____.

(c) For purposes of this Act, a “bank or a financial corporation” means a bank, a financial corporation, or a corporation that:

(1) is primarily engaged in the business of banking or financing; and

(2) is doing business in this state in that the entity—

(A) has a physical presence within the State of Ames; or

(B) directly, through its affiliates, or through other parties has established an economic nexus with the State of Ames, including but not limited to, actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.

Consistent with the foregoing Declarations, the Ames State Banking Department and the Ames State Department of Education are jointly authorized and instructed to form a Task Force to develop a program to improve the financial literacy of the residents of the State of Ames. The contents of the program shall be left to the discretion of these agencies acting in a manner consistent with the foregoing Declarations, and may include, but are not limited to, the development and publication of printed and internet-based educational materials, the development of teaching materials for school use, the distribution of information about other sources of financial information and of software of use to consumers, and the support of consumer advocacy efforts consistent with the purposes of this Act. The task force shall also be charged with reporting back to the Legislature within five years of the enactment of this Act and presenting a report regarding the success of the program and its impact on the residents of the state of Ames.

SEC. 5. Taxation of Certain Loans.

The following Section is added to the Revenue and Taxation Code, to read:

(a) For each taxable year beginning on or after the date of passage of this Act, an annual tax is hereby imposed on every qualifying bank or financial corporation, as defined in section 3(c) of this Act, to be assessed on the interest income from loans as identified in section (b) below at a rate of 1.5 basis points on (that is, 0.015% of) the total annual interest income on those loans. When an entity is found to satisfy all the criteria for the tax, the tax shall be imposed on the interest income only from those loans that are identified in subsection (b) below.

(b) The tax shall be imposed on total annual interest income on the following loans:

(1) balances due on credit cards that—

(A) are issued to state resident(s) (a billing address located within the state shall create a presumption of residency—this presumption may be overridden where the issuer has reason to know that the account holder is not a state resident); and

(B) include a provision in its credit card agreement that allows for an increase of the interest rate, after the credit card has
been issued, as a result of borrowers’ late payment to a different creditor; or

(2) consumer loans secured by the customer’s principal dwelling (other than a reverse mortgage) where the dwelling is located in the state and, where in the case of a loan secured—

(A) by a first mortgage on the consumer’s principal dwelling, the annual percentage rate at consummation of the transaction will exceed by more than 8 percentage points the yield on Treasury securities having comparable periods of maturity on the 15th day of the month before the month in which the application for the extension of credit is received by the creditor; or

(B) by a subordinate or junior mortgage on the consumer’s principal dwelling, the annual percentage rate at consummation of the transaction will exceed by more than 10 percentage points the yield on Treasury securities having comparable periods of maturity on the 15th day of the month before the month in which the application for the extension of credit is received by the creditor; or

(C) the total points and fees payable in connection with the loan exceed—

(i) in the case of a loan for $20,000 or more, 5 percent of the total loan amount; or

(ii) in the case of a loan for less than $20,000, the lesser of 8 percent of the total loan amount or $1,000; or

(iii) the loan documents permit the creditor to charge or collect prepayment fees or penalties more than 30 months after the loan closing; or

(iv) such prepayment fees or penalties exceed, in the aggregate, more than 2 percent of the amount prepaid.

SEC. 6. Effective Date and Publication.

This act provides for a tax levy and shall take effect immediately upon the enactment of this Act. To ensure the transparency of this levy, the Ames State Banking Commission shall from time to time publish a list of financial institutions subject to this levy, and the classes of loans on which the levy has been assessed.
SEC. 7. Severability.

If any provision of this Act or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this Act that can be given effect without the invalid provision or application, and to this end the provisions of this Act are declared to be severable.