Testimony

Before the

Pennsylvania Senate Banking and Insurance Committee

Presented by

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Introduction

Thank you Senator White and members of the Senate Banking and Insurance Committee for giving me the opportunity to speak with you today.

My name is Chris Hopkins and I am a tax partner with the public accounting firm Crowe Horwath LLP. Crowe is one of the largest public accounting and consulting firms in the United States. Serving financial institutions in all 50 states within the U.S. and its territories, Crowe Horwath is recognized nationally as a leading provider of accounting and consulting services to banking organizations. The firm currently audits more SEC-registered financial institutions than any other firm in the U.S. (including the Big Four). In addition to financial statement audits, Crowe Horwath provides tax, internal audit, regulatory compliance, loan review, corporate governance, transaction and enterprise-wide risk management services to banks, trust companies and other financial services organizations.

I am a CPA licensed in Pennsylvania and New York. I am also a resident of Pennsylvania (Washington Crossing, Bucks County; Senator Chuck McIlhinney's district). Prior to joining Crowe Horwath in 2011, I was a tax partner with the national public accounting firm Grant Thornton LLP, and I was based in that firm's Philadelphia office. I have been practicing in the state and local tax area in Pennsylvania for over 15 years, and a significant portion of my practice is devoted to providing state and local tax consulting services and related advice to banks and other financial services organizations.

My testimony generally is limited to observations regarding the Pennsylvania Bank and Trust Company Shares Tax ("Bank Shares Tax"). In particular, how the Bank Shares Tax compares to the bank tax regimes of other states.

Background

Technically, the Bank Shares Tax is a property tax imposed on the value of capital stock subscribed for or issued as of the preceding January 1. However, for practical purposes, the Bank Shares Tax can be viewed as a tax imposed on the value of an institution's equity or capital. Institutions subject to the Bank Shares Tax are not subject to the corporate net income tax or the capital stock-franchise tax.

Legislation enacted in 2013 (effective January 1, 2014) made significant changes to Bank Shares Tax regime (Act of July 9, 2013 (P.L. 270, No. 52) ("Act 52")):

- The tax is imposed at a rate of 0.89% of bank equity capital. Previously, the tax was imposed at a rate of 1.25% of total equity capital.
- The apportionment factor now is based only on receipts. The payroll and deposit factors were eliminated.
- A customer-based (market-based) approach to sourcing receipts for apportionment purposes generally applies.
- Bank equity capital is based on a one-year valuation formula instead of a six-year moving average.
- Nexus rules are expanded to subject more out-of-state banks to the tax.
- Appeals now are handled using the same administrative appeals process as other taxes. The provision that requires a special appeals process for the Bank Shares Tax (the so-called "pay-to-play" rule) was repealed.

Beginning in the mid-1980s, state legislatures passed laws allowing bank holding companies to acquire out-of-state banks on a reciprocal basis with other states. The ability to engage in interstate banking was extended to federally chartered banks by the Riegle-Neal Act of 1994. Act 52 effectively modernized the Bank Shares Tax, aligning it with the realities of present-day banking practices. Before Act 52, the Bank Share Tax could result in anomalous tax results. For example, a bank headquartered outside of Pennsylvania but with a significant portion of its loan portfolio secured by real property in the Commonwealth could pay little or no Bank Shares Tax.

State Bank Tax Analysis

In December 2014, Crowe Horwath was engaged by the Pennsylvania Bankers Association to assist with preparing a comparison of the Bank Shares Tax—taking into consideration the Act 52 changes—with the bank tax regimes of five neighboring states, Delaware, Maryland, New Jersey, Ohio and New York, along with the bank tax regimes of Michigan and North Carolina (the "Study"). Portions of the Study were included in the Act 52 Bank Shares Tax Reform Report issued by the Pennsylvania Department of Revenue in January 2015.

Significant variability exists with respect to taxes imposed on banks by states. Components of tax systems that contribute to the lack of consistency include:

- The tax base
- The tax rate
- Apportionment
- Statutory provisions specific or relevant to banks

Due to the variability and complexity, simply considering particular elements used in the calculation of tax liability (e.g., the tax base or tax rates) cannot provide an informative comparison of bank tax regimes. However, bank taxes imposed by states generally, and the states analyzed for the Study in particular, can be evaluated and compared by applying the respective bank tax rules to banks with assumed identical operational and financial profiles.

Because the rules for calculating a bank's state tax liability differed in some of the states depending on an institution's size, hypothetical composite bank taxpayers of three different asset levels were considered: small, assets of $500 million; medium, assets of $3 billion; and large, assets of $15 billion. The hypothetical composite bank taxpayers were constructed using average financial data from published call reports of 10 similarly sized banks for each size category.

To evaluate the impact of the different tax apportionment rules, two scenarios were considered for each size bank: (1) 100% of the loan portfolio located in the headquarters state, and (2) 50% of the loan portfolio sourced outside the headquarters state.

