

Approved: 1/28/98
Date

MINUTES OF THE Senate Committee on Financial Institutions and Insurance.

The meeting was called to order by Chairperson Don Steffes at 9:00 a.m. on January 22, 1998 in Room 529-S of the Capitol.

All members were present except:

Committee staff present: Dr. William Wolff, Legislative Research Department
Fred Carman, Revisor of Statutes
Nikki Feuerborn, Committee Secretary

Conferees appearing before the committee: Shirley Sicilian, Director, Office of Policy & Research
Kansas Department of Revenue
David Zinn, Office of Policy & Research
Kansas Department of Revenue

Others attending: See attached list

Chairman Steffes recognized a group from the Risk and Insurance Management Service who were visiting in the Capital on this date.

Shirley Sicilian, Director of the Office of Policy & Research, Kansas Department of Revenue, appeared before the Committee at the request of Chairman Steffes (Attachment 1). She explained in great detail the history of privilege tax which was levied against banking associations, banks, trust companies, and savings and loan association in 1964. This tax is not a tax on income but measured by net income earned in the preceding year. Figures in 1993 were distorted due to five quarters being counted as that was when the estimated taxing system was instituted. The amount of tax earned is usually approximately 1% of the state general fund. Receipts have averaged slightly more than \$30 million annually since 1994. The Consensus Estimating Group made up of representatives from Revenue, the legislative branch, and the executive branch meets in April and November of each year to review the viability of their budgetary estimates. In 1996 they noticed they were considerably low in their estimates for 1996. The "wild card" option was introduced in 1995 and those banks that took advantage of investment subsidiaries showed reductions in privilege taxes of approximately 57.1 percent from the privilege tax liability which normally would have been collected. These investment subsidiaries will probably increase and the estimate of a 70% ultimate impact may be conservative. There will probably be a reduction of \$18-20 million this year if no legislation is passed to impede the formation of such subsidiaries or increase the taxing structure.

Ms. Sicilian suggested proposed legislation which would include all banks subject to Kansas tax laws which have formed subsidiaries be subject to privilege taxes. There is a similar case pending in Manhattan regarding a holding company. The Committee requested Ms. Sicilian develop language addressing the combination plan and return said language to the Committee for their review.

Senator Barone moved for the introduction of legislation which would limit interest rates being charged on consumer credit sales of used automobiles. The motion was seconded by Senator Brownlee. Motion carried.

The meeting adjourned at 10:00 a.m. The next meeting will be held on January 27, 1998.

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Office of Policy & Research

MEMORANDUM

TO: Senator Don Steffes
 Chairman, Financial Institutions and Insurance Committee
FROM: Shirley Klenda Sicilian
RE: **Background on Financial Institution Privilege Tax Receipts**
DATE: January 22, 1998

Chairman Steffes and members of the Financial Institutions and Insurance Committee, thank you for the opportunity to present some background on the Kansas Privilege Tax. My name is Shirley Sicilian. I am Director of the Office of Policy & Research at the Kansas Department of Revenue.

I. Privilege Tax Basics.

On January 1, 1964, the Kansas privilege tax was imposed on national banking associations, banks, trust companies, and savings and loan associations "for the privilege of doing business within the state." (K.S.A. 79-1106 and 1107). Financial institutions subject to the privilege tax are exempt from paying corporate income tax. (K.S.A. 79-32,113).

Unlike the corporate income tax, the privilege tax is not a tax on income. Rather, the tax is *measured* by net income earned in the preceding year. (K.S.A. 79-1107). This distinction may not sound like much, but one important result is that income earned from federal securities can figure into the measurement of the privilege tax base, while it can not be taxed directly as income under the corporate income tax. (K.S.A. 79-32,117(c) (I), in accordance with the federal code).

The privilege and corporate rates also differ:

1. Banks: 4.25%, + 2.125% on income over \$25,000
2. S&Ls and trust companies: 4.50%, + 2.25 on income over \$25,000
3. Corporate income tax: 4.0%, + 3.35% on income over \$50,000

Table 4 summarizes these difference.

*Senate FDI
 Attachment 1
 1-22-98*

II. Privilege Tax Historic and Estimated Future Receipts.

Over the last decade, privilege tax has accounted for roughly 1% of SGF. Table 1 shows privilege tax receipts to the state general fund from 1981 to the present, including estimated receipts for FY1998 and FY1999. Receipts have traditionally been somewhat volatile. The largest percentage increase in privilege tax revenues occurred in 1993, partly from economic growth as the economy emerged from the 1990-1991 recession, but mainly from the acceleration of tax payments caused by instituting estimated payments for privilege tax liability. Declines in privilege tax revenues in 1994 and 1995 do not reflect falling liabilities as much as the loss of the cash flow effect of initiating estimated payment requirements. Revenues grew by 16.1 percent in 1996, but fell again in 1997, in part as a result 1996 FDIC assessments to replenish the savings association insurance fund. Since FY1994, receipts have averaged slightly more than \$30 million.

