Governor's Budget Amendment 19

Hearing May 21, 2024

Governor's Budget Amendment 19, dated May 10, 2024, proposes allowing financial institution taxpayers (banks) to choose how they apportion their net income beginning in Tax Year 2025. It adds business expenses or deductions to net income for certain types of financial institutions, and also requires a combined reporting study that analyzes the policy and fiscal ramifications of changing the financial institutions tax.

FISCAL IMPACT

The changes proposed in the amendment would result in a reduction in financial institutions tax collections of $7.6 million in FY2025, based upon a January 1, 2025, start date. The revenue loss grows to $15.6 million in FY2026, taking into consideration a full fiscal year of implementation.

ANALYSIS AND BACKGROUND

Business Taxes

The taxation of businesses by Rhode Island varies in method and by certain industries. The following table summarizes the business tax types and their rates

Tax by Business Type	RI Tax Liability Based On	Tax Rate
Business Corporations	Net income	7.0%
Financial Institutions (Banks)	Net income	9.0%
Public Utilities	Gross earnings	1.25% to 8.00%
Insurance Companies	Gross premiums from policies	2.0 % to 4.0%
Bank Deposits (Credit Unions)	Avg. daily deposits	.0625% to .0695%
Health Care Provider	Gross revenue derived from patients	5.5%

GBA 19 Changes

GBA 19 makes several changes related to the financial institutions tax.

- **Apportionment:** The amendment would allow banks to choose an apportionment methodology, beginning TY2025, that considers the three factors of sales activity, property, and payroll or just the single-factor sales method that Corporations use. The election cannot be changed for next five subsequent tax years, and only then with the Tax Administrator's approval.
- **Treatment of Combined Group Activity:** When determining tax liability businesses typically are allowed to deduct standard business expenses such as payroll, losses, depreciation, rent, bad debts, etc. The amendment would prohibit a bank subject to Rhode Island's financial institutions tax that is also part of a combined business group with units that are also subjected to the state's business corporations tax from deducting business expense transactions made between members of the group.
- **Combined Reporting Study:** The amendment requires banks to submit reports with additional information along with their tax returns for tax years 2024 and 2025 as part of a combined reporting study. The amendment establishes a penalty of up to $10,000 for failure to file reports on time or to falsify them. The purpose of the study is to assess the impact on tax liability and collections if financial institutions under combined ownership were required to report their income together with the combined group. The Division of Taxation is to issue a report on the the study on or before March 15, 2027.

Analyst Note: The Office of Revenue Analysis (ORA) looked at the impact on revenues if banks were not given choice of how to apportion their income but rather were required to use sales only (similar to the methodology Massachusetts will be using next year). Under this scenario ORA estimates a revenue loss of $6.0 million in FY2025 and $12.3 million in FY2026 (compared to losses of $7.6 million and $15.6 million, respectively).

According to the Division of Taxation, the average reduction in revenue from mandatory singles sales factor over the last five years is 32.9% for all taxpayers.

- For TY2022, there were 33 non-minimum filer financial institutions taxpayers and nine minimum filer taxpayers.

- Of the 33 non-minimum taxpayers, if they had been subject to mandatory single sales factor apportionment for TY2022, 18 would have paid more in taxes and 15 would have paid less.

- The 32.9 percent revenue loss results from the fact that the liability increase for the 18 taxpayers is substantially less than the 15 taxpayers whose liability would decrease.

This analysis by the Division is based on actual taxpayer return analysis. The estimate was based on the average liabilities of taxpayers and line items on the return, and averaged based on actual taxpayer data for five years.

Financial Institutions Tax Background

Banking institutions subject to the Financial Institutions tax include every state bank, federal savings bank, trust company, national banking association, mutual savings bank, building and loan association, and loan and investment company, excluding credit unions (these entities are subject to the bank deposit tax). The tax is assessed at 9.0 percent of net income, or $2.50 per $10,000 of authorized capital stock, whichever is greater. The minimum tax is $100 annually.

- **Apportionment:** A financial institution is required to apportion its income based on three factors – the sales activity, property, and amount of payroll located within the state (as compare to the single sales factor that corporations may use). A financial institution may petition the Division of Taxation to exclude one or more of these factors if the apportionment does not fairly represent the taxable business activity within the state.
- **Massachusetts:** Massachusetts requires combined reporting for both financial institutions and corporations. Beginning January 1, 2025, financial institutions will shift from three-factor apportionment to the single sales factor. The banks will also have the ability to petition for alternative apportionment method.

Business Corporations Tax Background

Corporations are required to remit taxes on a percent of net income or the $400 minimum business corporation tax, whichever is greater. Since tax year (TY) 2015, Rhode Island has imposed a business corporation tax equivalent to 7.0 percent of net income attributable to Rhode Island corporations and any affiliated companies under common ownership, known as combined reporting.

- **Combined Reporting:** Combined reporting captures the income of Rhode Island corporations and any affiliated companies that are under common ownership, and treats the group as if it is one business. Companies are required to report all income made by all subsidiaries, regardless of the state in which it was earned, and then remit state activity in the state as determined by an apportionment formula (the amount of business activity done within the state as compared to total business activity).
- **Apportionment:** Apportionment is how a business's income activity is assigned to states for the purposes of determining tax liability. Prior to TY2015, Rhode Island used a formula that placed equal weight on a corporation's sales activity, its property, and the amount of payroll located within the state, as compared to the ratio of these factors for the company as a whole. It was argued at the time that such a methodology might discourage in-state investment because it penalizes corporations with higher investments and payroll in state. In 2014, the General Assembly modified the apportionment formula for the Business Corporations tax only, by reducing the number of factors from three to just one - sales activity only.
- **Sales Activity Apportionment Methodology:** There are several methods that could be used to assign where sales activity is recorded for tax purposes. A company could assign the sales of services to the state in which the income-producing activity was performed. Prior to TY2015, Rhode Island used this method, known as performance-based sourcing. Current law; however, now uses a market-based approach, which allocates the activity to the state in which the service is delivered, not performed.