A three-year period was assumed, applying the bank tax provisions for the states considered in effect as of January 1, 2015 in Year 1. In order to consider the impact of a bank having unfavorable operating results in an individual tax year, a pre-tax loss equal to 50% of Year 1 pre-tax income was assumed for each composite bank in Year 2 and pre-tax income for Year 3 was assumed equal to Year 1 pre-tax income.

Where applicable, the analysis assumed that the composite banks made elections and applied statutory provisions that generally would minimize tax liability in the headquarters state. A number of assumptions were made to reduce the level of complexity. In all, six scenarios were modeled.

The analysis—again, taking into consideration the Act 52 changes—indicates that under the various scenarios considered substantially similar banks generally would pay more—often significantly more—state tax if headquartered in Pennsylvania than if headquartered in one of the other states. For example, for the small composite bank, over the three-year period Pennsylvania tax liability is more than 7½ times as much as New York tax liability.

Graphical representations of the differences between the Bank Shares Tax and the taxes imposed on banks by the other states analyzed are provided in Exhibit A.

Note that several of the states analyzed have favorable tax rules for banks:

- **Delaware**. In Delaware, banks generally are subject to a net income-based bank franchise tax. Although the stated tax rate is 8.7% (equivalent to the corporate income tax rate), the rate effectively is 4.872% (8.7% x 56%) because only 56% of the bank's adjusted taxable income is subject to tax. Further, the tax rate is *regressive*, decreasing from 8.7% to 1.7% for taxable income greater than $650 million.

- **Michigan**. Michigan's financial institutions tax is an equity/capital-based tax, very similar to the Bank Shares Tax. However, the Michigan tax rate is only .29%, less than a third of the current Bank Shares Tax rate of .89%.

- **New York**. For tax years beginning on or after January 1, 2015, banks are subject to the same tax regime that covers most other corporations (a separate financial institutions tax applied in prior years). The corporation franchise tax is based on the greatest of three tax calculations—an entire net income tax, a tax on capital or a fixed dollar minimum tax. The tax rate for the entire net income tax is 7.1%, decreasing to 6.5% for tax years beginning on or after January 1, 2016. While customer-based sourcing generally applies, a series of special, and generally favorable, apportionment rules apply to portfolio income. In addition, statutory incentives are available for banks with total combined assets under $8 billion. Consequently, many smaller New York-based banks will be subject to tax computed only on the capital base, which has a rate that decreases from .15% for the 2015 tax year to 0% beginning with the 2021 tax year (the fixed dollar minimum tax still will apply).

- **Ohio.** Beginning in 2014, Ohio banks are subject to an equity/capital-based financial institution tax. As in Delaware, the tax rate is *regressive*, decreasing from 0.8% to 0.25% for equity capital in excess of $1.3 billion.

Other states have specific tax rules that benefit banks. In Connecticut, for example, banks are encouraged to form statutorily permissible "passive investment companies" to hold loan assets secured by real property (e.g., mortgage loans). Passive investment companies are not subject to state tax; therefore, banks do not pay tax on income from real property loans.

Proposed Bank Shares Tax Rate Increase and Implications

In his budget bill, Governor Wolf proposes a <u>retroactive</u> Bank Shares Tax rate increase from .89% to 1.25%, a 40 percent increase. The rate increase will make an arguably uncompetitive bank tax regime even less competitive.

The proposed increase in the Bank Shares Tax rate *theoretically* could increase state tax revenue. On the other hand, total tax revenue associated with a tax rate increase in fact can decline. This concept is depicted by the Laffer Curve. The Laffer Curve illustrates the theory of tax elasticity—how tax revenue can change in response to changes in tax rate increases (as well as other legislated tax increases). It postulates that at some point, T, increases in tax size are counterproductive and result in a decrease in revenue. (See Exhibit B.)

To a large extent, bank operations are portable. Unlike other businesses (manufacturing, for example) the assets of a bank are predominantly intangible. Therefore, a bank's operations effectively can be managed from virtually anywhere. If the bank tax regime in Pennsylvania becomes overly burdensome, banks can relocate significant operations to states with more friendly and competitive tax environments. (As an example, under New York's tax rules effective January 1, 2015, moving the treasury function from Pennsylvania to New York would have virtually no impact on a bank's New York tax profile but would significantly decrease the bank's Bank Share Tax liability.)

Banks are the lifeblood of a strong state economy. Community banks in particular cater to individuals and businesses in less populous areas. Increasing the Bank Shares Tax rate, making Pennsylvania's bank tax regime even less competitive, will have a detrimental impact on the Commonwealth's economy. Lending requirements for Pennsylvania-based borrowers will be tightened, and borrowing costs for residents and businesses in the Commonwealth will increase. In addition, Pennsylvania-based banks will be discouraged from expanding in the Commonwealth, and bank branches in smaller communities deemed less profitable or too costly to operate likely will be closed.

