Testimony

before the

Pennsylvania House of Representatives Finance Committee

Presented by

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and

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Introduction

The Pennsylvania Bankers Association (PA Bankers) deeply appreciates this opportunity to appear before the Committee to discuss taxation from the perspective of the Commonwealth’s financial institutions.

My name is Mark Hughes. I am employed by Citizens & Northern Bank (C&N) in Wellsboro, PA where I serve as Executive Vice President, Chief Financial Officer and Treasurer. Prior to joining C&N in 2000, I was Principal and Manager at the accounting firm of Parente Randolph P.C. I appear here today in my capacity as chair of the PA Bankers Association’s financial institution tax advisory committee.

Citizens & Northern has been a local, community bank since 1864. Ever since our founding, Citizens & Northern has been instrumental in helping our communities thrive by providing needed funding for growth and contributing to local charities which share our mission to enhance the lives of our neighbors in the communities we serve. We operate in seven counties in northern PA and one in southern NY. We employ 295 people. We now have $631 million in loans outstanding to individuals, businesses and government entities. In 2014, C&N made $180,000 in charitable contributions in the communities we serve. Our staff volunteered countless hours in their communities last year.

Sizes, locations and business models may differ, but banks exist to help make their customers’ dreams come true – their first cars, homes, vacations, retirements, investments and educations in the case of individuals’ success, and expansion in the case of our business clients, and security and sustainability in the case of our nonprofit and government customers. If our customers do not prosper, our shareholders cannot either. Whether by direct investment or by participation in an employer’s benefit plan, many Pennsylvanians invest in one or more financial institutions, so many of your constituents have an interest in the banking industry.

Background

PA Bankers was invited here today to discuss our priorities as it relates to tax issues. I’d like to explain how banks are taxed currently in Pennsylvania under the Bank Shares Tax, the structural changes made to the tax by Act 52 of 2013, and explain our concerns and opposition to Governor Wolf’s Proposal\(^1\) to sharply increase the rate of the tax.

State tax policy clearly has economic and competitive implications on our industry, so we urge this Committee and the General Assembly to be very cautious regarding further changes to the Bank Shares Tax.

Banks are not taxed like other corporations in Pennsylvania. Most PA businesses are taxed on their income. Banks are taxed on their total bank equity capital or stockholders’ equity. Stockholders’ equity is equal to the excess of the company’s assets over its liabilities.\(^2\)

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\(^1\) See pages C1-6, C1-12, C1-13, C1-16, & C1-20 for Bank Shares Tax Information

\(^2\) Stockholders’ equity is often referred to as the book value of the company, and it comes from two main sources. The first and original source is the money that was originally invested in the company, along with any additional investments made thereafter. The second comes from retained earnings that the company is able to accumulate over time through its operations. In most cases, especially when dealing with older companies that have been in business for many years, the retained earnings portion is the largest component. Source: Investopedia
Our federal and state regulators place a great deal of importance on our capital level, a measure of our sustainability. Our capital is reported by our bank and all banks to the federal regulators on a quarterly basis on reports of our condition, known as Bank Call Reports. These reports are accessible online.

Because we are taxed on capital and not income, banks pay the Bank Shares Tax whether they make money or not. In the wake of the financial crisis, when federal regulators required banks to increase their capital, Bank Shares Tax revenue increased exponentially as depicted by the chart below.

![Chart showing Bank Shares Tax revenue growth from 2008-2013](chart.png)