Because the banking industry has been experiencing economic growth, and the FDIC assessments only occurred for 1996, the consensus revenue estimating group originally forecasted privilege tax revenues to reach \$38.0 million in FY 1998, a growth of 7.6 percent from FY 1996 and 43% from FY 1997. However, in November that estimate was drastically revised.

One recent development figured prominently in the department of revenue's rationale for revising privilege tax estimates for FY1998 and FY1999. That was an increasing propensity for banks and savings & loans to create investment subsidiaries to hold their U.S. securities.

If a bank moves U.S. securities to a subsidiary, the interest earned may escape state taxation. Because the bank does not hold the U.S. obligations, the bank does not pay privilege tax on the earned interest. And, because the interest on U.S. obligations is not subject to tax under the corporate income tax, the subsidiary does not pay tax on the earned interest either. When the subsidiary distributes the income back to the bank, it is regarded as an inter-company transfer and is not subject to tax. Table 2 provides a hypothetical example which illustrates these tax effects from investment subsidiaries.

To estimate the impact this issue could have on revenues, the department examined returns for 69 of the 100 largest privilege tax taxpayers over the periods for tax years 1993 through 1996 (approximately FY 94 through FY 97 collections). In some cases, 1997 returns were also available. Income from U.S. obligations was determined and the tax base was recalculated without it. Tax returns were then recalculated and the change in liability examined. The analysis indicated that if privilege tax filers did not alter their asset portfolios while making use of investment subsidiaries, a decline of approximately 70 percent in privilege tax revenues could be expected. The declines were consistent across all 4 years of data. Among the returns examined, approximately 30 percent of the 1997 returns already showed indications of moving U.S. assets to a subsidiary, for an average tax reduction of 57.1 percent from their 1996 Privilege Tax liability. Three of these firms, with a combined 1996 liability of \$308,540, were able to reduce their combined 1997 liability to \$0 by moving U.S. assets to a subsidiary. Table 3 provides

actual historic data which illustrates that, in the aggregate, income from U.S. assets could very well completely outweigh overall net income.

The department feels the use of investment subsidiaries will increase over time and the full impact will not be felt immediately. This movement will necessarily take place as banks, initially reluctant to utilize this procedure, will feel compelled to reduce their tax bill if possible.