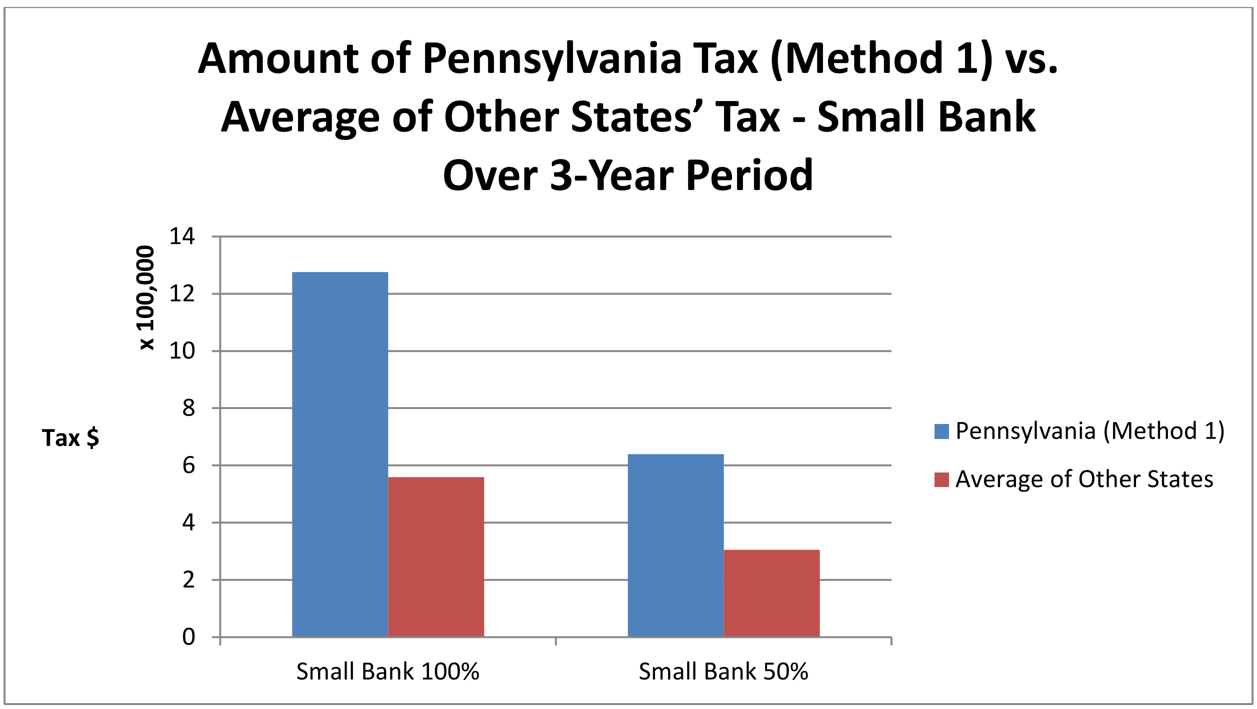
I respectfully urge this committee and the legislature at large to carefully consider all the implications—including the unintended consequences—associated with Governor Wolf's proposed Bank Shares Tax rate increase.