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>FY 2008-9</th>
<th>FY 2009-10</th>
<th>FY 2010-11</th>
<th>FY 2011-12</th>
<th>FY 2012-13</th>
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<tbody>
<tr>
<td>Total General Fund Taxes</td>
<td>25,294.5</td>
<td>24,909.9</td>
<td>26,460.6</td>
<td>27,148.5</td>
<td>27,995.0</td>
</tr>
<tr>
<td>Corporate Taxes</td>
<td>2,767.6</td>
<td>2,552.2</td>
<td>2,950.8</td>
<td>2,859.6</td>
<td>2,990.0</td>
</tr>
<tr>
<td>Insurance Taxes</td>
<td>431.5</td>
<td>459.5</td>
<td>428.6</td>
<td>458.4</td>
<td>446.9</td>
</tr>
<tr>
<td>Bank Shares Tax</td>
<td>191.1</td>
<td>212.1</td>
<td>226.5</td>
<td>258.0</td>
<td>337.0</td>
</tr>
<tr>
<td>Sales and Use Tax</td>
<td>8,135.5</td>
<td>8,029.2</td>
<td>8,590.2</td>
<td>8,772.3</td>
<td>8,893.7</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>10,198.6</td>
<td>9,968.7</td>
<td>10,435.7</td>
<td>10,800.5</td>
<td>11,371.2</td>
</tr>
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</table>

This sharp spike in banks’ PA tax burden came at a time when revenue from other business taxes grew very slowly or declined.

In addition to growing much more rapidly than other taxes, the Pennsylvania Bank Shares Tax is much higher than taxes imposed on banks by other states. The Pennsylvania Bankers Association engaged the accounting firm of Crowe Horwath to conduct an evaluation that compared the taxes imposed on typical banks under Pennsylvania law with the taxes that would be imposed if the laws in several other states were substituted for Pennsylvania law, including the taxes imposed by most of our neighboring states. The results of this analysis, which was incorporated by the Department of Revenue into the study of Bank Shares Tax...
conducted by the Department of Revenue as required by Act 52 of 2013, are illustrated below:

![Average 3-Yr. Total Tax Paid By Small, Medium & Large Banks in PA and Other States](chart)

Pennsylvania banks are also disadvantaged by the tax benefits made available to some of their strongest emerging competitors for consumer and business relationships, federally and state chartered credit unions. In contrast to the high rates of tax paid by banks, credit unions do not pay any federal, state or local taxes, except for taxes on real property. The Governor's 2015-16 Budget Proposal estimates that these tax exemptions will cost the Commonwealth $26.3M in lost revenue in Fiscal Year 2015-16.\(^3\)

Prior to enactment of Act 52 of 2013, Pennsylvania banks were exposed to unsustainable year-to-year tax increases, and were subject to a tax system in Pennsylvania that was uncompetitive\(^4\) with surrounding states. Moreover, the prior tax did not encourage banks to locate operations in Pennsylvania. In addition the prior tax was the subject of frequent litigation. Therefore, the PA Bankers Association requested that the Bank Shares Tax be modernized and adjusted to a more sustainable growth rate.

**Changes Made by Act 52 of 2013**

As a result, the General Assembly in Act 52 of 2013 made the following structural changes to the Bank Shares Tax:

- Eliminated the use of a six-year moving average of equity capital to determine the base of the tax, and instead required banks to calculate Bank Shares Tax liabilities using the most recent year-end value of equity capital. This change eliminated the

\(^3\) Governor’s 2015-16 Budget, page D45

\(^4\) As demonstrated by the comparison research performed by the accounting firm of Crowe Horwath provided to the Committee in a separate document.
discrimination that occurred under the prior tax system that did not include equity as a result of mergers for the prior five years when a bank merged with an out-of-state institution not previously subject to the tax, but included equity for the prior five years when two institutions subjected to the tax merged.

- Required the interstate apportionment of tax liabilities be based solely upon receipts, rather than based equally on receipts, deposits and payroll. This change is similar to the move to a single sales factor for the Corporate Net Income Tax that the General Assembly enacted several years ago. Using apportionment based solely on receipts, rather than including payroll and deposits, eliminated disincentives to locate bank operations in Pennsylvania.

- Excluded non-controlling interests in consolidated subsidiaries from equity capital. Non-controlling interests in subsidiaries represent the portion of the equity of subsidiaries not owned or controlled by a bank or its parent company. Excluding these interests from equity avoids taxing banks on property they do not own or control.

- Provided a clear definition of receipts subject to apportionment in order to eliminate a frequent source of tax assessments and appeals.

