

PA Bank Shares Tax: Big News for Banks Involved in Mergers

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Today, the Commonwealth Court decided the [Lebanon Valley Farmers Bank case](#)¹. The case produces a big problem for banks that have, in the past six years, been involved in a merger between a bank that is a bank shares taxpayer and another bank that is not a bank shares taxpayer. We encourage our clients and friends who are in the banking industry to [register for our August 23 teleseminar](#) that will cover this issue.

The Lebanon Valley case involves the Pennsylvania bank shares tax. The bank shares tax is based on a six-year average of a bank's equity. For a bank involved in a merger, the statute includes a combination provision that combines the pre-merger equity of the merged banks. But under the First Union case (which we won five years ago²) - if a bank that is a bank shares taxpayer merges with a bank that is not a bank shares taxpayer, the historical equity values are not combined. Instead, for pre-merger years, the equity of only the surviving bank is used in the six-year average.

The Lebanon Valley case has been brought by a bank that is a bank shares taxpayer that was involved in a merger with another in-state bank that was also a bank shares taxpayer. Lebanon Valley wanted to exclude the equity value of the bank that did not survive the merger. Lebanon Valley argued that the merger of two in-state banks is treated less favorably than the merger of an out-of-state bank with an in-state bank, and that the different treatment violated the uniformity clause of the state constitution.

The court agreed with Lebanon Valley that there is a constitutional problem. The court concluded that the statute "renders an artificially low tax base for only certain taxpayers" and "is unconstitutional and cannot be employed." The court concluded that the "averaging methodology ... can be severed ... when the taxable amount of shares results from the merger of an institution with a non-institution or an institution that has been in existence for fewer than six years" Thus, the court agreed with the Department's remedy that "***the institution resulting from the merger [between an in-state bank and an] ... out-of-state bank must be treated as a new institution for purposes of computing the taxable amount of shares.***" (emphasis added)

Thus, if the court's decision stands, for a bank that has been involved in a merger in the past six years, the years preceding any merger with a non-bank shares tax taxpayer are cut off and disregarded in computing the tax base for post-merger years.

The court's order is effective "prospectively" - although it's not clear whether that means starting with the bank shares tax return due by September 2011 or the bank shares tax return due next year. The court also ordered the Commonwealth to provide meaningful backward-looking relief by either: (1) assessing tax against banks involved in mergers with out-of-state banks; (2) refunding tax to banks involved in in-state mergers; or (3) some combination of (1) and (2).

The decision may be appealed to the Pennsylvania Supreme Court.

Please join us on the August 23 teleseminar for more information.

If you have questions about the impact of the *Lebanon Valley* case, please [join us for the August 23 teleseminar](#). For more information on Reed Smith's Pennsylvania tax practice, visit www.reedsmith.com/patax.

¹ *Lebanon Valley Farmers Bank v. Commonwealth*, 698 F.R. 2005. (See link to case.)

² *First Union National Bank v. Commonwealth*, 587 Pa. 507 (2006).

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