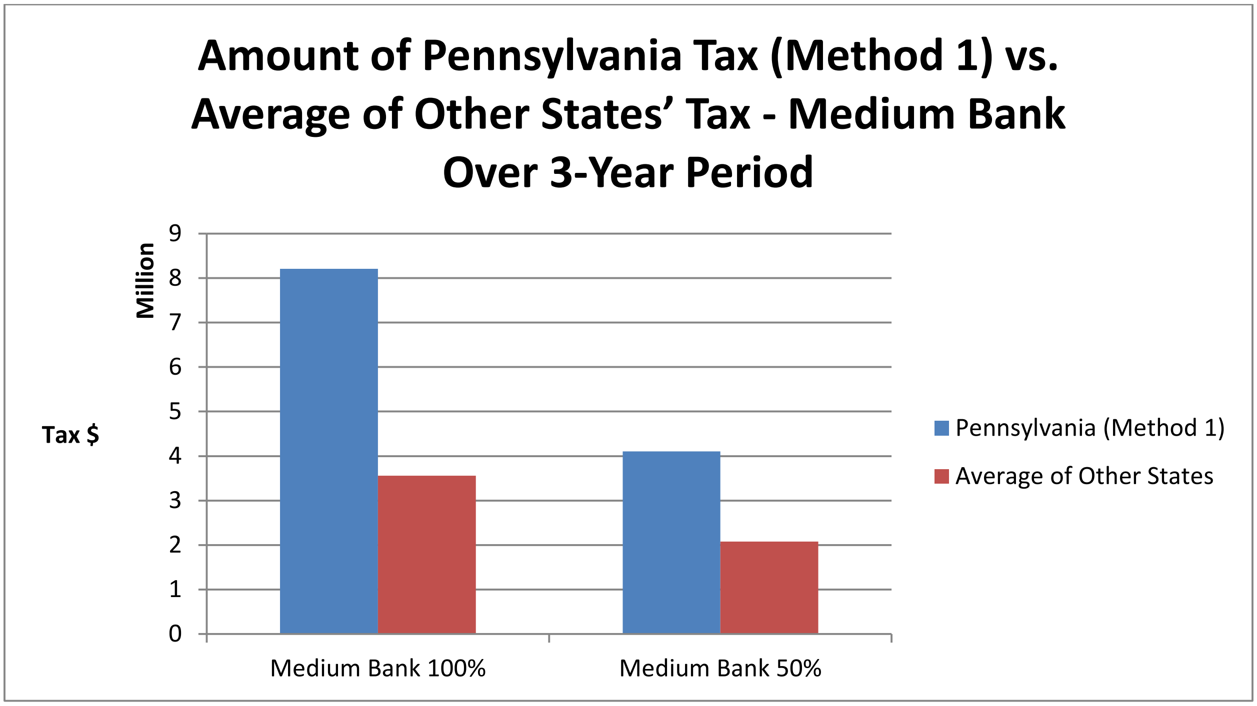
EXHIBIT A

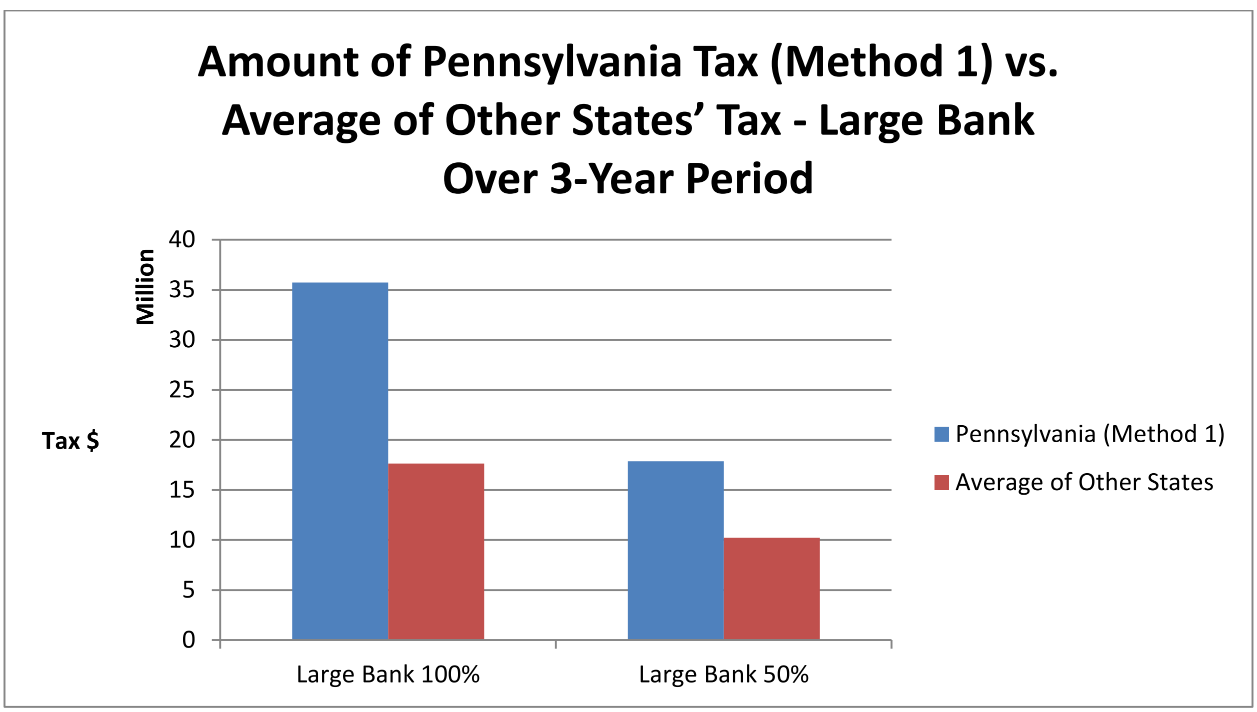
Following is a summary of tax liability of states considered in the Study under six scenarios (State Bank Tax Analysis, Pennsylvania Bankers Association, February 10, 2015).

