

Federal Taxation of Financial Institutions

By Margaret E. Bedford

Taxation of financial institutions promises to be a major topic of discussion this year and next as Congress considers a number of tax reforms and proposals to restructure the nation's financial system. Proposals to reduce or eliminate various tax shelters are likely to receive particular attention in view of the continuing large deficits of the U.S. Treasury. Financial institutions like other tax-paying groups can benefit from legalized tax shelters. Some of the tax shelters utilized by financial institutions include the exclusion from taxable income of interest on state and local securities, deductions for bad debt or loan loss reserves, and tax credits to reduce total tax liabilities such as the investment and foreign tax credits.

Tax reform also is likely to be of considerable interest within the financial community itself, particularly for those depository institutions that feel they bear a high tax burden relative to other depository institutions. In the early 1960's, for example, commercial banks argued for tax reform since their income taxes averaged 34 per cent of net income while most thrift institutions paid little or no Federal

income taxes.¹ Since 1962, however, **commercial** banks have reduced their effective tax rates substantially. In contrast, the tax burden of thrift institutions has risen sharply. Consequently, thrift groups recently have been critical of the current tax laws.

This article examines the upward trend in the Federal income tax burden of savings and loan associations and mutual savings banks since 1962. The article also discusses the major

¹ Throughout this article, the tax burden, or effective tax rate, of financial institutions is measured by dividing Federal income taxes by net income which is equivalent to profits before taxes. It is not taxable income, but rather includes such items as interest earned on state and local government obligations, net long-term capital gains, etc. Possible biases may occur in these ratios due to the timing of gains or losses, changes in depreciation methods, differences in amounts of tax liabilities actually paid and tax estimates reported to financial regulatory agencies, etc., but the relationships of these ratios among groups of institutions are not likely to be altered. Ratios for commercial banks and mutual savings banks were computed from call and income report data reported to the F.D.I.C. by insured institutions. Ratios for savings and loan associations were computed from figures published by the Federal Home Loan Bank Board in *Combined Financial Statements*.

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tax shelters utilized by these institutions. The use of tax shelters by commercial banks and the resulting drop in their Federal income tax burden was examined in a previous article in this *Review*.² Finally, the tax burdens of thrift institutions and commercial banks are compared and reasons are given for differences in their tax burdens.

FEDERAL INCOME TAXATION OF THRIFT INSTITUTIONS

Savings and loan associations and mutual savings banks first became subject to the Federal corporate income tax laws in 1952. In general, the base for taxable corporate income represents income from operating transactions, such as interest on loans and securities, etc., less allowable operating expenses, such as salaries, wages, and interest paid on savings accounts, etc. This figure is then adjusted to make allowance for net loan losses or recoveries, net securities gains or losses, loss carryover and carryback provisions, and other modifications to income. Special tax provisions applying to thrift institutions were also instituted in 1952. The most notable of the special provisions were the treatment of gains and losses on securities transactions—which also applied to commercial banks—and the treatment of additions to bad debt reserves for losses on loans.

Federal Tax Burden

Although thrift institutions became subject to Federal corporate income tax laws in 1952, their actual tax burden was quite small over the next decade. (See Chart 1.) Contributing to their modest tax burden were the liberal provisions regarding transfers to bad debt reserves. Specifically, thrift institutions were not subject to a tax liability on additions to bad debt reserves until these reserve funds reached

² See Margaret E. Bedford, "Income Taxation of Commercial Banks," *Monthly Review*, Federal Reserve Bank of Kansas City, July-August 1975, pp. 3-11.

