I'm Ballard Cassady, President and CEO of the Kentucky Bankers Association. I am joined at the table by John Cooper and Debra Stamper. Behind me is Henry Hawkins (MCM) and Matt Vance.

We're here to speak **for** the 22,000 people employed at Kentucky's 177 banks – and for the hundreds of thousands of Kentuckians who need their community's bank to buy a home, to start or expand a business, or to support their schools and hospitals with donations.

Every one of those people – *your constituents* – is being impacted by the problem that I'm here to make sure this Committee understands.

Today, Kentucky is taxing its banks at a rate that is higher by 92%, on average, than it taxes **any other** corporation or business in this state. The corporate tax reforms enacted by the General Assembly in 2018 actually *increased* that gap. It's a serious problem with serious consequences, for banking as a key economic engine for industry and for Kentucky's tax revenue.

In every conversation a Kentucky banker has had with you individually, the question has come up: how did this happen?

It can be traced to a series of events that began in 1995. Before that, the taxes on banks and other corporations had different names but the overall rates on average differed very little.

In 1995, we had a court case that made its way from the Kentucky Supreme Court to the U.S. Supreme Court and back. Along the way, Kentucky's method of taxing banks was found to be unconstitutional.

In response, the banking industry employed tax professionals and attorneys to work with the Revenue Cabinet in developing the Bank Franchise Tax, which was the model being used in most states at the time. The reason it's called a "bank franchise tax" is a quirk of history; it doesn't refer to franchise in the usual sense. But it was popular because it "apportioned" in-state revenue, people and real estate to banks whose headquarters were located out-of-state.

This new bank tax model was, at the time, revenue-neutral for the Commonwealth and involved slight changes in overall rates for our banks. We were still being taxed at about the same rates as other Kentucky corporations.

That began to change in 2005, when Kentucky lowered the top rate on corporations from 8.25% to 6%, with no changes to the bank tax model.

In a minute, we'll take a look at how the Bank Franchise Tax is calculated, how parts of it are based on a five-year average of the bank's <u>net</u> capital. Because of that "five year look back", the consequences of the 2005 tax changes didn't show up immediately.

But they were certainly being felt by 2007-08. We needed reforms then, but if you were here in 2007 and 2008, you'll appreciate why we were not heard then. The entire country was in recession, for reasons that had absolutely nothing to do with a single Kentucky bank, and the state was dealing with a sharp drop-off in tax receipts. Cities were nervous about insolvency, hospitals were closing or forced to merge, our bond ratings were under attack. Times were really tough.

Unfortunately for banks, they got even tougher in 2010, with the overwhelming new federal bank regulations known as Dodd-Frank.

Dodd-Frank **<u>forced</u>** every bank in the country to move more of their assets into capital, the <u>primary component of the Bank Franchise Tax</u> – even though Kentucky banks had nothing to do with the problem Dodd-Frank was trying to solve.

Because capital is the largest component of the state's Bank Franchise Tax, that immediately skewed our state tax rate upward and <u>further</u> widened the imbalance between tax rates on Kentucky banks and every other corporation in the state.

The Kentucky Department of Financial Institutions used this slide recently to show that Kentucky's state-chartered banks have the highest capital in any of these states in our region.

And the FDIC reports that the average capital level of ALL banks in Kentucky is even higher at 11.42%

Having some of the best-capitalized banks in the country is a good thing**.** It kept our banks from failing in the 2008 recession – states like Georgia had a bank a week fail. **But the Bank Franchise Tax turns that strength into a weakness.** Because capital is the key component of the Bank Franchise Tax calculation, our high capital rate contributes to the imbalance between Kentucky's bank tax rates and the tax rate on all other corporations. And it is part of the reason Kentucky's bank tax rate is so much higher than in any of these states around us.

The remainder of this presentation will take a closer look at this tax imbalance and its consequences for banks and for Kentucky's tax receipts.

The end result of the history I've shared is that, by 2016, Kentucky was taxing its banks at a rate that was 60% higher on average than on any other corporation in the

state. Like so many others in the state, we hoped and waited for comprehensive tax reform within which to seek a solution for that issue.

But there's a reason we can't wait any longer. As of July 1, 2018, with the reduction of taxes on corporations from 6% to 5%, again with no adjustment to bank taxes, Kentucky is now taxing its banks at a rate that is **92% higher** on average than on any other corporation in the state. In fact, Kentucky now taxes its banks higher than any other state in the United States.

The consequences, for many of our most vulnerable community banks and communities, has passed the point of being irrational and unfair. They are now becoming a danger… a danger for not only our banks and communities but for the state as a whole.