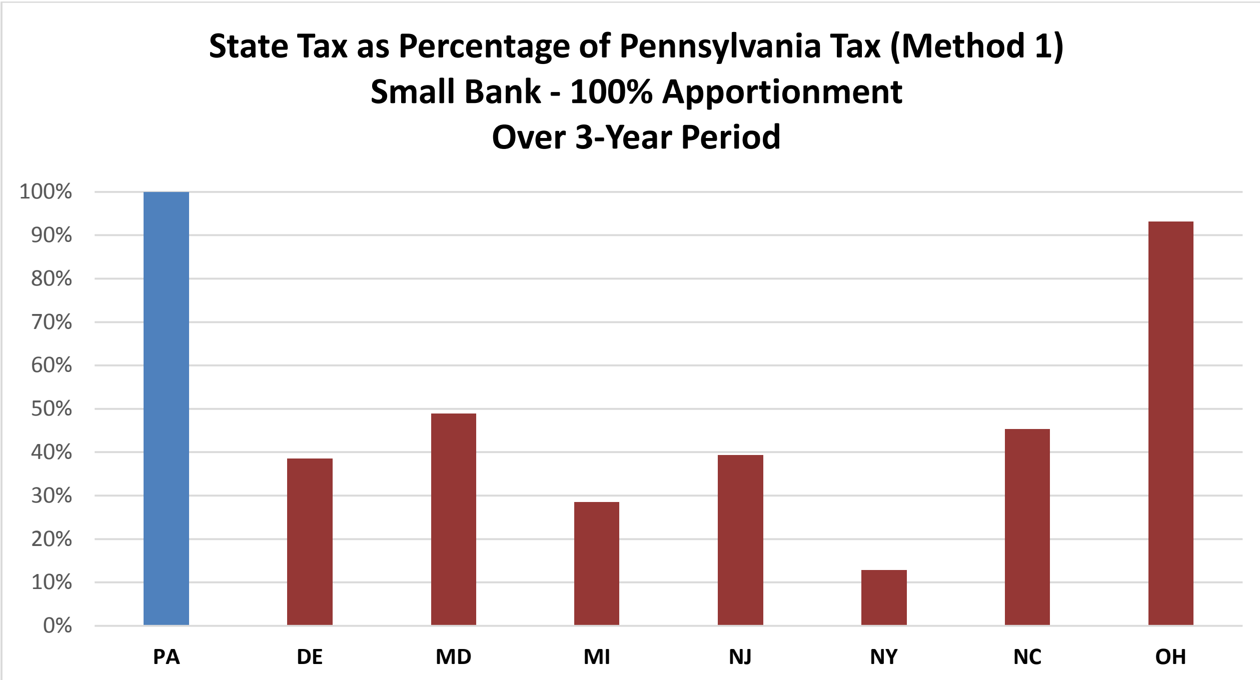
	PA	DE	MD	MI	NJ	NY	NC	OH
Small Bank A	1,276,000	492,000	625,000	364,000	501,000	164,000	579,000	1,188,000
Percent of Small Bank A PA Tax	100%	39%	49%	29%	39%	13%	45%	93%
Small Bank B	639,000	276,000	313,000	205,000	377,000	83,000	293,000	593,000
Percent of Small Bank B PA Tax	100%	43%	49%	32%	59%	13%	46%	93%
Medium Bank A	8,208,000	3,414,000	4,335,000	2,419,000	3,433,000	1,079,000	3,868,000	6,373,000
Percent of Medium Bank A PA Tax	100%	42%	53%	29%	42%	13%	47%	78%
Medium Bank B	4,105,000	1,946,000	2,167,000	1,380,000	2,550,000	547,000	1,956,000	3,973,000
Percent of Medium Bank B PA Tax	100%	47%	53%	34%	62%	13%	48%	97%
Large Bank A	35,712,000	8,644,000	23,094,000	12,318,000	18,158,000	18,480,000	20,569,000	22,298,000
Percent of Large Bank A PA Tax	100%	24%	65%	34%	51%	52%	58%	62%
Large Bank B	17,855,000	6,262,000	11,547,000	7,122,000	13,157,000	9,375,000	10,425,000	13,639,000
Percent of Large Bank B PA Tax	100%	35%	65%	40%	74%	53%	58%	76%

