Ohio Enacts Major Reform of Taxes on Financial Institutions and Their Affiliates; Repeals Dealer Tax on Net Worth

Overview

Today, December 20, 2012, Governor John Kasich signed into law Amended Substitute House Bill 510. The Ohio Senate recently approved the bill which replaces the existing franchise tax on a financial institution's net worth with a new franchise tax imposed at the parent holding company level for typical financial institution groups ("Financial Institution Tax"). The bill also repeals the Dealer in Intangibles ("Dealer") Tax on an entity's net worth and instead taxes such entities within the Commercial Activity Tax ("CAT") regime. The new financial institution tax will be imposed starting with the 2014 tax year (based on equity capital at December 31, 2013) and the Dealer provisions go into effect during 2013. These provisions were based on the Governor's proposals with some modifications and received widespread support throughout the financial services industry.

Background

In March of 2012, the Governor proposed reforming the tax on financial institutions. The Governor had indicated that his proposal was intended to close certain "loopholes" utilized by big banks and using the increased revenue to refund reductions for smaller community banks. Traditionally, Ohio would subject regulated financial institutions to a tax based on its net worth with certain reductions including "appreciation" which included subsidiary income and certain mark-to-market adjustments for financial statement purposes. A financial institution's net worth was sourced based on financial institution specific sourcing substantially similar to the Multi-State Tax Compact ("MTC") model rule. Affiliates of a financial institution were subject to the Corporation Franchise Tax on the greater of income or net worth (rather than the CAT) or subject to the Dealer Tax. Financial services companies with an Ohio location including brokers, lenders, and discounters were subject to a separate tax on net worth known as the Dealer Tax.

The Dealer Tax included a number of lending type entities in non-financial services groups (e.g., a lending arm of a manufacturer).

Financial Institution Tax

The new financial institution tax will be imposed starting with the period ending December 31, 2013, referred to as the 2014 tax year. The tax will be based on "total equity capital" measured for most traditional banking institutions at the holding company level as reported on its Call Report. For certain other financial institutions ("diversified savings and loan holding companies"), the capital base will be based on the financial institution's own equity rather than its parent or holding company's equity. Diversified savings and loan holding companies are holding companies of savings and loan banks that are not part of a traditional banking group, such as a bank in a retailing group or manufacturing group.

The original tax on a bank's net worth was assessed at a rate of 13 mills. The new tax's rate is a graduated rate: 8 mills on the first $200 million; 4 mills on equity capital between $200 million and $1.3 billion; and 2.5 mills to equity capital in excess of $1.3 billion. There are provisions in the bill that increase or decrease the applicable rate depending on whether certain tax revenue targets are met by fiscal year 2014 or 2016.

Certain Ohio qualified real estate investment trusts ("REITs") are phased in to the equity capital base and the apportionment factor over time. These REITs include publicly traded REITs that were traded on a public stock exchange on January 1, 2012.

Financial Institution Apportionment

The tax base will be sourced using a single gross receipts factor using a market approach of where the customer receives the benefit of the services received. The physical location where the customer ultimately uses or receives the benefit of the services will be "paramount" in determines where the benefit is received. A series of examples, such as interest and other receipts from loans, are provided which are *similar* to the MTC model language previously in place. Unlike the prior apportionment methodology, however, the sale of services will be sourced based on a market approach (versus previously under the greater cost of performance standard). Likewise, investment assets are sourced based (upon the taxpayer's election) on the ratio of the other receipts in the factor or where the assets are managed.

Dealer In Intangibles Tax

The bill eliminates the Dealer Tax based on net worth, and subjects most prior Dealers (those not subject to the financial institution tax) to the CAT starting with the period starting January 1, 2013. Interestingly, interest income is typically exempt from the CAT and can be a majority of lending Dealers' gross receipts. Broker type Dealers will continue to use a market based sourcing.

The provisions provide a credit at a bank for the final Dealer Tax paid by a bank subsidiary under the prior Dealer Tax regime. The prior Dealer Tax utilized a lien date concept such that the final Dealer Tax on net worth as of December 31, 2012, was due and payable in calendar year 2013 (the 2013 tax year). A Dealer credit was available to a bank under the prior Corporation Franchise Tax to offset the Dealer's net worth that was also being included in the bank's tax base. The provisions allow the bank a credit for the final Dealer Tax paid in 2013 on the bank's first return under the new Financial Institutions Tax. A credit is not available in subsequent years since a Dealer subsidiary will be treated as part of the financial institution under the new Financial Institution Tax.

CAT Amnesty on Insurance Company Affiliates

The bill provides that the Tax Commissioner shall not assess or hold a person liable for failure to report or pay the CAT for any tax periods ending before January 1, 2013, so long as the person paid the Corporation Franchise Tax and was an affiliate of an insurance company subject to the Ohio tax on premiums. Previously, the statutory language was purportedly unclear on whether insurance affiliates were subject to the CAT or the Corporation Franchise Tax. Many insurance affiliates filed Corporation Franchise Tax returns and the Tax Commissioner had challenged this methodology on audit. This statutory language would prevent such actions by the Tax Commissioner and the CAT exemption was amended to subject affiliates of insurance companies to the CAT in the future.

Municipal Exemption

The bill continues the prohibition of imposing a municipal tax on financial institutions.

Observations

The bill provides much needed reform to the financial institution area with respect to smaller community banks and overall reducing the rate on all financial institutions. It also eliminates some of the issues the Department and taxpayers most frequently disagreed on including net worth reductions claimed as "appreciation" under the old tax. At the same time, the change to market sourcing relieves some of the tax pressure on banks with a headquarters or significant operations in Ohio. With limited reductions in the net worth tax base, there will be more emphasis on the receipts factor and the addition of the entire affiliated group could generate some interesting considerations. Likewise, the elimination of the Dealer Tax and subjecting such entities to either the CAT or new Financial Institution Tax represents a fundamental shift that will require analysis of the entity's overall activities.