I've gotten authorization to share publicly here today what this tax imbalance means to some of our community banks in your Districts in terms of tax burden… The 92% tax gap between our banks and other corporations is an ***average.*** For many of our small banks, it's much higher. For example:

- Metro Bank (Louisville) – 1,186%
- Kentucky Farmers Bank (Cattlettsburg) – 1,092%
- First & Peoples Bank (Russell) – 1,039%
- First National Bank of Manchester – 852%
- First National Bank of Russell Springs – 287%
- River City Bank (Louisville) – 234%
- Bank of Cadiz & Trust – 200%
- Hyden Citizens Bank – 195%
- Commercial Bank of Grayson – 149%
- First State Bank of the Southeast (Middlesboro) – 127%

We are the only state in the country where even if a bank suffers an operating loss they still have a tax bill.

Taxing banks an average of 92% more than other corporations has unintended consequences, for your constituents and for the state's revenue.

If Kentucky's banks were taxed like every other corporation in Kentucky they'd still be paying their fair share of taxes, but more resources would stay at work in **YOUR** local communities, enabling more homes to be built, bought and sold — more businesses to start or expand — more jobs to be created for your constituents. Banks could better serve their historical role as the primary donors in support of local civic life – with donations to schools, hospitals, the arts, and volunteer services of all kinds. You and I both know that anytime volunteer money is needed in the community, for any project, the first stop…the bank!

When a bank's capital remains at work locally, it ripples through the local economies so as to be multiplied, most economists say by a factor of 10. That enlarges the local tax base and grows Kentucky's tax revenue the right way. When taken from local communities by excessive taxation, that economic multiplier effect is lost. Growth opportunities are lost. We lose. You lose. Your constituents lose.

All this has been happening for years, even when we were taxed an average of 60% more than other corporations. Now, with a gap that has grown to 92% as of July 1, *a new problem is gathering steam*.

Kentucky's banks have ended up with an average Effective Tax Rate of 13.30%. That's the highest rate in the nation by a significant margin, one that is sharply higher than in the states all around us.

Higher than California. Higher than New York.

But the bigger problem is that it's higher than every state across any one of our seven borders.

How much higher?

THIS much higher.

For all the states in this Table other than Kentucky, the ETR – Effective Tax Rate for banks –is a simple percentage and these numbers have been reviewed by the Revenue Cabinet.

Kentucky's Effective Tax Rate for banks was a lot harder to come by because we're one of only **five states left,** in the entire country, that still has the antiquated Bank Franchise Tax. With a Bank Franchise Tax, every individual bank ends up with a different Effective Tax Rate.

So, to make sure we had an apple-to-apples comparison between KY and these other states, we worked with three CPA firms (MCM/Crowe/BKD) to create a large sample of Kentucky banks. These three firms chose 59 banks of all sizes serving all parts of the state – that's more than a full third of the total number of banks in the state, which is a very strong and reliable sample size. Those 59 banks agreed to provide their 2016 tax data so that these accounting firms could determine an average Effective Tax Rate for this comparison. (Since then we continue to increase this sample size to assure accuracy of our findings.)

Note that Kentucky's 13.30% rate reflects just the **bank franchise tax** and **local deposits tax**, which is in lieu of a local net profits tax. Banks have payroll, sales and property taxes on top of that, as do banks in all these other states. So, what you're seeing here is a true apples-to-apples comparison.

In the far-right column, you're shown what the Kentucky banks in our 59-bank sample would be paying in taxes in each of these states. In Kentucky, it's over $46 million. If they were located next door in Indiana or in West Virginia, it's under $25 million. Two miles to the north from where we are sitting today banks in Northern Kentucky could save 50% in taxes by building a branch in Ohio and calling it their main office.

The most important thing to know about these numbers, however, is how they spell trouble for Kentucky's revenue picture.

To understand Kentucky's precarious situation, you have to understand how the Bank Franchise Tax works.

This slide shows you how it's calculated.

- For both Kentucky-chartered banks and multi-state banks, the Revenue Cabinet starts with a bank's five-year average of Net Capital. What is Net Capital? It's capital stock paid in, surplus, undivided profits, capital reserves, and more – a **very** wide net.

- Net Capital gets multiplied by the bank's Kentucky payroll, property, and revenue. If the bank does ALL of its business in Kentucky like most all of our local community banks do, that's 100% of payroll, 100% property and 100% revenue. For the multi-state bank, the formula is a little different, it is based on the percentage of its payroll, property and revenue as it relates to its business activity in Kentucky. That's what is meant by "apportionment".

- All that is multiplied by the Bank Franchise Tax rate, and that equals the bank's tax liability.

All but four other states in the country have ditched this convoluted formula in favor of taxing banks like other corporations, which kept their bank taxes at a fair share as compared to other corporations in those states.