- Adopted extensive new rules for the apportionment of receipts based upon the apportionment recommendations of the Multistate Tax Commission, but which rely more heavily on market-based sourcing and eliminate disincentives to maintain headquarter operations in Pennsylvania.

- Expanded nexus requirements for purposes of determining when banks engage in business in Pennsylvania and are subject to the Bank Shares Tax.

- Reduced the rate from 1.25% to 0.89% to prevent the changes in the tax base from resulting in an overall increase or decrease in tax liabilities.

The modernizations the legislature made to the Bank Shares Tax by Act 52 of 2013 encourage banks to locate employees and operations in the Commonwealth. As you know, states may only tax to the degree taxpayers have reasonable contacts with the state known as nexus.

The prior Bank Shares Tax discouraged banks from locating employees and operations in PA and did not adequately tax banks located elsewhere which generate receipts from within PA. So, Act 52 expanded the tax’s nexus to include banks which operate in Pennsylvania (beyond a de minimis level) whether they locate employees and operations here in order to do so, or not.

At the time the Bank Shares Tax was revised, we were told that any changes had to be “revenue neutral.” The current .89% Bank Shares Tax rate was calculated by the Department of Revenue to be “revenue neutral.” The department did not share the bases of their estimate with us, so we could not test its assumptions.
When Bank Shares Tax revenue received in 2014 was less than the $350M in cash the department told us was expected for that fiscal year, we tried to assist the department in determining why. In particular, we asked the department whether, based on more recent data, their June 2013 estimate that revenues for the 2013-14 fiscal year would have been $350M had the law not been changed were accurate. We suspect this base-line “revenue neutral” estimate may have been overly optimistic and that had Act 52 not been enacted revenue collections would have been more consistent with the actual $307.5M actually collected in the 2013-14 fiscal year.

One indicator that the $350M revenue estimate was too high is that between February of 2013 when the Governor’s Budget Proposal for the 2013-14 fiscal year was released, and the time the 2013-14 budget was enacted, the Revenue Department increased the estimate of Bank Shares Tax collections by $42.5M, without in our view any adequate explanation. To date, we have not received enough data from the department to determine whether the $350 revenue estimate was accurate, and if the estimate did accurately reflect what would have been collected had the law not been changed, why cash collections under Act 52 fell below this estimate.

We strongly believe, however, that other factors were responsible for the shortfall. For example, the department’s Bank Shares Tax Report issued on January 9, 2015 demonstrates on page 1 of its Appendix A that banks’ shares tax liabilities rose in 2013-14, so we suspect that prior years’ over-payments, use of tax credit programs and other factors resulted in less cash being received. Despite our attempts to reduce litigation about the bank shares tax, disputes occur. These disputes may last several years and may result in assessments or refunds/credits that significantly impact a given year’s cash revenue from the bank shares tax. We are also concerned that the estimate included amounts in dispute. Prior to the enactment of Act 52, banks were required to pay their assessments before having the opportunity to appeal them. Act 52 brought banks in line with all other businesses by not requiring them to “pay to appeal”. We do not believe that the Department of Revenue accounted for this change in its 2014 estimate.

The Bank Shares Tax Study

As mentioned above, Act 52 required the Department of Revenue, working with representatives of the banking industry, to submit to the legislature a detailed joint report to enable the legislature to determine whether the revisions to the Bank Shares Tax statute made by the Act sufficiently addressed the significant changes in the structure and regulatory environment within the banking industry and provided predictable tax revenues for the Commonwealth.

The Association believes that analysis of the growth rate of reported tax liabilities provided in the report illustrates that Act 52 achieved and exceeded the rate of growth of tax liabilities included in the Fiscal Notes that supported enactment of the legislation. Further, data provided in the report demonstrates that shortfalls of cash collections reflect cash-flow timing issues that will be resolved over time, caused by variability in the timing and

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5 Appendix A of the department’s Bank Shares Tax Report shows $41.6M of assessments which increased 2012-2013 tax over the amounts reported by banks on their returns. That is a significant amount the impact of which merits a careful analysis as to how it may have impacted the department’s Act 52 revenue estimate.
amounts of assessments, changes in economic conditions not anticipated during the consideration of Act 52, and actions taken in other legislation to increase the availability of tax credits.