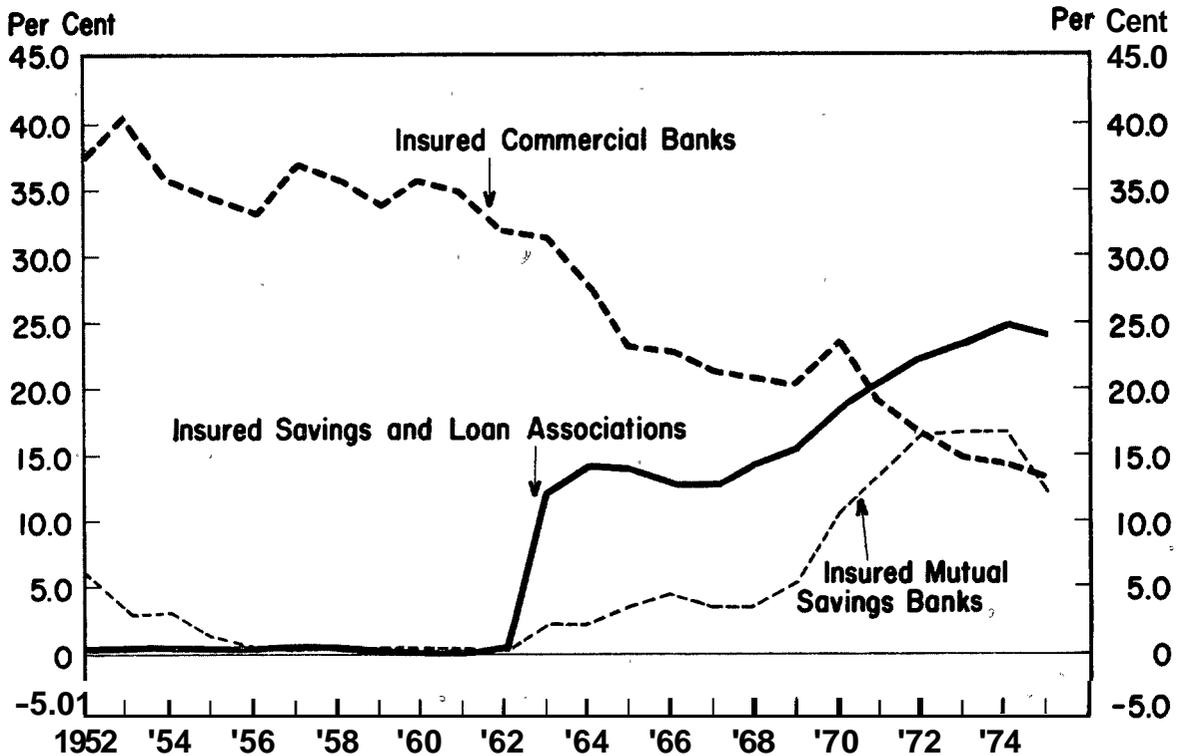
12 per cent of their total savings account balances. Reflecting these provisions, insured savings and loan associations in 1962 paid out only \$3.1 million in Federal taxes, or 0.4 per cent of net income, while maintaining reserves and undivided profits of \$6.1 billion. Insured mutual savings banks in 1962 paid \$0.5 million, or 0.2 per cent of net income, in Federal income taxes and carried reserves, surplus, and undivided profits accounts of \$3.3 billion.

Realizing that allowable tax-free transfers to reserves were unnecessarily large, Congress revised the tax laws under the Revenue Act of 1962. **As** a result, taxes paid by savings and loan associations rose to \$93.1 million in 1963 and their tax burden rose sharply to 12.2 per cent. The effective tax rate paid by mutual savings banks showed a much milder increase to 2.0 per cent as their tax payments rose to \$3.4 million. Corporate tax rates were reduced in 1963, but no other major tax changes affecting thrift institutions occurred between 1963 and 1968. During this period, though, the tax burdens for both savings and loan associations and mutual savings banks rose moderately.

Under the Revenue Act of 1969, substantial revisions were made in the tax laws governing financial institutions. These revisions included changes in the treatment of net long-term capital gains, provisions to further restrict additions to bad debt reserves, and the application of a minimum tax on those additions as well as on other items of preference income. A surtax also was levied on all taxable income in 1968, 1969, and the first half of 1970, and tax rates on net long-term capital gains on securities were raised beginning in 1969. The Tax Reduction Act of 1975 lowered corporate tax rates on income less than \$50,000 for 1975 and 1976.

As a result of the 1969 changes in the tax structure, thrift institutions experienced a significant increase in their tax burdens. The

Chart 1
FEDERAL INCOME TAXES AS A PER CENT OF NET INCOME



effective tax rate for savings and loan associations rose from 14.4 per cent in 1968 to 24.8 per cent in 1974, and the tax burden of mutual savings banks increased from 3.3 per cent to 16.9 per cent over the same period. However, the decline in corporate tax rates in 1975 resulted in a slight reduction in tax burdens. The effective tax rate for savings and loan associations in 1975 was 24.0 per cent and for mutual savings banks 12.4 per cent. In 1975, savings and loan associations paid \$0.5 billion in Federal taxes and mutuals paid \$67 million. With the erosion of traditional tax shelters and the rise in effective tax rates, thrift institutions sought new avenues of reducing taxable income and holding down their rising tax burdens.

TAX SHELTERS OF THRIFT INSTITUTIONS

Tax shelters are legal methods of using tax accounting rules or intended tax incentives to obtain an immediate reduction in tax payments. Financial institutions use a number of these methods to reduce their tax liabilities. Tax benefits result from sheltering income through tax-free additions to reserves for future losses on loans, earning interest on tax-exempt municipal securities, and managing capital gains and losses to obtain maximum tax advantages. Tax reductions can also be realized by deferring tax payments to future periods through such methods as accelerated

Table 1
SELECTED TAX ADVANTAGES FOR MAJOR FINANCIAL INSTITUTIONS, 1973

Deductions From Income	In Thousands of Dollars	Estimated † Increase in Tax Burden Without Tax Provision (Per Cent)	Credits or Additional Taxes	In Thousands of Dollars	Estimated † Increase in Tax Burden Without Tax Provision (Per Cent)
Interest on state and local securities			Investment tax credit		
Savings and loan associations	16,892	0.3	Savings and loan associations	4,992	0.2
Mutual savings banks	52,982	3.3	Mutual savings banks	2,083	0.3
Commercial banks	3,862,232	20.8	Commercial banks	99,616	1.1
Bad debt losses on loans*			Foreign tax credit		
Savings and loan associations	699,456	12.6	Savings and loan associations	0	0.0
Mutual savings banks	155,451	9.7	Mutual savings banks	78	0.0
Commercial banks	856,908	4.6	Commercial banks	343,809	3.9
Gross depreciation ‡			Minimum tax on preference items		
Savings and loan associations	166,918	3.0	Savings and loan associations	44,479	-1.7
Mutual savings banks	61,429	3.8	Mutual savings banks	19,267	-2.5
Commercial banks	1,681,793	9.0	Commercial banks	9,087	-0.1

*Bad debts for savings and loan associations and mutual savings banks were estimated from changes in reserve accounts and thus may reflect changes in reserves for reasons other than transfers to loan loss reserves.

