Testimony on the proposed Financial Institutions Tax to the House Ways and Means Committee

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We applaud the governor for a new bank tax proposal to close exemptions that, according to Director Tim Keen, threaten the viability of the existing bank tax structure. The proposed Financial Institutions Tax (FIT) would streamline a fragmented system that has favored large, multistate institutions with the resources to take advantage of aggressive tax planning. However restorative the changes might be, the proposal would just replace the revenue of the current tax, lowered as it is by evasion and other problems; it would give funds that should be raised from fixing the tax back to the financial sector through much lower rates and a new apportionment formula, and it is likely that a substantial part of the gains would go to a dozen large institutions.

Thank you for this opportunity to offer testimony a second time before this committee. In this testimony, we focus on the level at which the FIT proposal caps collections; issues around beneficiaries of the proposal; tax credits; and the trigger mechanism for adjusting the FIT.

Why are we changing bank taxes? Financial industry growth and lagging collections in the past decade – Under Ohio's current financial sector taxes, some financial institutions may legally transfer funds among covered companies to minimize tax payments. The $119.6 million exemption for goodwill, appreciation and abandoned property may be used in a similar fashion. Commissioner Testa provided good examples of how aggressive tax planning is used to minimize taxes in his testimony of March 21, 2012. The Financial Institutions Tax would cut off these opportunities by replacing the two taxes with a single tax and closing the exemption. Yet the proposed fix would not capture revenue foregone as a result of the current fragmented tax structure and exemption.

Long-term stagnation in tax collections from Ohio's financial institutions suggests that the Kasich administration set the target revenue for the tax too low. The banking industry has grown since the mid-1990s in Ohio: Bank deposits at Ohio institutions insured by the Federal Deposit Insurance Corporation increased by more than $90 billion, or 70 percent, between 1995 and 2010.[1] According to the U.S. Bureau of Economic Analysis, Ohio Gross Domestic Product from the financial subsector that includes lending, mortgage brokerage and other services grew by 88 percent between 1997 and 2009,[2] the most recent year for which data are available. Yet the corporate franchise tax has been relatively stagnant. In part because of increases in capital required by regulators, revenues from the franchise tax grew in 2010 but by tax year 2011, financial institutions paid only 7 percent more in

[1] Federal Deposit Insurance Corp., Summary of Deposits: Summary Tables Report, State Totals by Year Time Series, All FDIC-Insured Institutions, Summary of Deposits as of June 30, available at www2.fdic.gov/sod/SODSumReport.asp.
[2] U.S. Department of Commerce, Bureau of Economic Analysis, Regional Data, GDP and Personal Income, GDP by State, Index, for Federal Reserve banks, credit intermediation and related services (subsector 151), Ohio, available at www.bea.gov/iTable/iTable.cfm?ReqID=70&step=1&isuri=1&acrdn=1.

franchise tax than they did in 2002.[3] Overall, the taxes that the FIT would replace are lower in inflation-adjusted terms than they were in 1998.

The Governor's proposal caps collections at a level that does not adequately reflect the scale of the sector in Ohio's economy today and gives revenues from closing loopholes and strengthening the system back to the banks instead of using them to address the issues of our day: the huge foreclosure problems in every county of the state, the need to restore slashed aid to schools and local services.

Who benefits from changes in bank taxes? Apportionment and rate cuts – Under the current formula, banks are taxed according to a three-part formula that includes the share of their property, payroll and sales within the state of Ohio. The FIT changes the formula to a single factor: how much of a bank's gross receipts are in Ohio. In places where the single factor apportionment formula has been used with general corporate taxes, it favors large, multi-state companies with most of their gross receipts in other states or countries. It appears this will attract these companies because it lowers their state taxes, but that has not been the experience in Ohio. Since adopting the Commercial Activity Tax in 2005, a tax based on gross receipts and not the three-factor formula in the corporate franchise tax it replaced, the state has lost 275,000 or 5.1 percent of its jobs, more than seven times the rate of job loss in the nation as a whole. (The nation lost 0.7 percent during the same time.)

A company like JPMorgan Chase, which handles business from all over out of its giant Ohio operations, would find a small share of its capital would be taxed under the Kasich plan. The payroll of its 20,500 Ohio employees[4] and property of its big operations here would no longer be counted in determining how much it should be taxed—even though those operations depend on police patrols, well-lighted streets, public schools and libraries, and a host of other state and local public services.

The new single-factor formula may appear to tax big, out-of-state institutions operating in Ohio with little on-the-ground presence more heavily, but it will be hard to tell unless the proposal includes reporting requirements that allow monitoring of who is paying the tax.

For small Ohio banks that do business only in the state, it makes no difference which formula is used, since all of their capital would be taxed, either way. This part of the proposal doesn't help small banks, it helps big ones.