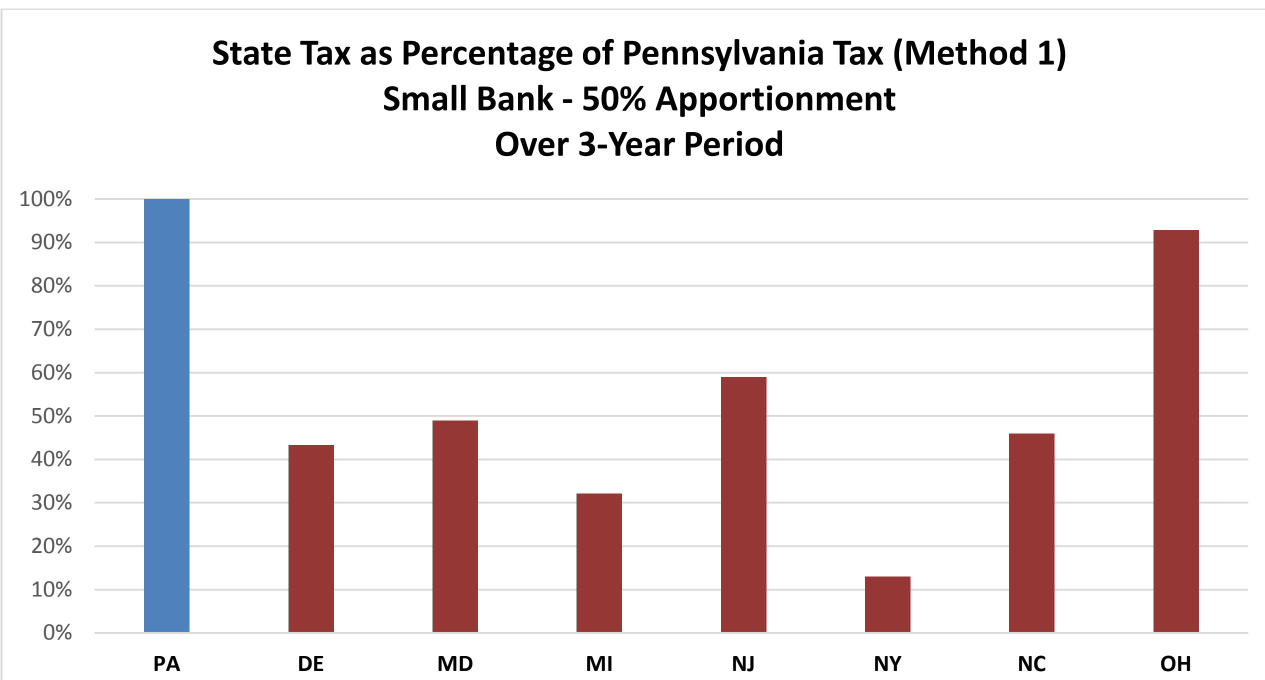
Table 1 - Summary of tax liability over 3-year period. A - 100% apportionment to headquarters state; B - 50% of loan income apportioned to headquarters state. Method 1 is assumed for the Bank Shares Tax.