†Depreciation deductions cannot be separated between normal depreciation for ordinary bank assets and accelerated depreciation nor can depreciation on leased assets be determined.

‡The calculation of the percentage increase in taxes assumes a marginal tax rate of 48 per cent applicable to all institutions. Insofar as some banks would have been subject to lower tax rates, the tax benefits shown would be overestimates.

depreciation. In addition, tax payments may be reduced by utilizing tax credits such as the investment and foreign tax credits. Such credits result in a dollar-for-dollar reduction in taxes since they are deducted directly from the amount of tax payable, rather than from net income before the tax rate is applied.

The relative importance of several tax shelters to financial institutions in 1973 is shown in Table 1. As can be seen, thrift institutions realized the largest tax benefits from transfers to bad debt reserves, while commercial banks utilized tax-free interest on municipal securities as their major tax shelter. Gross depreciation resulted in a significant tax saving for all financial institutions, but the amount of sheltered income is not as large as the figures shown. Depreciation cannot be separated between that on assets used directly

in bank operations and that on leased assets nor can the amount of accelerated depreciation be ascertained from the available data. Depreciation on regular plant and equipment is an expense of doing business, while accelerated depreciation and depreciation realized through leasing operations reflect, at least in part, a tax shelter. The tax benefits from the investment and foreign tax credits were very small for thrift institutions but represented significant savings for commercial banks.

Transfers to Bad Debt Reserves. Thrift institutions, as well as other taxpayers, are allowed a deduction for bad debts in arriving at taxable income. This deduction may be calculated under the specific charge-off method or on the reserve method. The specific charge-off method allows institutions to deduct actual losses from, or add recoveries to, taxable

income in the year they occurred. Few thrift institutions use this method, however, because the reserve method generally provides greater tax savings. Under the reserve method, losses are charged against a reserve account rather than income and recoveries are credited to the reserve. Thrifts are able to make a reasonable addition to these reserve accounts for future losses on loans, and the net amount transferred is a deduction from taxable income. Tax codes specify the meaning of "reasonable" additions for thrift institutions, and these definitions have changed over time.

From **1952 to 1962**, tax provisions regarding allowable transfers to bad debt reserves were so lenient that savings and loan associations and mutual savings banks paid very little Federal income taxes. The definition of reasonable additions to reserves, however, was changed in **1962** and again in **1969**. These changes resulted in significant increases in the taxes paid by thrift institutions.

Table 2 shows the allowable methods of calculating reserve additions under the Revenue Act of **1962** and the Tax Reform Act of **1969**. In general, thrift institutions have been allowed to make additions to a reserve on qualifying loans and to a reserve on nonqualifying loans. Qualifying loans pertain to loans secured by improved real property, mobile homes, etc., while nonqualifying loans are unsecured or other than qualifying loans. Tax-free transfers to the qualifying loan reserve can be computed under one of three options—the percentage of income method, the experience method, or the bank percentage method. Reserve additions for nonqualifying loans must be based on the loss experience for recent years. Of the three methods available, the percentage of income method is used by the majority of savings and loan associations, while the bank percentage method is the second most frequently used.³

The percentage of income method allows an institution to transfer a portion of taxable income to reserves. Under this method, from

1962 to 1969, an institution could transfer up to **60** per cent of its taxable income to the tax-free reserve. The Tax Reform Act of **1969**, however, reduced this percentage to **40** per cent over a 10-year phase-in period. The allowable percentage fell by **3** per cent per year from **1970 to 1972**, by **2** per cent from **1973 to 1976**, and will be reduced by 1 per cent from **1977 to 1979**, and remain at **40** per cent thereafter.

The experience method allows an institution to deduct an amount based on actual losses in recent years. The amount is also related to the volume of qualifying loans outstanding at the end of the year. More specifically, the experience method allows a deduction equal to the volume of loans outstanding at the end of the year times a certain percentage. The percentage is based on the ratio of losses on loans for the most recent **6** years to the amount of loans outstanding at the end of those years. Prior to **1969**, the provision was more liberal in that the number of years used to calculate the percentage was equal to the average life of the institution's qualifying loans.

The bank percentage method, also known as the percentage of loans method, allows an addition to reserves in an amount necessary to bring the total reserve up to a specified percentage of qualifying loans. This percentage was **1.8** per cent in **1969-75**, will be **1.2** per cent in **1976-81**, **0.6** per cent in **1982-87**, and will be the percentage computed under the experience method after **1987**. Prior to **1969**, thrift institutions were allowed to transfer an amount necessary to increase the reserve to **3** per cent of qualifying loans outstanding at the end of the year.