The Association disagreed with the Department of Revenue’s interpretation, as suggested by the report, that Act 52 limits the use of Method 1 apportionment only to receipts from trading activities and that clarifications to current law are needed to allow continued use of the goodwill deduction. However, in order to eliminate any perceived ambiguity in the Act, PA Bankers does support enactment of legislation, as recommended in the report, to provide clarity to these provisions and allow banks to choose either Method 1 or Method 2 for apportionment of receipts and to continue to be able to deduct goodwill from the tax base.

I wish to highlight the fact that even with the changes made to the Bank Shares Tax by Act 52 of 2013, the Study notes that Pennsylvania’s bank tax structure remains uncompetitive with how banks are taxed in our surrounding states. The Crowe Horwath Report cited previously shows that even after enactment of Act 52 of 2013 Pennsylvania imposes substantially higher taxes on banks than other states.

Opposition to Governor’s Proposal

We see absolutely no justification for raising the Bank Shares Tax rate to 1.25% retroactive to 2014 when by the department’s own data that would increase Pennsylvania banks’ state tax burden far in excess of even a $350M measure of “revenue neutrality.”

According to the Governor’s Budget Proposal, if the tax rate is increased to 1.25% retroactive to 2014, total Financial Institutions Tax collections for the five fiscal years from 2013-14 through 2017-18 will be $583.5 million higher than the collections for this five year period as were estimated by the Department of Revenue in its 2013-2014 Estimate Documentation (Bureau of Research, February 19, 2013) prior to the enactment of Act 52 of 2013 and $404.6 million higher than the collections for this five year period were estimated by the Department of Revenue in its 2014-15 Estimate Documentation (Bureau of Research, February 18, 2014) after the enactment of Act 52.6

Five-Year Total Financial Institutions\textsuperscript{7} Tax Collections (millions of dollars)

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<tbody>
<tr>
<td>FY 2013-14 Revenue Estimate</td>
<td>322.7</td>
<td>328.8</td>
<td>335</td>
<td>341.4</td>
<td>347.9</td>
<td>1675.8</td>
<td>583.5</td>
</tr>
<tr>
<td>FY 2014-15 Revenue Estimate</td>
<td>325.5</td>
<td>355.3</td>
<td>372.9</td>
<td>390.7</td>
<td>410.3</td>
<td>1854.7</td>
<td>404.6</td>
</tr>
<tr>
<td>FY 2015-16 Budget Proposal</td>
<td>317.8</td>
<td>314.8</td>
<td>672.1</td>
<td>467.5</td>
<td>487.1</td>
<td>2259.3</td>
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Five-Year Total Revenue
(Millions of Dollars)

Even if the fairness issue were set aside, the impact to the Commonwealth’s economy should be enough to reject this proposal.

Using a rough approximation\textsuperscript{8} of the impact of this tax increase on the Pennsylvania banking industry’s ability to lend to your constituents, an increase to a 1.25% Bank Shares Tax rate could result in $3.8B fewer loans over a five-year period. That is a serious reduction in credit availability that would diminish individuals’ and businesses’ ability to prosper in the Commonwealth with further economic impacts that we cannot calculate.

We respectfully urge your opposition to that proposal.

Thank you for your invitation and your attention today. If you have any questions, I will answer them to the best of my ability.

\textsuperscript{7} This includes revenue projected to be received from the Mutual Thrift Institution Tax (MTIT).

\textsuperscript{8} This estimate is based upon the following formula: (Additional shares tax multiplied by inverse of the marginal income tax rate) multiplied by equity multiple. In other words, since banks typically have assets equal to (roughly) 10 times their equity, the after-tax additional expense has an impact of 10 times that amount in reduced funds available for lending.