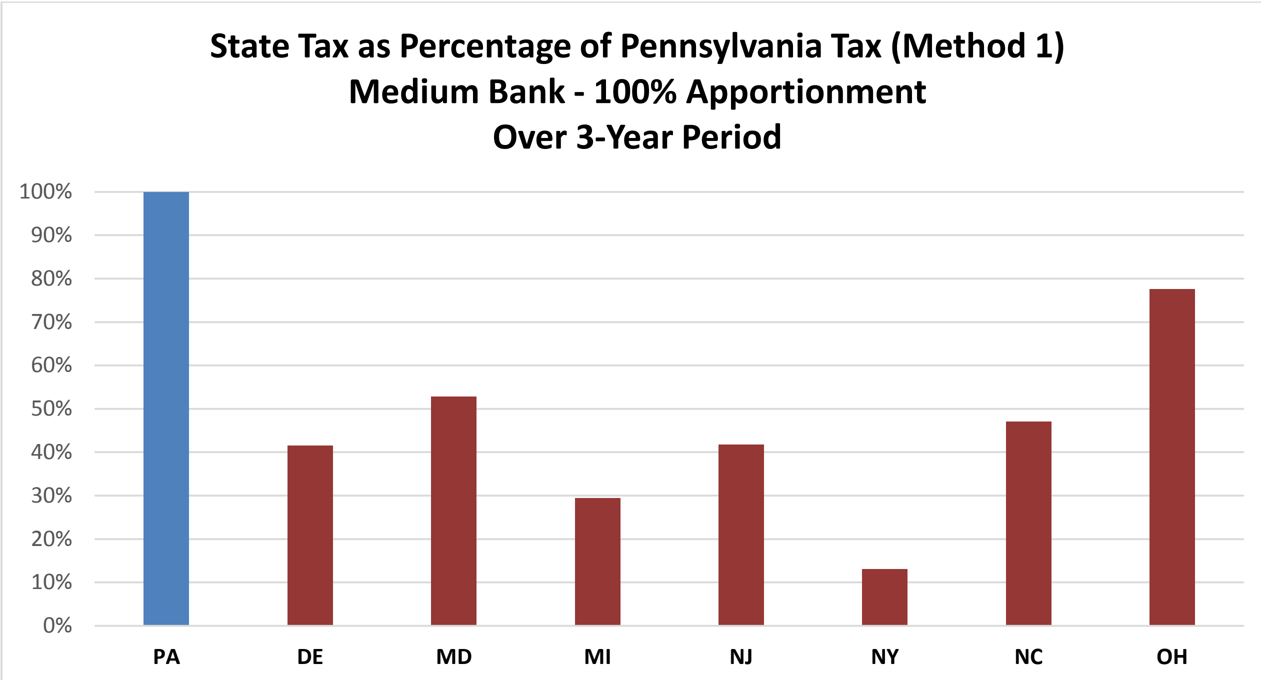


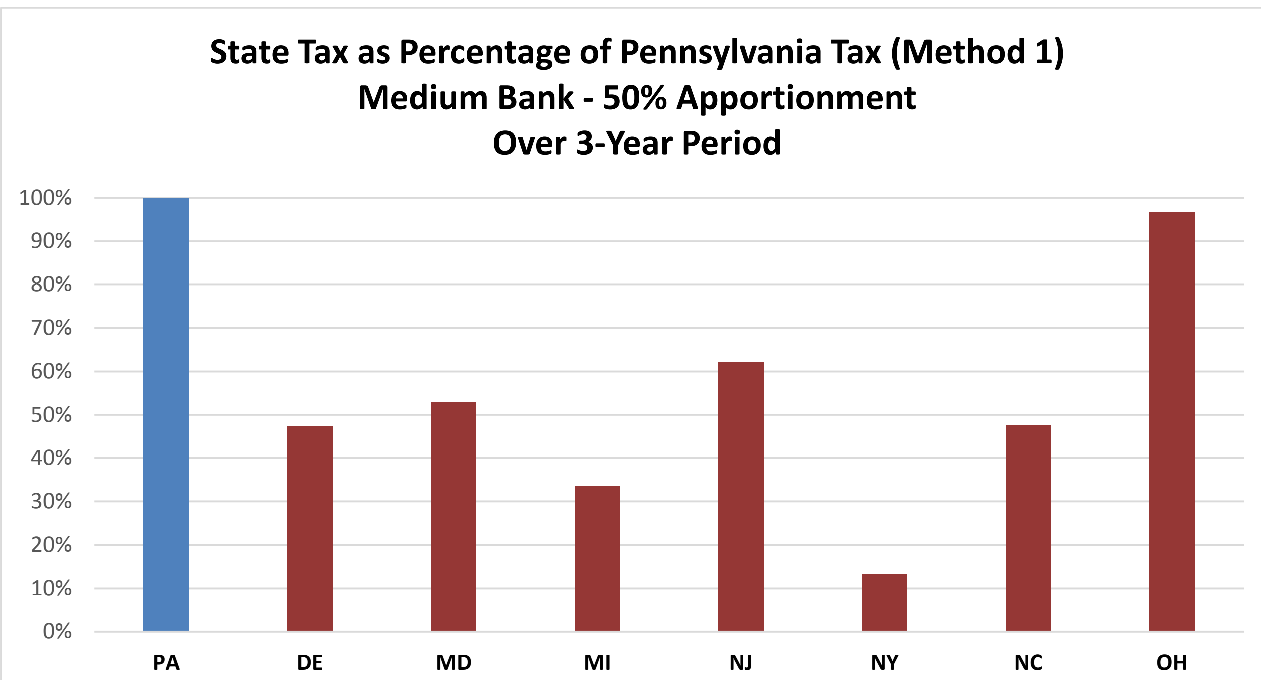

Amount of Pennsylvania Tax (Method 1) vs. Average of Other States' Tax - Medium Bank Over 3-Year Period
Tax $
Million
9
8
7
6
5
4
3
2
1
0
Medium Bank 100%
Medium Bank 50%
Pennsylvania (Method 1)
Average of Other States