To be eligible for these bad debt reserve deductions, an institution must meet certain criteria. Basically, an institution's business has

³ Edward J. Kane and John S. Valentine, "Income-Tax Payments by Savings-and-Loan Associations Before and After the Tax Reform Act of 1969," Working Paper No. 45, Office of Economic Research, Federal Home Loan Bank Board, October 1973.

Table 2
METHODS OF COMPUTING TAX
DEDUCTIBLE ADDITIONS TO BAD DEBT
RESERVES OF THRIFT INSTITUTIONS

Revenue Act of 1962—October 16, 1962. to July 12, 1969

I. Savings and Loan Associations

A. Reserve additions for nonqualifying loans (all loans other than qualifying loans below)

1. Experience method—allows a maximum addition of

$$\left(\frac{\text{sum of losses on unsecured loans for a number of years}^*}{\text{sum of nonqualifying loans at the end of each year}} \right) \times \left(\begin{array}{l} \text{nonqualifying loans} \\ \text{at the end of the} \\ \text{current year} \end{array} \right)$$

*The number of years used is equal to the average life of the institution's nonqualifying loans.

B. Reserve additions for qualifying loans (loans secured by an interest in improved real property or by an interest in real property which is to be improved out of the proceeds of the loan)

1. Experience method—same as A above using qualifying loans

2. Percentage of income method—allows a maximum addition of 60 per cent of taxable income† less the amount transferred in A above.

Limitations:

- a) A net operating loss cannot be created by the deduction
- b) The reserve cannot exceed 6 per cent of qualifying loans outstanding at the end of the year.
- c) The reserve addition cannot exceed 12 per cent of the difference between total deposits at the close of the year and surplus, undivided profits, and reserves at the beginning of the year.
- d) The association must primarily engage in acquiring savings of the public and investing in certain loans. Most notably this required that at least 82 per cent of an institution's total assets be represented by residential mortgages, cash, government securities, and passbook loans.

3. Percentage of real property loans method — allows a maximum transfer of the amount necessary to increase the reserve to 3 per cent of such loans outstanding at the close of the year.‡

Limitations: See c and d under B2 above.

II. Mutual Savings Banks—same as for I above except under B2, limitation d, 72 per cent of an institution's investments had to be in the specified categories.

† Taxable income is computed before any net operating loss carryback and deductions for bad debts, charitable contributions, and certain other items.

‡ Noncapital stock companies in operation less than 10 years were allowed an additional amount

§ Taxable income is computed before the deduction for bad debt reserve additions and by excluding from gross income net gains from the sale of certain stocks and bonds, 3/8 of net long-term capital gains, dividends, and some other items of income. The portion of the nonqualifying reserve addition that must be deducted is equal to the ratio of 18 per cent (28 per cent for a mutual savings bank) to the percentage of assets in nonspecified categories

to consist of acquiring savings of the public and investing them in certain loans and assets within specified limits. Most notably, the latter restriction requires that at least 82 per cent of a savings and loan association's investments and 72 per cent for a mutual savings bank be in residential mortgages, cash, government

securities, and passbook loans. Under the 1969 Tax Reform Act, this rule was relaxed somewhat and allowed an institution not meeting the full asset requirements to deduct a portion of taxable income according to a sliding scale. That is, the percentage of taxable income deductible declines as the percentage of assets

Table 2
METHODS OF COMPUTING TAX
DEDUCTIBLE ADDITIONS TO BAD DEBT
RESERVES OF THRIFT INSTITUTIONS

Tax Reform Act of 1969—after July 12, 1969

III. Savings and Loan Associations

A. Reserve additions for nonqualifying loans

1. Experience method—allows a maximum addition of

$$\left(\frac{\text{sum of losses on nonqualifying loans in the most current 6 years}}{\text{sum of unsecured loans outstanding at the end of each year}} \right) \times \left(\frac{\text{nonqualifying loans at the end of the current year}}{\text{at the end of the current year}} \right)$$

B. Reserve additions for qualifying loans (loans secured by real property, mobile homes, urban renewal, and certain other loans)

1. Experience method—same as A above using qualifying loans.
 2. Percentage of income method—allows a maximum addition of the applicable percentage of taxable income less the amount transferred in A above⁵ where the applicable percentage is:

60% in 1969	49% in 1973	42% in 1977
57% in 1970	47% in 1974	41% in 1978
54% in 1971	45% in 1975	40% in 1979 and thereafter
51% in 1972	43% in 1976	

Limitations:

- a) See IB2a, b, and c.
 b) An institution had to meet the requirements of IB2d, but the percentage of income deductible would be reduced by $\frac{1}{3}$ of 1 per cent for each percentage that qualifying assets fell below 82 per cent. Qualifying assets cannot fall below 60 per cent of total assets.
 3. Bank percentage or percentage of qualifying loans method—allows a maximum addition of an amount necessary to increase the reserve at the end of the year to the applicable percentage of eligible loans outstanding at the end of the year less the amount transferred in A above, where the applicable percentage is:

1.8% in 1969-75	0.6% in 1982-87
1.2% in 1976-81	The percentage computed under the experience method from 1988 and thereafter.