That is why banks in other states can now buy a Kentucky bank and save enough in taxes to essentially fund the purchase with the tax savings. Look again at how the Kentucky Bank Franchise Tax is based on three components: payroll, property, and revenue… the number of bank employees in Kentucky, the property owned in Kentucky, and the revenue produced in Kentucky.

- With payroll, when a bank acquires another bank, one of the first entries the acquiring bank makes in its *proforma* projections is a reduction on average of 35% of the employees of the acquired bank because of redundancy. The acquiring bank will naturally tend to retain the staff they know best, so when the acquiring bank is out-of-state, chances are job loss will be higher among Kentucky-based employees. **That does three things. One, because payroll is a component of the Bank Franchise Tax, that reduces Bank Franchise Tax revenue for Kentucky. Two, it reduces payroll taxes receipts – and it produces <u>tax savings for the acquiring bank</u>. Three, it costs Kentucky jobs.**

- Property owned in Kentucky includes its loans and **real estate**. When an acquiring bank has a branch across the street from the one it's acquiring, there's no reason to keep both so they close one of them….right? **The result, again, is lower Bank Franchise Tax revenue for Kentucky – and <u>tax savings for the acquiring bank</u>.**

- The third component is the bank's revenue, which is both investment income and the income on banking activity like fees associated with mortgage lending. Any bank with a presence in multiple states will naturally take advantage of the ability to transfer investments and book some of those other income generators in whichever state offers the most advantageous tax treatment. As things stand today, with Kentucky having the highest bank taxes in the nation by a wide margin, that won't be Kentucky. **The result? Lower Bank Franchise Tax revenue for Kentucky – and <u>tax savings for the acquiring bank</u>.**

These tax savings available to multi-state banks, all perfectly legal, are big enough, over time, to essentially fund the cost of acquiring a Kentucky bank. How often is it happening?

This table shows you the acquisitions of Kentucky financial institutions by banks headquartered in other states over the past five years. This is the most important slide you will see today. You can see the acquisitions are accelerating.

You can also see that, as a result of these acquisitions, Kentucky has lost control of $665M in capital over the past five years. (The second highlighted #.) <u>Every time a Kentucky bank is acquired by a multi-state bank, the acquiring bank takes control of the Kentucky bank's capital, to be used as the acquiring bank sees fit **at any of its locations**, in Kentucky or in any other state where it has a presence</u>. The

members of this General Assembly know well the critical role of the state's capital in attracting new businesses and creating jobs. So, loss of that capital has consequences beyond reducing tax revenue.

If this bank tax gap is not closed quickly, this trend will accelerate, eroding Kentucky tax revenue base at a time we're already short on revenue to fund pensions, education, and Medicaid.

Note that the bottom line in this table – that $7.3M figure (the third highlighted #) – is the amount of bank tax revenue that you *may* not be able to collect as a result of bank sales across state lines so far. Whether you collect this or not is up to ***them, not you.***

Maybe most important to notice is that American Founders Bank was bought by an out-of-state **CREDIT UNION.** (The first highlighted #.) Credit unions don't pay any federal income taxes. More importantly, they don't pay any state income or franchise tax. So on top of losing control over American Founder's capital, Kentucky just lost ALL of the Bank Franchise Tax the bank was paying. When the buyer is a credit union, we're not talking about possibilities; we ***know*** all of this tax revenue is gone.

Although only one bank in Kentucky has been acquired by a credit union so far, there's been a steep increase nationally in credit unions acquiring community banks. One attorney writing for the *American Banker* projects twenty of these credit union acquisitions of banks will close within the next 12 months, and we don't know how many could impact Kentucky.

In conclusion, I come back to these numbers and the basic facts that are driving all these issues, for banks and for our Commonwealth.

- Kentucky is taxing its banks at a rate that is 92% higher than it taxes any other corporation in the state.

- Kentucky is taxing its banks at the highest rate in the nation.

- And Kentucky's tax rate is much higher than the states all around us, whose banks are purchasing ours with serious consequences for Kentucky's revenue and capital.

What I first learned at my granny's knee and again every day of my professional life is that ***money goes where it's invited***. Kentucky banks, and the capital they represent, are being invited to every state around us by Kentucky's excessive bank taxes.

We've been lucky so far that the acquiring banks who have come into Kentucky over these past years have been good corporate citizens in our state. They are not to be blamed or shown any disrespect for honoring their responsibilities to their shareholders when making these strategic acquisitions. *Of course,* they consider differences in tax policy in the states where they do business. Kentucky just needs to be as smart and far-sighted with our own bank tax policy, to invite the money in our banking system to stay right here …working in Kentucky, for Kentucky. We can't afford any more delay in getting that done.