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Are Production Credit Associations Taxpayers?

State of Arkansas v. Farm Credit Services of Arkansas, PCA et.al.

by Mark Baran

Agricultural lenders and state tax administrators nationwide have anxiously awaited the outcome of a U.S. Supreme Court case known as *State of Arkansas v. Farm Credit Services of Central Arkansas, PCA, et. al.* On June 2, 1997, the high court unanimously decided to reverse a prior ruling in the Eighth Circuit Court of Appeals which held that Production Credit Associations (PCAs), as instrumentalities of the federal government, are constitutionally immune from the imposition of Arkansas state sales and use tax. This decision is of particular significance, resulting in several case reversals. One such reversal involved a federal credit union employees' claim for an exemption from a transient hotel tax. Another case reversal dealt with a federal judge's claim of immunity from an Alabama privilege tax. This trend indicates that subsequent claims of tax immunity will be subject to judicial scrutiny.

History of Financial Institution Tax Immunity

Attempts to gain tax immunity based upon a federal instrumentality designation is not a recent trend. Supreme Court cases dating back to the early 1800s established an inter-governmental immunity doctrine in an effort to create and enforce a system of federalism in our government's infancy. In *M'Culloch v. Maryland* (1819), Justice Marshall created the doctrine exempting federal instrumentalities from discriminatory state taxation. In contrast, modern federal instrumentalities (those that are simply designated as such in the statute), such as PCA's or federal credit unions, are vastly different from the centuries old perception of federal instrumentalities. Distinguishing characteristics of these modern instrumentalities include limited or non-existent ownership or control by the United States, operated and structured for profit, and are in direct competition with similarly situated entities. These distinguishing characteristics provide the essence of the arguments presented by the State of Arkansas and the supporting organizations which filed amicus curiae briefs with the Supreme Court.

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Case Background

In June, 1994, four federally-chartered PCAs located in Arkansas brought a declaratory judgment suit in a federal district court claiming an exemption from Arkansas sales and income tax. Arkansas tax authorities denied the PCA's prior request for a tax refund and formal recognition that the PCA institutions are exempt from state taxation. However, the federal district court in Arkansas ruled in favor of the PCAs, finding that PCAs are federal instrumentalities from which arises an implied immunity from state taxation under the U.S. Constitution. Further, the Arkansas district court noted that this immunity must be expressly waived by Congress in order to subject PCA's to state taxation. A subsequent appeal to the Eighth Circuit Court of Appeals by the State of Arkansas was also unsuccessful. In April of this year, the U.S. Supreme Court granted a writ of certiorari and agreed to listen to the case. In support of the State of Arkansas' position on PCA's, the American Bankers Association (ABA) and the Nebraska Bankers Association jointly filed an amicus brief along with twenty-three (23) other states, the United States Solicitor General, and the Multi-state Tax Commission.

Legal Arguments

Arguments supporting state taxation of PCA's are substantial, and supported by statutory and judicial precedent. For example, the Farm Credit Act has undergone Congressional revision several times since its inception. Yet, despite many statutory changes to the operation and structure of the Farm Credit System, Congress did not alter the PCA's tax provisions until 1985. Most importantly, this particular 1985 technical alteration was unrelated to the subject of taxation. Thus, the origins of this case can be traced to unintended statutory developments concerning the Farm Credit Act — specifically changes that occurred in the PCA's tax provisions contained in 12 U.S.C. §2077.

In 1985, a drafting error occurred as

Congress made several technical changes, including the replacement of the Governor of the Farm Credit Administration with a three-member board. In omitting all references to the Governor of the Farm Credit Administration, Congress unknowingly deleted specific sentences which contained the word "Governor" within the entire Farm Credit Act, including 12 U.S.C. §2077. The relevant portion of 12 U.S.C. §2077 reads as follows:

"Such associations, their property, their franchises, capital, reserves, surplus, and other funds, and their income shall be exempt from all taxation now and hereafter imposed by the United States or any State, territorial, or local taxing authority; except that interest on the obligations of such associations shall be subject only to Federal income taxation in the hands of the holder thereof pursuant to the Public Debt Act of 1941 (31 U.S.C. 742(a) and except that any real and personal property of such associations shall be subject to federal, State, territorial and local taxation to the same extent as similar property is taxed. **The exemption provided in the preceding sentence shall apply only for any year or part thereof in which the stock in the production credit associations is held by the Governor of the Farm Credit Administration.**"

Unfortunately, the legislative drafters in this case inadvertently deleted the final sentence of the conditional tax language addressing a PCA's tax status. The deletion within the statute provided the necessary loophole for a PCA's claim of immunity status. Prior to 1985, 12 U.S.C. §2077 contained the above language exempting PCA's from income taxation provided that the United States, by and through the Governor of the Farm Credit Administration, continued to own stock in these entities. Legislative history does not reflect a congressional intent to purposefully remove the previous tax exemption language conditioned upon continued ownership of PCA's by the United States government. The federal government's divestiture of ownership in PCAs in 1968, combined with the legislative history in 1985 indicating Congress' intent only to

make technical and conforming amendments, did not create a new and expanded tax immunity for PCA's. Nonetheless, Congress inadvertently created a tax loophole which was seized upon and effectively exploited by the PCAs.

