Iowa Legislative Fiscal Bureau

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ISSUE REVIEW

Franchise Tax

ISSUE

Some banks are limiting Iowa franchise tax liability by locating deposits in other states.

AFFECTED AGENCIES

Department of Revenue and Finance (DRF)

Department of Commerce - Banking Division

CODE AUTHORITY

Chapter 422 (various sections), Code of Iowa

BACKGROUND

Franchise Tax in Iowa

The franchise tax is paid by financial institutions for the privilege of doing business in the State. For franchise tax purposes, financial institutions include: State and nationally chartered banks, production credit associations, federally chartered savings and loan associations, and financial institutions chartered by the Federal Home Loan Bank Board. State and federally chartered credit unions are not subject to the franchise tax.

Financial institutions pay franchise tax on net income, which is determined using the same method as net income for State corporate income tax purposes, with 2 exceptions. There is no deduction for interest and dividends from federal securities or for federal income taxes paid. The franchise tax rate is a flat 5.0% of Iowa net income.

Franchise tax receipts affect local governments as well as the State's General Fund. The State's General Fund receives 55.0% of a financial institution's franchise tax receipts. The county in which the institution is located receives 27.0% of the receipts, and the city in which the institution is located receives 18.0% of the receipts.[1]

[1] The General Assembly passed, and the Governor signed, SF 425 during the 1994 Legislative Session. The bill capped the local disbursement of franchise tax receipts at $8.8 million annually, with 60.0% going to cities and 40.0% to counties.

Franchise Tax in Other States

According to a Multistate Tax Commission survey, Wyoming and Nevada are the only states that do not levy a tax on banks. In these 2 states, banks only pay tax on real and tangible personal property. All other states have either a franchise tax, tax banks like corporations, or have some type of receipts or capital assessment tax. Iowa is 1 of 39 states that ties bank taxes to net income, although the determination of net income varies across states. Several states, like Nebraska, have moved to a franchise tax based on deposits.

Deposit taxes are similar to property taxes. They are levied independent of the income of the bank, unless there is some type of income qualifier. In Nebraska, for example, banks pay a franchise tax equal to 0.45% of deposits. Also, Nebraska has an income limitation provision such that banks who break even or lose money are not required to pay franchise tax.

CURRENT SITUATION

Recently, it has come to the attention of the Iowa General Assembly that some banks are reducing their Iowa franchise tax liability by setting up investment subsidiaries in other states. Specifically, banks are taking portions of their securities portfolios and depositing them into out-of-State wholly-owned subsidiaries with no nexus (presence) in Iowa.

Unlike businesses who pay corporate income tax, financial institutions that pay the franchise tax must pay tax on the income earned from federal securities. By locating the deposits in a state with no nexus, the banks avoid paying franchise tax on the relocated assets.

It is not known exactly how many banks are utilizing the deposit relocation strategy, or how extensive the portfolios are. Although State chartered banks are required to get subsidiary location approval from the Division of Banking, nationally chartered banks are under no such restriction. This creates two problems. First, it is difficult to estimate how much income is being relocated. Secondly, if a State chartered bank is denied approval from the Division of Banking, the bank could become a nationally chartered bank and move the securities at will.

ALTERNATIVES

The following alternatives exist to address the issue of banks sheltering net income:

- Adopt a deposit tax
- Adopt a deposit tax with a net income limitation
- Abolish the franchise tax and replace it with a corporate income tax

Deposit Tax

This alternative would represent a shift away from a franchise tax based on income to a franchise tax based on bank size, as measured by deposits. Currently, a bank that loses money in Iowa (has net income less than $0) pays no franchise tax. Under a deposits tax, assuming the change would be revenue neutral, the most profitable banks would receive a slight tax reduction, and the least profitable banks would receive a tax increase.

