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FINANCIAL INSTITUTION FRANCHISE FEE BASE ESTIMATES

A REVIEW AND ANALYSIS WHITE PAPER

APRIL 2003

APPLIED ANALYSIS



ASSEMBLY TAXATION
DATE: 7/10/03 ROOM: 4100 EXHIBIT 5
SUBMITTED BY: Giunchigliani (1-9)

INTRODUCTION

Applied Analysis was asked to estimate the potential tax base for a franchise fee imposed on the net profit of financial institutions operating in the State of Nevada ("Nevada") as proposed in AB 517. This white paper briefly summarizes our approach and the findings of our analysis. Please note that this is a draft document and its findings are subject to material review and revision.

FINDINGS IN SUMMARY

Based on the information available to date and our current understanding of AB 517, we estimate the potential tax base is \$1.0 billion. The provision of this estimate notwithstanding, the reader is cautioned that several important questions, which could materially impact revenue estimates, remain unanswered. As such, the information and finding contained herein should be viewed critically and used cautiously.

METHODOLOGY

The analysis contained herein is based on general operating information collected and reported by the Federal Depository Insurance Corporation ("FDIC") for financial institutions operating in Nevada as well as revenue reports from selected states.¹ While these data were incomplete in some areas, we believe that they are sufficient to support the findings contained herein.² All data reported herein are for the 12 months ending December 31, 2002 unless otherwise noted.³

There are two important limitations to this analysis that should be noted. First, issues of revenue apportionment and allocation are not fully addressed, as AB 517 is effectively silent on this issue.⁴ This is an area that requires additional study before any reliable estimates might be generated.⁵ Another important area is the general belief that financial institutions have "shifted" assets and income into Nevada, intending to benefit from the state's tax structure.⁶ We have not attempted to quantify the extent to which this practice would be reversed or otherwise altered due

¹ See www.fdic.gov.

² Particular areas of concern included banks chartered outside of Nevada but operating in Nevada, the treatment of "credit card" houses, and the allocation of multi-state operations. These issues were addressed through analytical interpolation and/or conversations with the data research staff of the FDIC.

³ See www.fdic.gov.

⁴ Multistate Tax Commission, *Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions*, Adopted November 1994. Consider AB 517, Sec. 13 (2) states "[i]f the net income of a financial institution is derived from business conducted within and outside this state, the net income of the financial institution derived from business conducted by it in this state must be determined in accordance with regulations adopted by the Commission." These particular apportionment rules will be important to the amount of revenue actually taxable.

⁵ Note that any analysis of apportionment and allocation must include consideration of revenues booked by Nevada institutions for consumers residing in other states as well as revenues booked by non-Nevada institutions generating revenues from Nevada consumers.

⁶ Consider that, on average, banks deposits per capita are \$2,470 and in Nevada they are \$13,000. Consider also that Nevada accounts for 3.89 percent of the nation's banks deposits, 0.74 percent of the nation's population, and 0.72 percent of the nation's gross product. See also, note 7, *infra*.

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to the implementation of the proposed levy. Wherever possible, conservative assumptions were used with regard to these issues.

ANALYSIS SUMMARY

Market Share Analysis

The simplest way to estimate total and taxable income for Nevada's banks is to use a share analysis technique. That is to say, make the assumption that Nevada bank income is proportional to its share of some representative factor (i.e., deposits, gross state product, employment, population, or income).

The FDIC reports that banks, nationwide, have after-tax operating incomes of \$97.2 billion. They further report that Nevada institutions maintain deposits of \$27.4 billion at 435 locations. This is roughly four percent of the \$703 billion deposited in the 9,400 commercial banks nationwide. Please see Exhibit 1 for a market share analysis of deposits for Nevada commercial institutions. If one were to assume that banks' after-tax operating income is distributed similarly to deposits, Nevada banks would be assumed to generate nearly \$3.8 billion in after-tax operating revenue. Similarly analyses using population or gross state product as the controlling variable yield estimates in the \$700 million range. This wide difference reflects the fact that deposits per capita in Nevada are five times the nation average,⁷ and financial institutions are using Nevada's tax system to "manage" their annual tax liability.⁸

⁷ Id.