Another argument relates to the economic effects of tax immunity and its impact on PCA competitors. For commercial agricultural lenders, conferring a blanket state tax exemption on PCAs would render disastrous effects on lending institutions and distort competition in the marketplace. Published economic data reveals that PCAs earned \$1.2 billion in 1995, outperforming commercial farm banks on a average return on assets and the percentage increase of total loans and assets. By eliminating provisions for the payment of taxes, PCA's lending costs would be further decreased, thus allowing PCAs to offer lower rates on their loans, popularizing PCA loans and creating an unfair advantage. The banking industry argued that these damaging economic consequences greatly outweigh the PCAs claim of state tax immunity as a federal instrumentality.

Supreme Court Decision

While the Supreme Court's decision was favorable to the banking industry, the controlling issue in the case was not whether PCAs are constitutionally exempt from Arkansas state sales and income tax on the basis of designation as a "federal instrumentality" under the federal banking laws. Instead, the case was decided on jurisdictional grounds. Justice Kennedy wrote the opinion of the Court and relied upon a jurisdictional tax statute known as the Tax Injunction Act (12 U.S.C. §1341) to remove the case from the federal court system. The Tax Injunction Act bars federal courts from enjoining the collection or enforcement of state taxes unless no state law remedies exist or the United States files suit to protect itself or its instrumentalities. The Supreme Court found that PCAs are not included within any of the exceptions under the act and thus cannot initiate a lawsuit on their own in federal

court for a state tax injunction without joining the United States as co-plaintiff. The main issue of immunity was not directly addressed by the high court, stating in the opinion that "[e]ntitlement to the immunity is the underlying substantive issue, were we to reach it. The Tax Injunction Act, however, is an initial obstacle, for by its terms it would bar the relief the PCA's seek absent some exception."

Future for PCAs

While the Supreme Court decision of *State of Arkansas v. Farm Credit Services of Central Arkansas, PCA, et. al* is relatively straightforward, it has created tremendous roadblocks for claims of immunity by the PCA's pursued through the state court system. The Supreme Court opinion is littered with useful statements, analogies, and implied meanings concerning the issue of immunity for PCA's, albeit within the purview of the Tax Injunction Act. It is for that reason PCA's will encounter difficulties in the future. Justice Kennedy summarized with the following language:

"The PCA's' business is making commercial loans, and all their stock is owned by private entities. Their interests are not coterminous with those of the Government any more than most commercial interests. Despite their formal and undoubted designation as instrumentalities of the United States, and despite their entitlement to those tax immunities accorded by the explicit statutory mandate, PCA's do not have or exercise power analogous to that of the NLRB or any of the departments or regulatory agencies of the United States."

This language is clear and undoubtedly serves as useful information for state courts considering a PCA's claim of tax immunity. It could be argued that the Supreme Court has implied that PCA's should not be able to shield themselves from payment of taxes. In fact, some respected legal analysts have suggested that the Court fully intended to decide the case on the merits.

As a result of this decision, it appears

that the PCA's probability of prevailing through the Arkansas state court system is remote. The reasoning is simple and is based on the procedural holding in the Supreme Court case. An entity designated as a "federal instrumentality" that conducts its activities similar to that of a private entity is precluded from using the federal court system to hear its tax exemption claim unless the United States is a co-plaintiff. Why should a state court grant broad immunity from the imposition of lawful state taxes based upon a federal instrumentality exemption theory? Simply, if a PCA does not possess sufficient governmental powers enabling that PCA to independently file suit in federal court, it is doubtful that PCAs would be considered to possess the requisite governmental attributes entitling them to state tax immunity in a state court.

As indicated earlier, state court determinations are yet to be decided. However, we understand that the PCA's pending state court lawsuit in Arkansas Chancery Court, which was previously delayed pending the outcome of the Supreme

Court case, will resume. In the meantime, commercial agricultural lending institutions should be optimistic that state courts will logically apply the analysis of the Supreme Court ruling and find no merit to the PCAs claim of tax immunity.

Common sense dictates that profitable, private, retail entities that are simply classified as "federal instrumentalities" should not be permitted a free ride to the detriment of other similarly-situated taxpayers. Unless PCA's can prove that they are truly governmental in nature, state taxing authorities should be permitted to lawfully and equitably impose taxes. The Supreme Court made it clear that the PCA's "interests are not coterminous with those of the Government any more than most commercial interests." The Court further noted that PCA's "do not have or exercise power analogous to... any of the departments or regulatory agencies of the United States". PCA's should simply accept the fact that they are taxpayers just like banks and pay there fair share of the costs of government. ▲