One advantage to the deposits tax is that shifting income to other states would not reduce tax liability. The tax would be imposed on the amount of deposits, regardless of what a bank chooses to do with the deposits. Another advantage is that franchise tax receipts would tend to stabilize. This is due to the fact that, in times of economic downturn, bank profits tend to decline as defaults increase and loan profits decrease. A tax based on deposits would probably be less sensitive to these cycles.

The advantage of stability has a corresponding disadvantage. Under a net income franchise tax, banks are given a cushion during recession. Banks pay more tax when they can most afford it, and pay the least tax when financial times are less profitable. Conceivably, a small bank on the margin could survive under a net income tax and fold under a deposits tax.

Deposits Tax With a Net Income Limitation (Modified Deposits Tax)

This is the option suggested by various banking associations. The tax would be imposed on deposits, as described above, but banks would also have the option of using a net income determination[2]. When net income is high, banks would pay a deposits tax, and in periods of low net income, the net income tax. This is similar to the current procedure in Nebraska.

When bank profits are high, there would be no tax incentive to locate deposits in other states, because it would not reduce tax liability. When bank profits are low, however, banks under a modified deposits tax system would be expected to utilize the net income determination, and the incentive to relocate deposits would return. It is difficult to predict the overall effect of this system on the deposit relocation strategy.

Another potential problem with a modified deposits tax concerns the nature of the net income determination as a floor rather than a ceiling. This issue is related to revenue neutrality. Revenue neutrality can be attained when comparing two identical years. Under this system, as banks become more profitable, franchise tax receipts would probably not grow as fast as under the current system. As bank profits decline, franchise tax receipts would be expected to decline at a rate similar to the current system. Thus, in the future's worst years, franchise tax receipts would be similar to the current system, but in the future's best years, receipts would be less than the current system.

Replace the Franchise Tax With the Corporate Income Tax

This option would treat financial institutions (insofar as it is legal to do) the same as other corporations. This option runs the risk of dramatically reducing the taxes paid by financial institutions, since net income for franchise tax purposes is higher than net income for corporate income tax purposes. This option could conceivably address the problem of asset relocation, due to the fact that apportionment might be able to capture the income on assets moved across state lines.

A corollary to this option would be to impose a franchise tax on all corporations. This would allow the State to capture income on such things as federal securities, which currently cannot be done, except on those institutions described earlier. Companies like GMAC, for example, provide many of the services that banks provide, but are not taxed accordingly. This option would probably result in a sizable, though unquantifiable, increase in General Fund revenues. It is less clear how it would solve the problem of asset relocation.

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[2]During the 1994 Legislative Session, in proposed legislation offering a net income fallback provision, net financial income was used rather than net income. There were a number of concerns raised by the DRF with regards to this shift, including such issues as how net operating loss carryforwards would be addressed. This ***Issue Review*** does not attempt to address these kinds of technical issues, or the constitutionality of the process.

BUDGET IMPACT

Gross franchise tax receipts totaled $34.1 million in FY 1994, including the $8.8 million disbursement to local governments. The Revenue Estimating Conference FY 1995 estimate is $32.9 million. It is not known how long banks have been utilizing the deposit relocation strategy. The option has existed for many years, but use appears to be increasing. If the State maintains the franchise tax in its present form, there will probably be a decline in franchise tax revenues, though the amount is not possible to predict. As previously indicated this affects the State General Fund, cities, and counties.

The deposits tax and modified deposits tax options could be implemented as revenue neutral options, at least with respect to FY 1994 revenues. With the deposits tax, revenues would be somewhat higher in low profit years, and somewhat lower in high profit years. With the modified deposits tax, revenues would be similar in low profit years, but somewhat lower in high profit years.

The corporate income tax replacement of the franchise tax could solve the problem of asset relocation, but would likely result in a net decrease in General Fund revenues. The effect on local governments would depend on enactment of specific bill drafts. The expansion of the franchise tax to all corporations would be a potential source of new revenues, but may not solve the problem of asset relocation.

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