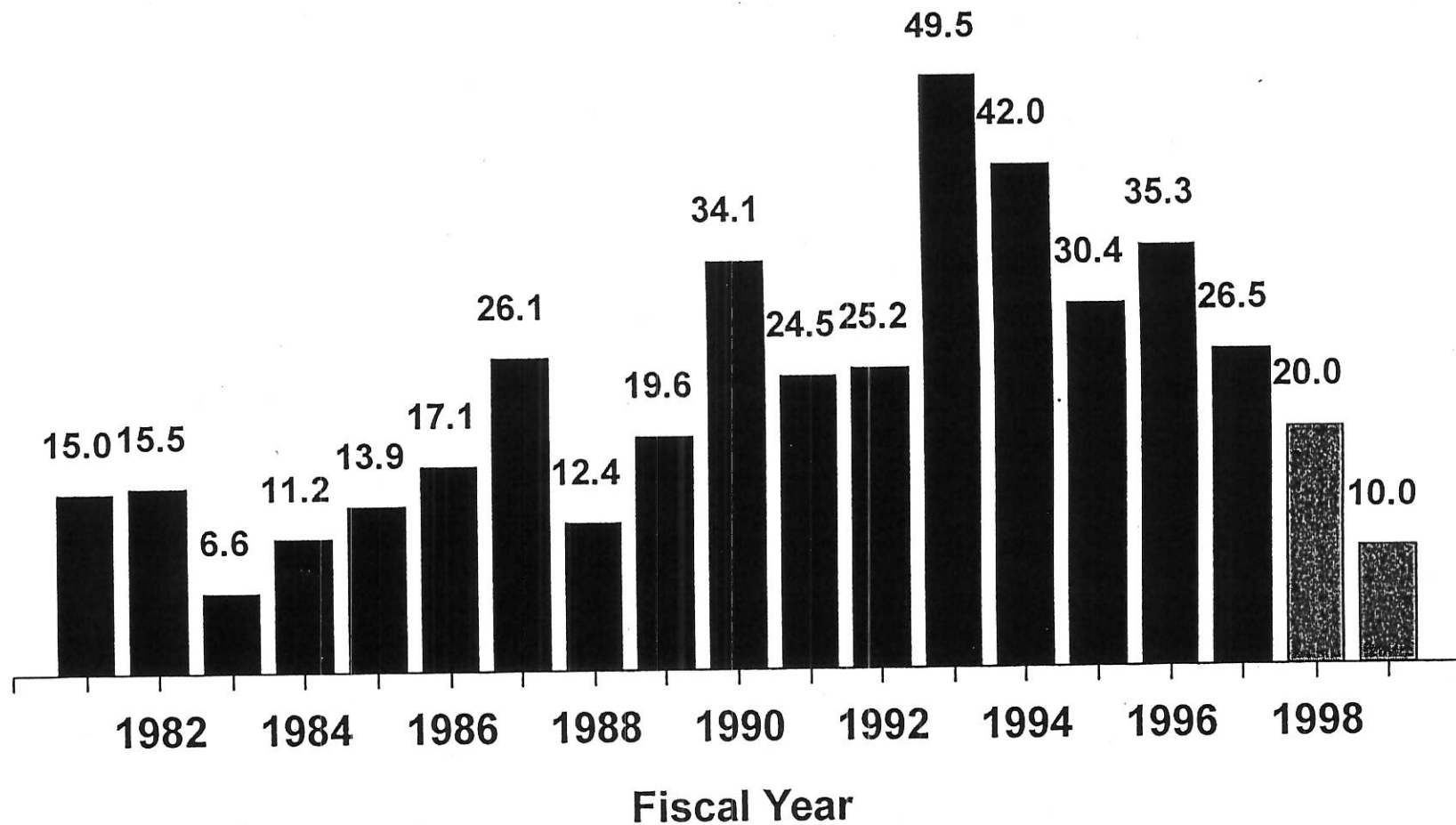
The estimate of a 70% ultimate impact may be conservative. As indicated above, the estimate assumed filers do not alter their asset portfolios. However, investment subsidiaries create an incentive to move U.S. assets to a subsidiary because privilege tax liability can be reduced or eliminated, thereby raising the after-tax rate of return of U.S. assets. Because interest earned on obligations of the U.S. is exempt from the Kansas corporate income tax, the interest earned by such subsidiaries on these assets faces a marginal effective state tax rate of zero. Raising the after-tax rate of return on U.S. assets should encourage financial institutions to increase their holdings of U.S. securities. As a result, interest claimed on either the privilege or corporate income tax returns from other types of assets should fall. For many banks, interest income from U.S. securities represents a large portion of the tax base under the privilege tax. If bank portfolios change to increase holdings of U.S. assets and those assets are held by subsidiaries, then privilege tax revenues could easily fall to zero for all filers.

We have been asked whether Sub-S changes, the FDIC special assessment for savings and loans, or the new bank apportionment formula might have been the cause of declining revenues.

- 1) Sub-S changes. The new federal law allowing banks to elect sub-s status will have no affect on privilege tax revenues. Last session the department and the banking community worked on Senate bill 51 which amended K.S.A. 79-1109 and K.S.A. 79-32,117. Pursuant to these amendments, Sub-S distributions are subtracted out at the individual income tax level, and instead, taxed at the privilege tax level.
- 2) FDIC assessment of Savings and Loans. The department's estimate is based on the impact that investment subsidiary issue will have on a future revenue stream. The FDIC assessment was a one time assessment in 1996, and would have no impact on that future revenue stream.
- 3) Multi-state banking apportionment. Apportionment formulas allocate income between states for tax purposes. The new apportionment formula would not change the size of the tax base, but only the size of the tax base attributable to Kansas. The department's analysis of the investment subsidiary issue is an analysis of the changes in the tax base. We know investment subs will cause the tax base to decrease. Apportionment is simply a means of allocating that dramatically lowered tax base. To the extent that some banks may continue to have non-zero tax bases, apportionment may further reduce the tax liability, but this would be an ADDITIONAL effect on top of the liability reduction we've estimated will occur from the use of investment subsidiaries, and was not taken into account in our revised estimate.