Limitations: See IB2c.

- IV. Mutual Savings Banks—same as III above except under B2, limitation b, the percentage of income deduction is reduced by 1.5 per cent for each 1 per cent difference between 72 per cent of total assets and assets held in the specified categories. The specified assets must be at least 50 per cent of total assets before 1973 and 60 per cent after 1973 to use the percentage of income method.

in the specified categories declines. However, a thrift institution holding less than 60 per cent of assets in the specified categories is ineligible for the percentage of income method.

Reflecting the tax changes made in 1962, bad debt reserve deductions taken by savings and loan associations fell by nearly one-third

from 1962 to 1963. As a result, the effective tax rate of savings and loans rose from 0.4 per cent to 12.2 per cent. After the 1969 tax revision, the bad debt reserves of savings and loans posted an increase in dollar terms, but fell substantially as a per cent of taxable income. As a result, the effective tax rate in 1971 was

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about 10 percentage points higher than would have prevailed under the provisions prior to 1969.

In addition to the changes in the computation of bad debt reserves for financial institutions, the Tax Reform Act of 1969 instituted a minimum tax on preference items of income. Tax preferences include accelerated depreciation on real property and personal property subject to a net lease, amortization of certain facilities, stock options, depletion, capital gains, and reserves for losses on bad debts of financial institutions. These items are subject to a second round of taxation at a flat rate of 10 per cent after an exclusion of \$30,000 plus all Federal taxes paid during the year. The imposition of this tax was important to financial institutions because of their large reserves for losses on bad debts. The minimum tax rate applies to the amount by which the "reasonable" addition to the reserve for the taxable year exceeds the amount that would have been allowed if the institution had used the experience method. Excess bad debt reserves account for nearly all of thrifts' preference items. For the 1970-73 period, this second round of taxation on preference income raised the effective tax rates of savings and loan associations about 2 percentage points.

The continuing erosion of tax-free additions to bad debt reserves and the imposition of the tax on preference items contributed greatly to the upward trend of thrift institutions' effective tax rates. However, the sliding scale provision for using the percentage of income method allows institutions to diversify their assets to utilize other tax shelters while still obtaining a significant benefit from the bad debt deduction. For example, when the full reduction in the allowable percentage of taxable income has taken place in 1979, an institution maintaining only the minimum level of qualifying assets, 60 per cent, could still shelter nearly one-fourth of its taxable income through transfers to bad debt reserves.

Other Tax Shelters. The decline in the tax advantages obtained by transferring funds to bad debt reserves and the imposition of the minimum tax on those reserve additions have encouraged thrift institutions to seek other methods of tax reductions.

One approach open to thrift institutions has been to increase their holdings of tax-exempt state and local securities. Holdings of these assets, however, represent only a small portion of the asset portfolios of thrift institutions. In 1975, state and local securities accounted for less than 1.5 per cent of the total assets for both savings and loans and mutual savings banks. In many cases municipal securities are held only to help satisfy regulatory liquidity requirements. Nonetheless, tax-free income from state and local obligations can be a significant aid in reducing taxable income, particularly for large institutions. For institutions in the highest tax bracket, there is generally a greater after-tax return from tax-exempt securities even though the pretax return may be considerably lower than on taxable securities. Smaller institutions, though, may find it more advantageous to invest in higher yielding taxable securities, particularly when costs of selling securities are considered.

Another tax advantage for thrift institutions can arise from securities transactions. In 1952, thrift institutions were granted the same tax advantages as commercial banks with regard to the sale or exchange of securities. Financial institutions were allowed to treat net long-term gains on sales of securities as capital gains while treating net long-term losses as ordinary deductions from income. Thus, if an institution in the highest tax bracket alternated years of taking gains and losses, its gains would be taxed at the lower capital gains rate of 25 per cent and about half of its losses would be absorbed by the Internal Revenue Service. The Tax Reform Act of 1969 required that thrift institutions treat both gains and losses on securities and mortgage sales as ordinary

income and thus reduced the benefits from alternating years of gains and losses, although it did not entirely eliminate those benefits.

Prior to 1969, thrift institutions obtained another benefit from securities transactions. Long-term capital gains were included in taxable income when using the 60 per cent of taxable income deduction for computing bad debt reserves. Thus, long-term gains increased the bad debt deduction when reserves were below ceiling levels. In many cases, this reduction in taxes more than offset the increase in taxes from the 25 per cent rate applied to the net long-term **capital gain**.⁴ Since 1969, the percentage of income method for computing bad debt reserves requires thrift institutions to exclude from taxable income a portion of net long-term capital gains for the taxable year. In addition, capital gains are considered a preference item and are therefore subject to the minimum tax rate. These changes in tax laws regarding security transactions further served to erode tax advantages of thrift institutions and contributed to the rise in their tax burdens.