⁸ Banoff, S. J.D and Kanter, Burton, J.D. Ed., *States Compete to Save Taxes in Other States*, The Journal of Taxation Volume 80, Number 3 March, 1994 (referencing Nevada based material suggesting that because Nevada has no income tax, any corporation, including banks and thrifts, operating in a state that taxes capital gains, dividends, rents, or royalties, allegedly may be able to eliminate the tax imposed on this income by taking advantage of a Nevada Holding Corporation); see also Young, V., *Bill Aims to Boost State Collections; Republican Sponsor Says Measure Would Generate \$31 Million for Missouri*, St. Louis Post-Dispatch, March 13, 2003; see also Chevreau, J., *OECD's attack on tax havens hits a snag: hypocritical move designed to protect local tax coffers*, National Post, June 2001 (noting the states, such as Nevada and Delaware as tax havens); see also Bronstien, B., *Wisconsin Eyes Plan to Tax Banks' Out-of-State Units*, American Banker, Tuesday, June 25, 1996 (stating, to avoid taxes imposed by some states on investments such as U.S. Treasury securities, many companies - including banks, which hold a lot of this sort of investment - create subsidiaries in low-tax havens such as Delaware and Nevada); see also Steinmetz, G. *Land probe could hurt others using similar tax strategy*, Newsday, Monday, February 11, 1991 (noting plains-based American Savings Bank owned a company called ASB Capital Corp., a finance subsidiary headquartered in Reno. Financial records show the low costs of operating an out-of-state finance subsidiary. In 1989, for instance, the subsidiary cleared \$16.8 million in profits and had a mere \$387,000 in expenses); Simpson, G., *Diminishing Returns: A Tax Maneuver In Delaware Puts Squeeze on States*, The Wall Street Journal, August 2002. (noting concern by state officials that domestic tax havens such as Delaware and Nevada are going unchecked and citing that the average effective state tax rate for corporations -- what companies really pay, as opposed to what the tax schedules say they should pay -- has declined from 9.6% in 1980 to about 5.2% in 2002); *Business Loopholes Are Under the Microscope*, Wall Street Journal, April 2001. (noting Mississippi passage of a law seeking to scrutinize a practice of corporations in many states: transferring intangible assets, including trademarks and patents, to subsidiaries incorporated in low-tax or no-tax venues such as Nevada and Delaware.); Bailey, S., *No Time for Loopholes*, The Boston Globe, February 2003. (noting Massachusetts legislations intended close loophole allowing companies to avoid Massachusetts taxes by transferring their intellectual property such as

Individual Bank Analysis

The FDIC reports income and expense data for 36 state and federally chartered banks operating in the state of Nevada.⁹ A summary of these data is provided in Exhibit 2. Combined, these institutions account for a pre-tax operating income of \$3.0 billion and an after-tax operating income of \$2.0 billion. Three of these institutions, Wells Fargo, Citibank, and Household Bank, account for 88 percent of the state's aggregate after-tax operating income total.

Noteworthy in this analysis is the fact that several multistate banks, including without limitation, Bank of America, U.S. Bank, California Federal Bank, Colonial Bank, and Washington Mutual Bank, are not included in the income figures cited above. These operations are federally chartered without an independent subsidiary or headquarters domiciled within Nevada. Combined the five firms noted account for roughly one-third of Nevada's total bank deposits, with Bank of America accounting for 19.5 percent of the state total (second to only Wells Fargo).¹⁰ Assuming these institution's after-tax revenue-to-deposit ratios are similar to the 36 financial institutions for which data are available, Nevada's after-tax net operating income for all financial institutions would increase to approximately \$2.6 billion.