Privilege Tax Revenues

(millions of dollars)



Example Comparison of Kansas Privilege Tax and Kansas Corporate Income Tax
Example 1: Different Tax Liabilities for Identical Firms

<u>Kansas Privilege Tax</u>		<u>Kansas Corporate Income Tax</u>	
Federal Taxable Income for Kansas Privilege Tax purposes	\$1,800,000	Federal Taxable Income	\$1,800,000
plus		plus	
State and municipal interest income	\$463,000	State and municipal interest income	\$463,000
other additions (bad debts, operating losses, other)	\$1,000	other additions (bad debts, operating losses, other)	\$1,000
less		less	
Other subtractions	\$41,000	Interest on U.S. obligations	\$1,250,000
		Other subtractions	\$41,000
Subtotal	\$2,223,000	Subtotal	\$973,000
Less		Less	
Kansas reductions to tax base	\$5,000	Kansas reductions to tax base	\$5,000
Privilege Tax base	\$2,218,000	Corporate Income Tax base	\$968,000
Normal Tax (4.25%, 4.5% for S&Ls)	\$94,265	Normal Tax (4.0%)	\$38,720
Surtax on base over \$25,000 (2.125%, 2.25% for S&Ls)	\$46,601	Surtax on base over \$50,000 (3.35%)	\$31,591
TOTAL TAX LIABILITY	\$140,866	TOTAL TAX LIABILITY	\$70,311

Prepared by: Office of Policy and Research, Kansas Department of Revenue

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9-1

Example Comparison of Kansas Privilege Tax and Kansas Corporate Income Tax
Example 2: Bank Uses Investment Subsidiary to Manage U.S. Obligations

<u>Kansas Privilege Tax</u>	
Federal Taxable Income for Kansas Privilege Tax purposes	\$550,000
plus	
State and municipal interest income	\$463,000
other additions (bad debts, operating losses, other)	\$1,000
less	
Other subtractions	\$41,000
 Subtotal	 \$973,000
 Less	
Kansas reductions to tax base	\$5,000
 Privilege Tax base	 \$968,000
Normal Tax (4.25%, 4.5% for S&Ls)	\$41,140
Surtax on base over \$25,000 (2.125%, 2.25% for S&Ls)	\$20,039
 TOTAL TAX LIABILITY	 \$61,179

<u>Kansas Corporate Income Tax</u>	
Federal Taxable Income	\$1,250,000
plus	
State and municipal interest income	\$0
other additions (bad debts, operating losses, other)	\$0
less	
Interest on U.S. obligations	\$1,250,000
Other subtractions	\$0
 Subtotal	 \$0
 Less	
Kansas reductions to tax base	\$0
 Corporate Income Tax base	 \$0
Normal Tax (4.0%)	\$0
Surtax on base over \$50,000 (3.35%)	\$0
 TOTAL TAX LIABILITY	 \$0

Prepared by: Office of Policy and Research, Kansas Department of Revenue
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Aggregate Data on the Impact of Investment Subsidiaries
(dollar figures in thousands)

Data from the Kansas Bank Commissioner on all commercial banks in Kansas (state and national)	<u>Dec. 31, 1992</u>	<u>Dec. 31, 1993</u>	<u>Dec. 31, 1994</u>	<u>Dec. 31, 1995</u>	<u>Dec. 31, 1996</u>	<u>June 30, 1997</u>
1 Total Assets	\$30,141,558	\$30,317,578	\$30,662,439	\$31,427,940	\$28,607,075	\$28,623,700
2 Year-end holdings of securities	\$11,229,505	\$11,466,563	\$11,042,915	\$10,500,822	\$9,448,875	\$9,092,119
3 Year-end holdings of US obligations	\$9,595,977	\$9,686,893	\$9,348,571	\$8,917,316	\$7,997,194	\$7,665,620
4 Total Interest Income	\$2,231,707	\$1,955,041	\$2,000,437	\$2,257,855	\$2,062,241	\$1,057,804
5 Interest income from securities	\$786,547	\$646,184	\$612,614	\$615,495	\$552,396	\$275,361
6 Pre-tax net operating income	\$404,988	\$408,682	\$472,952	\$499,553	\$423,220	\$250,388
Estimates						
7 Share of securities comprised of US obligations <i>(line 3 divided by line 2)</i>	85.45%	84.48%	84.66%	84.92%	84.64%	84.31%
8 Interest from US obligations <i>(line 7 times line 5)</i>	\$672,130	\$545,893	\$518,619	\$522,679	\$467,528	\$232,159
Interest from US obligations share of pre-tax operating income <i>(line 8 divided by line 6)</i>	165.96%	133.57%	109.66%	104.63%	110.47%	92.72%
Taxable income if subsidiary holds US obligations <i>(line 6 minus line 8)</i>	-\$267,142	-\$137,211	-\$45,667	-\$23,126	-\$44,308	\$18,229
Liability if bank keeps US obligations	\$25,287	\$25,522	\$29,619	\$31,315	\$26,449	\$15,431
Liability if subsidiary receives US obligations	\$0	\$0	\$0	\$0	\$0	\$631
Change in liability	-\$25,287	-\$25,522	-\$29,619	-\$31,315	-\$26,449	-\$14,800