Beginning in 1962, corporations were allowed to take a credit against taxes for investment in new equipment and machinery. The credit was equal to 7 per cent of the full amount of such investments.⁵ However, thrift institutions were limited to a credit on only 50 per cent of their qualifying investment up to a maximum of \$12,500 plus the applicable percentage over that amount. The investment tax credit was raised to 10 per cent for the period from January 22, 1975, through December 31, 1976,

⁴ *Federal Income Taxation of Banks and Financial Institutions*. Warren, Gorham, and Lamont, Inc., Boston, 1971.

⁵ The amount of the investment to which the credit applies is \$25,000 plus 25 per cent of all amounts over that (50 per cent for years after March 10, 1967). The investment tax credit has remained in effect except for two short periods of suspension from October 1966 to March 1967 and from April 1969 to December 1970. During the first period, \$20,000 of new investment was exempted from the suspension.

but thrift institutions still receive only half the credit. Thus, the investment tax credit has resulted in a smaller tax benefit to thrift institutions than to other **corporations**.⁶

The justification for thrifts' smaller investment tax credit allowance was that they were already given generous tax benefits under the special provisions for transfers to bad debt reserves. Thrift institutions also receive smaller investment credit benefits than commercial banks and other corporations because they do not engage directly in leasing activities which allow investment tax credits. Still, investment tax credit deductions may have encouraged thrift institutions to invest in expensive computer equipment and expand their electronic funds transfer operations rapidly in recent years.

Thrift institutions take almost no foreign tax credits. Savings and loan associations are not engaged in foreign activities or branching and only a small number of mutual savings banks operate in this area.

COMPARISON OF THE TAX BURDEN OF THRIFT INSTITUTIONS AND COMMERCIAL BANKS

As shown in Chart 1, the Federal tax burden for savings and loan associations and mutual savings banks has risen sharply since 1962, while the tax burden for commercial banks has declined. As a consequence, the tax burden in 1975 was 24.0 per cent for savings and loan associations, 12.4 per cent for mutual savings banks, and 13.5 per cent for commercial banks.

Differences in the tax laws for thrifts and commercial banks do not appear to be a prime

⁶ Thrift institutions can receive the full investment credit on purchases made by a service corporation or subsidiary. Service corporations have grown since 1970 when the Federal Home Loan Bank Board relaxed restrictions on their activities. Leasing activities of savings and loan associations are usually carried on through these subsidiaries.

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factor accounting for the differences in tax burdens at the present time. Available tax shelters are generally the same for thrift institutions and commercial banks, and tax laws regarding these shelters are similar in many ways for both groups.

One minor difference in the tax laws is in the treatment of bad debt deductions. From 1954 to 1964, commercial banks were permitted rather generous additions to bad debt reserves,⁷ as were thrift institutions in the 1952-62 period. Beginning in 1965, though, tax laws applying to banks were made more restrictive, with banks allowed to build up reserves equal to only 2.4 per cent of eligible loans outstanding or to use the experience method based on losses over the past 6 years. Under the 1969 Tax Reform Act, tax laws regarding bad debt reserves were equalized for thrift institutions and commercial banks, but thrifts meeting certain asset requirements could choose a percentage of income method which usually resulted in larger tax deductions.

Another minor difference in the tax laws for the two groups relates to the investment tax credit. Commercial banks are allowed the full investment credit, as are other corporations, while thrift institutions are allowed only half of the credit. Thus, differences in tax laws for the two groups are few and essentially minor. How, then, is it possible that commercial banks have reduced their tax burdens while effective tax rates paid by savings and loan associations and mutual savings banks have increased?