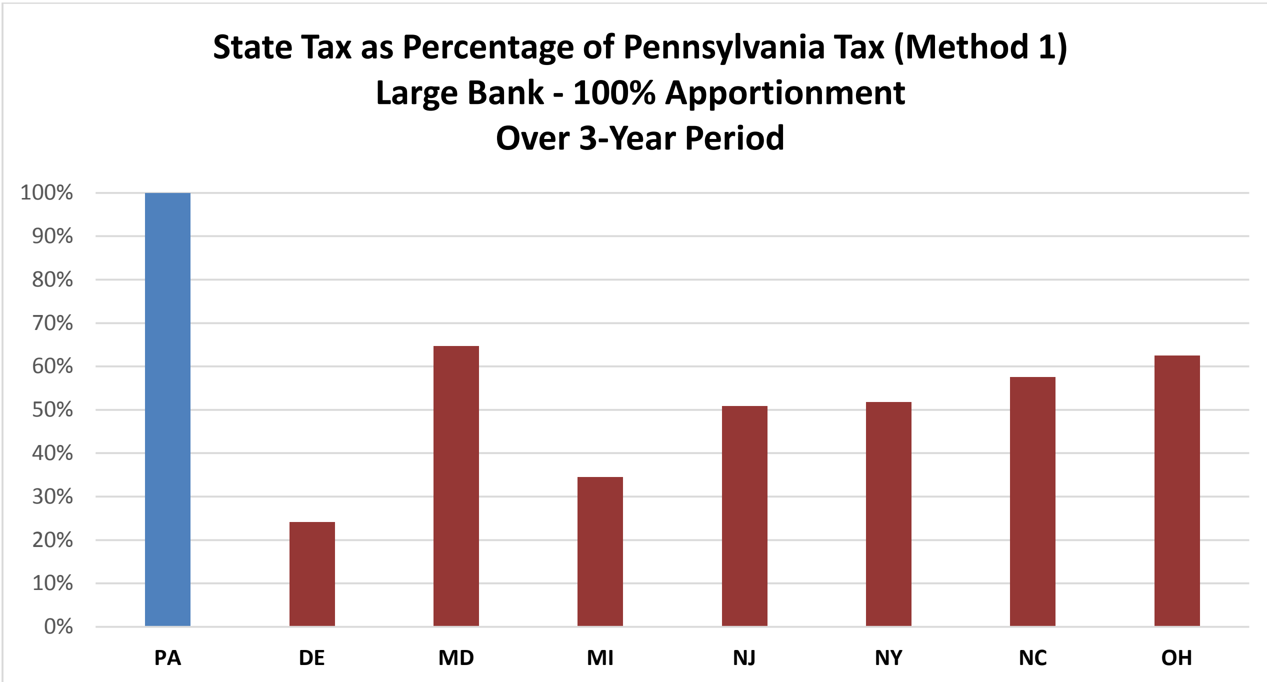

Amount of Pennsylvania Tax (Method 1) vs. Average of Other States' Tax - Large Bank Over 3-Year Period
Tax $
Million
40
35
30
25
20
15
10
5
0
Large Bank 100%
Large Bank 50%
Pennsylvania (Method 1)
Average of Other States


State Tax as Percentage of Pennsylvania Tax (Method 1)
Small Bank - 100% Apportionment
Over 3-Year Period
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
PA
DE
MD
MI
NJ
NY
NC
OH


State Tax as Percentage of Pennsylvania Tax (Method 1)
Small Bank - 50% Apportionment
Over 3-Year Period
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
PA
DE
MD
MI
NJ
NY
NC
OH


State Tax as Percentage of Pennsylvania Tax (Method 1)
Medium Bank - 100% Apportionment
Over 3-Year Period
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
PA
DE
MD
MI
NJ
NY
NC
OH


State Tax as Percentage of Pennsylvania Tax (Method 1)
Medium Bank - 50% Apportionment
Over 3-Year Period
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
PA
DE
MD
MI
NJ
NY
NC
OH


State Tax as Percentage of Pennsylvania Tax (Method 1)
Large Bank - 100% Apportionment
Over 3-Year Period
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
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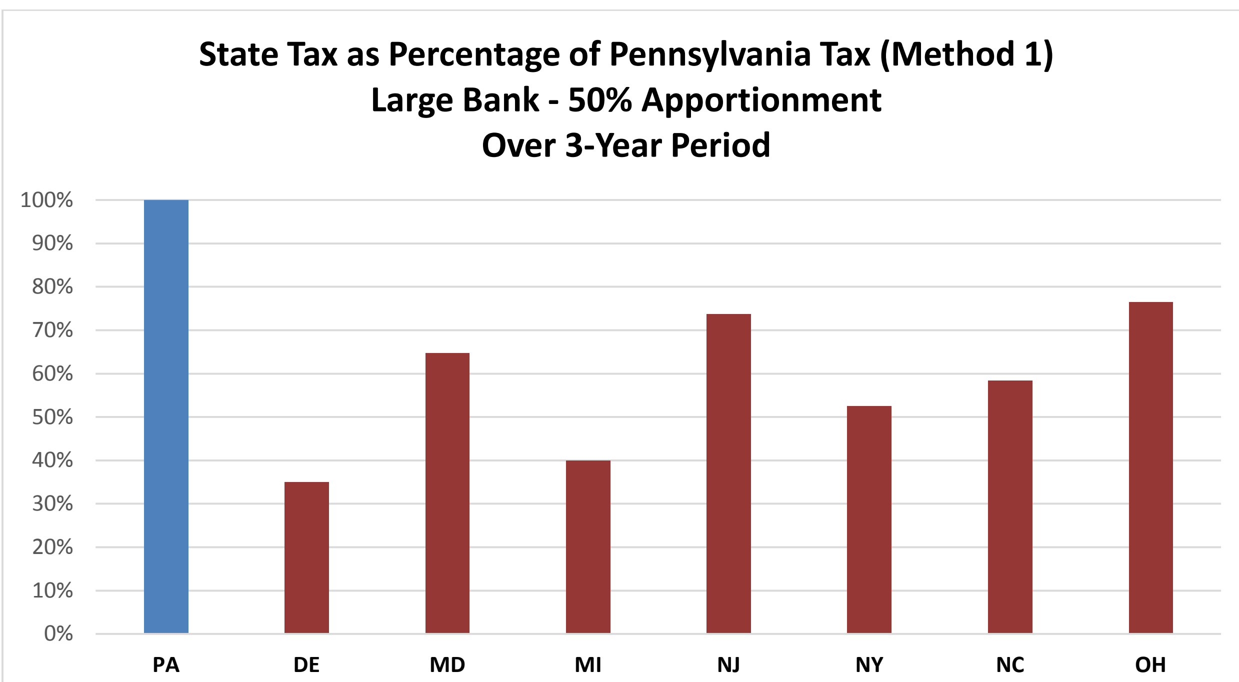
State Tax as Percentage of Pennsylvania Tax (Method 1)
Large Bank - 50% Apportionment
Over 3-Year Period
100%
90%
80%
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20%
10%
0%
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EXHIBIT B