The FIT returns the revenue it could have raised by closing loopholes and streamlining the system by reducing the tax rate from the 1.3 percent of the corporate franchise tax to the lower rate at which dealers in intangibles have been taxed: 0.8 percent. It would also would reduce the tax rate on Ohio equity capital of over $500 million to just a quarter of 1 percent. According to taxation department

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[3] Ohio Department of Taxation, Tax Data Series, Corporation Franchise Tax, available at http://bit.ly/HAM4qb and data for Tax Year 2011 supplied by the taxation department to the author. Rates of the corporate franchise tax were reduced from the previous 15 mills to 14 mills in 1999 and 13 mills in 2000, but even accounting for these reductions, tax liability wasn't much higher in 2010 than it was in the mid- to late 1990s. Meanwhile, collections under the Dealers in Intangibles Tax rose significantly beginning in 2003, when the General Assembly closed a loophole that earlier had allowed such dealers that were controlled by banks or insurance companies to avoid paying the tax.

[4] Ohio Department of Development, Policy Research and Strategic Planning Office, "Ohio Major Employers," March 2012, available at http://development.ohio.gov/research/documents/b2001.pdf

simulations, there would be 12 financial institutions or groups, which could include banks, associated dealers, and associated holding companies, with Ohio equity capital of over $500 million.[5]
The Kasich administration has estimated that a few banks that have been using loopholes and some out-of-state institutions will see their taxes go up about $30 million annually, but almost all others will see their combined total tax burden cut by approximately $30 million annually.[6] However, it isn't so clear who will be the biggest beneficiaries of this windfall—and it's not unlikely that a number of the biggest Ohio banks will get a large piece of it.

Tax credits - Under the governor's proposal, seven tax credits would be available under the new Financial Institutions Tax. Allowing all of these credits to be applied to the new tax amounts to a lost opportunity to simplify the tax code and reduce unneeded incentives.

Trigger mechanism - The new tax would have a trigger under which rates would be automatically raised or lowered if the revenue raised by the tax was more than 10 percent above or below the $225 million target in Tax Year 2014. The General Assembly approved a similar trigger mechanism in 2005 when it created the Commercial Activity Tax – and then turned around two years later and eliminated the upward trigger. It also is problematic if the target amount is really set too low, since it would cut rates and keep the tax from generating what it otherwise would have. Also, the proposed trigger covers just one year, and does not prevent new loopholes in the future.

Recommendations – Communities across Ohio have been badly damaged by foreclosures. The revenue that could be raised by the FIT could be used to put a dent in this massive problem through support for foreclosure counseling and demolition of vacant and abandoned houses, among other things. Moreover, Ohio's tax revenue still hasn't recovered to pre-recession levels because of $2.5 billion in annual tax cuts to businesses and individuals in the 2005 tax overhaul.[7] Cities are struggling to maintain services as they feel the impact of cuts in the current state budget. Schools have been cutting hundreds of teaching positions, and many anticipate growing class sizes, cuts in spending for materials and reductions in course offerings.[8] Ohio hardly can afford to cut tax rates on its banks at the expense of opportunities for its students and public services that are critical to economic success.

Maintaining current tax rates on the biggest Ohio banks, instead of lowering them as in Governor Kasich's proposal, would allow the FIT to produce revenue that is more in line with the growth of Ohio's financial institutions since the 1990s. The current 1.3 percent rate should be retained and there should be no special lower rate for big banks. The new FIT should also include geographical reporting requirements so we can tell how much of the tax is being paid by Ohio and out-of-state banks, and how the change affects banks of different sizes. Additional revenue that results from a more robust tax should be used first to provide aid to combat the foreclosure crisis, and then to restore public services that were undercut in the current state budget.

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[5] E-mail from Frederick Church, Ohio Department of Taxation, April 5, 2012. The simulation depends on estimates of one major unknown: What share of equity capital is in Ohio according to the new formula for doing so.
[6] Governor John Kasich, Mid-Biennium Review, Management Efficiency Plan: Bank Tax Reform, available at www.governor.ohio.gov/Portals/0/FINAL%20Bank%20Tax%20Reform.pdf
[7] See Office of Budget and Management, Monthly Financial Reports, available at http://bit.ly/HxAwmL, and testimony of Deputy Tax Commissioner Frederick Church, "Understanding the Commercial Activity Tax in the Context of the 2005 Tax Reform Package," Legislative Study Committee on Ohio's Tax Structure, Aug. 24, 2011
[8] Patton, Wendy, Piet van Lier and Elizabeth Ginther, *The state budget and Ohio's schools,* Policy Matters Ohio, Jan. 19, 2012, available at www.policymattersohio.org/state-budget-ohio-schools-jan2012.