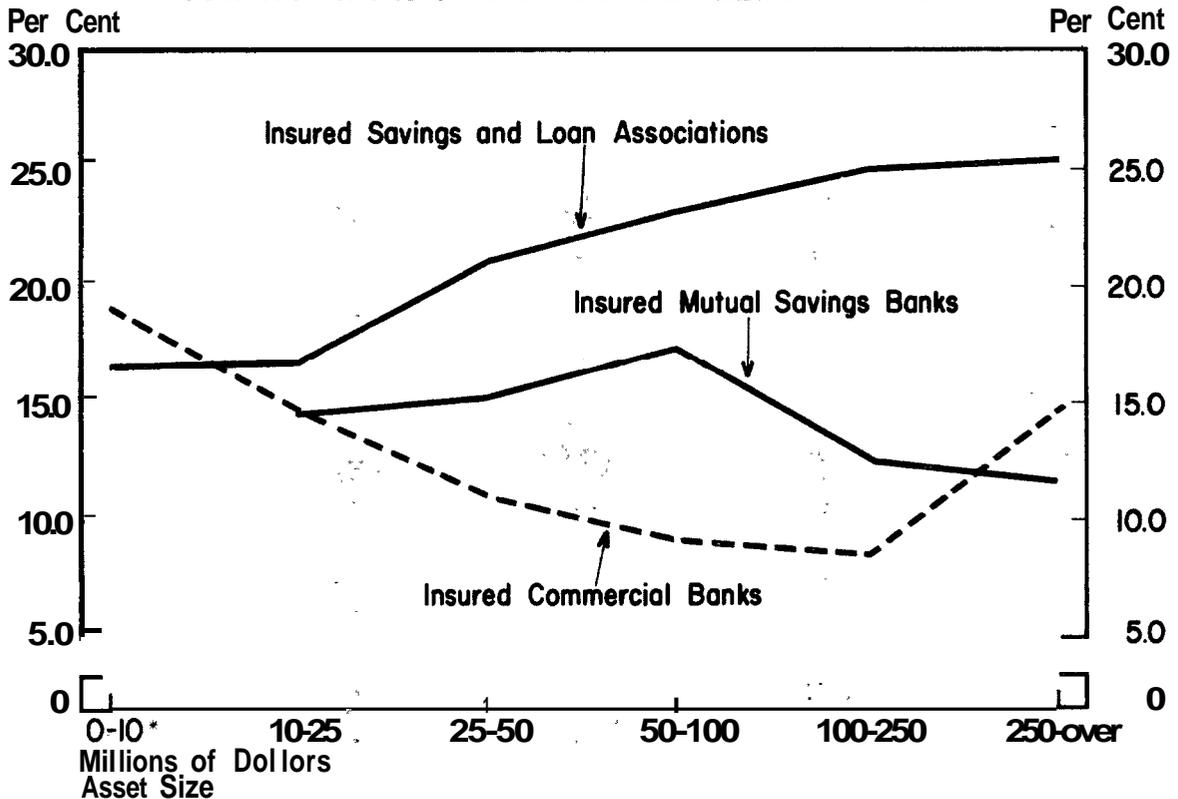
A principal reason for the marked difference in the trends in the tax burdens of thrifts and commercial banks relates to the ability of institutions to utilize available tax shelters. Generally speaking, the ability to utilize tax shelters is associated with the asset structure of

⁷ Loan losses were calculated by an experience method using a 20-year average. This average often included the Depression years of the 1930's when loan losses were historically high and resulted in bad debt deductions greatly in excess of banks' recent experience.

the institution and the flexibility it has to shift assets to capitalize on tax shelters or substitute new tax advantages for eroding shelters. Thrift institutions, for example, are primarily engaged in mortgage lending activities. Mortgage loans accounted for 82 per cent of savings and loan associations' total assets in 1975, while other loans and securities amounted to only 9.2 per cent of their portfolios. Mutual savings banks were somewhat more diversified with 64 per cent of their assets invested in mortgage loans and 31.6 per cent in other loans and securities. Thus, thrift institutions are largely limited to the use of tax shelters related to mortgage loans—at the present time only the bad debt reserve deduction is such a shelter. Commercial banks, however, held only 14.2 per cent of their assets in mortgage loans in 1975 with 42.4 per cent of their portfolio in other loans and 23.5 per cent in investment securities. Thus, commercial banks are able to utilize a number of the tax shelters available to financial institutions. In addition, laws other than tax codes can affect an institution's ability to use tax shelters. Regulations regarding involvement in foreign and leasing operations are more liberal for commercial banks than for thrift institutions, thus affording banks the opportunity for greater tax credits and tax-sheltered depreciation deductions.

To gain further insight into reasons for differences in effective tax rates among financial institutions, it is useful to examine relative tax burdens by size of institution. In 1970, for example, all size groups of savings and loan associations and mutual savings banks paid lower effective Federal tax rates than equivalent commercial bank size groups. By 1975, though, the picture had changed dramatically. As Chart 2 shows, savings and loan associations in all asset size categories except the smallest had a higher tax burden than commercial banks. In the case of mutual savings banks, a similar but slightly different picture emerges. Commercial banks had lower

Chart 2
COMPARATIVE 1975 TAX BURDENS BY SIZE OF INSTITUTION



*The smallest size category has been omitted for mutual savings banks since it contains only five institutions and data were distorted by the unusual behavior of one bank.

tax burdens than mutual savings banks with the exception of two asset size categories. Mutual savings banks with assets over \$250 million had a tax burden below that of commercial banks, while savings banks in the \$10-\$25 million asset category had a tax burden below commercial banks but the difference was negligible.

The lower tax burden for small thrift institutions points out the importance of the bad debt reserve deduction for these institutions vis-a-vis commercial banks. Small commercial banks, it has been found, tend to utilize few tax shelters. Moreover, many of these institutions use the specific charge-off

method of accounting for loan losses rather than the reserve method which provides greater tax reductions. Small commercial banks also are rarely engaged in foreign or leasing activities and the tax reductions obtained through securities swaps or investment in municipal securities are often minimal because of the banks' lower tax bracket. In contrast, small thrift institutions normally use the reserve method of accounting for loan losses and thus realize reductions in their tax burdens. Most of these smaller thrift institutions pay no minimum tax on their bad debt transfers because of the large exemption given on preference income. Thus, the bad debt reserve

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deduction is an important factor in allowing small thrift institutions to post lower tax burdens than small commercial banks.

As shown in Chart 2, larger savings and loan associations pay higher effective tax rates than similar sized commercial banks. For savings and loan associations, the tax burden generally increases with the size of institution. For commercial banks, in contrast, the tax burden declines as bank size increases up to the largest bank size.

The rise in the tax burden of savings and loan associations as size increases results partly from the progressive nature of the corporate tax structure and partly from the second round of taxation on preference income. The corporate tax rate in 1975 was 20 per cent on the first \$25,000 of taxable income, 22 per cent on income of \$25,000 to \$50,000, and 48 per cent on all income over \$50,000.⁸ Despite this progressive tax structure, however, the tax burden of savings and loans peaked in the \$50 to \$100 million range during the late 1960's, as larger institutions were more efficient in sheltering their income than smaller institutions. With the implementation of the minimum tax in 1969, though, the tax burdens also increased for the larger institutions. In 1971, the minimum tax on preference income raised the effective tax rate only 0.1 per cent for savings and loan associations with total assets less than \$10 million, but the tax burden was increased to 2.3 per cent for associations with over \$100 million in assets.

The general decline in the tax burden of commercial banks as size increases results from the relatively small impact of the minimum tax and the increasing ability to shelter income. The largest tax advantage for commercial banks is derived from investment in municipal securities and this interest income is not subject to the minimum tax. Also, as size increases,

banks have greater flexibility to shift to tax-sheltered activities and are better able to utilize accounting and tax experts to reduce tax liabilities. Not only have the larger banks been able to utilize the traditional tax shelters for financial institutions, but they have also adopted other tax savings programs such as accelerating depreciation, offering equipment leasing programs, taking investment and foreign tax credits, and benefiting from merger and holding company accounting rules. Although the effective tax rate of banks generally falls as bank size increases, banks in the largest asset size category experienced a slightly rising tax burden. This tendency appears to reflect the effects of the progressive corporate income tax structure and the fact that the largest banks held a smaller proportion of assets in municipal securities than did banks in other size groups.

As thrift institutions diversify their activities and as their size increases, they too can be expected to make greater use of available tax shelters. There is some evidence that this shift has already begun. In the 1971-74 period, when tax laws were not changed, the general rise in tax burdens tended to fall as size increased. Tax burdens rose 6.6 per cent for savings and loan associations with assets of \$10 to \$25 million but increased only 3.6 per cent for associations with assets over \$100 million. This pattern was interrupted in 1975 since the changes in corporate tax rates benefited medium-sized institutions more than larger institutions. The shift to the greater use of tax shelters other than bad debt reserve transfers has also taken place at mutual savings banks, particularly the larger ones. Mutual savings banks increased the percentage of interest-free income from municipal securities to net income before taxes from 2.7 per cent in 1971 to 13.9 per cent in 1975. This ratio rose even more rapidly at large mutuals, enabling them to reduce their tax burden below that paid by medium-sized mutual savings banks. Thus, tax

⁸ From 1965 to 1974, the corporate tax rate was 22 per cent on the first \$25,000 of taxable income and 48 per cent on income over \$25,000.

laws and the use of tax shelters can affect not only the share of the tax burden among varying types of institutions but also the tax burden among various size groups within the same type of institution.

SUMMARY AND CONCLUSION

Changes in tax laws, since 1962 have resulted in an erosion of the tax shelters available to thrift institutions and led to a sharp increase in their Federal tax burden. The tax burden for savings and loan associations was 24.0 per cent in 1975 and for mutual savings banks it was 12.4 per cent. Commercial banks, on the other hand, experienced a reduction in their tax burden to 13.5 per cent in 1975. Tax burdens, however, vary greatly with the size of the institution. Smaller commercial banks and mutual savings banks do not benefit as significantly from tax shelters as larger banks, while large savings and loan associations pay higher tax rates than smaller institutions.

Recently proposed changes in tax laws could greatly alter the relative tax burden of financial institutions. One such major proposal is a plan for a mortgage tax credit.⁹ This credit would allow a deduction from taxes equal to a percentage of an institution's residential mortgage interest income. Since thrifts already hold a large proportion of their assets in

mortgages, they would probably benefit more from this credit than commercial banks. Another proposal that could alter the comparative tax advantage of commercial banks is a Federal subsidy for interest payments of state and local governments issuing taxable securities. According to the proposal, the subsidy would be greater than or equal to the difference in interest costs on taxable and nontaxable securities so as to encourage municipalities to issue the taxable securities in favor of tax-exempts.¹⁰ To the extent this occurs, commercial banks would have less opportunity to earn tax-free income. Thus, the combination of the mortgage tax credit and the elimination of tax-exempt municipal income could greatly reduce the tax burden of thrifts relative to that of commercial banks.

⁹ With the institution of a mortgage tax credit, the percentage of income method of computing thrifts' bad debt reserves would be eliminated, and all financial institutions would use the experience or bank percentage reserve methods. However, the Treasury has estimated that the mortgage tax credit would result in a greater tax benefit to thrift institutions than the current bad debt deduction. See *Statements to House Budget Committee Task Force on Tax Expenditures at Hearing, February 25, 1976, on Proposed Mortgage Interest Tax Credit.*

¹⁰ See *Joint Committee on Internal Revenue Taxation Report in House Ways and Means Committee Hearings on HR 12774, March 30, 1976.*