A second consideration is the tax treatment of credit card interest income, which may have a unique subset of tax issues.¹¹ In 2002, interest from credit cards accounted for \$1.6 billion of Nevada's \$2.7 billion in total interest income,¹² or roughly 61 percent of the state's interest income total.¹³ Some Nevada-based institutions, such as Citibank and Household Credit, operate their national credit card clearinghouses out of Nevada. This is an area that requires additional study; and, to be conservative, these revenues have been removed from the tax base.

The table on the following page summarizes the 2002 taxable income estimates given the data available and reflecting the adjusted discussed above.

trademarks and patents to shell corporations in tax havens like Delaware and Nevada. Estimated savings were \$130 million to \$180 million annually, according to the state Revenue Department.); *States fight back for lost business*, Wilmington News Journal Service, San Antonio Express-News, February 1996 (noting that Nevada, which imposes no business income tax and therefore requires no special exemptions, has begun to copy Delaware's strategy of promoting itself aggressively as a corporate haven.)

⁹ Note that the FDIC reports that there are a total of 54 institutions operating a total of 435 branch locations within Nevada.

¹⁰ See Exhibit 1.

¹¹ This is a topic requiring additional research. Multistate Tax Commission, *Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions*, Adopted November 1994.

¹² Note that income from interest and non-interest sources was reportedly \$6.8 billion in 2002.

¹³ Telephone interview with Ms. Johnson, Division of Revenue and Statistics, Federal Depository Insurance Corporation. April 2003.

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EXHIBIT 3
TAX BASE ESTIMATE, 2002
(FIGURES EXPRESSED IN THOUSANDS)

Reporting institutions	
Interest income ¹⁴	\$ 2,765,728
Non-interest income ¹⁵	<u>4,066,834</u>
Total income (gross)	6,832,562
Pre-tax net operating income ¹⁶	3,068,190
Net operating income ¹⁷	1,973,807
Adjustments	
Add: market share adjustment ¹⁸	651,356
Less: credit card interest income adjustment ¹⁹	(1,601,350)
Net taxable income	<u>1,023,814</u>

¹⁴ Sum of income on loans and leases, plus investment income, interest on interest bearing bank balances, interest on federal funds sold and interest on trading account assets earned by the institution.

¹⁵ Income from fiduciary activities, plus service charges on deposit accounts in domestic offices, plus trading gains (losses) and fees from foreign exchange transactions, plus other foreign transaction gains (losses), plus other gains (losses) and fees from trading assets and liabilities.

¹⁶ Net income (loss) before income taxes and extraordinary items and other adjustments minus gains (losses) on securities not held in trading accounts. Taxes include all applicable federal, state and local, and foreign income taxes.

¹⁷ Net income excluding discretionary transactions such as gains (losses) on the sale of investment securities and extraordinary items. Income taxes subtracted from operating income have been adjusted to exclude the portion applicable to securities gains (losses).

¹⁸ Market share adjustment reflects the share of banks representing two percent or more of Nevada's total deposits applied to the net operating income of all institutions reporting.

¹⁹ Assumes that the share of revenue generated from credit card interest will be exempt from taxation. Note that not all interest would be exempt from taxation in Nevada.

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Exhibit 1
Nevada Bank Market Share Summary (In-state Market)

Institution Name	No. of Offices	Deposits (in \$1,000s)	Market Share
Wells Fargo Bank Nevada, National Association	101	5,589,128	20.4%
Bank of America, National Association	73	5,334,091	19.5%
Citibank (Nevada), National Association	5	5,295,689	19.3%
Nevada State Bank	62	2,254,938	8.2%
U.S. Bank National Association	42	1,634,191	6.0%
California Federal Bank	17	962,078	3.5%
BankWest of Nevada	5	611,275	2.2%
Colonial Bank	11	610,458	2.2%
Washington Mutual Bank, FA	22	578,424	2.1%
Bank of the West	10	396,858	1.5%
Community Bank of Nevada	4	322,466	1.2%
Silver State Bank	7	235,413	0.9%
World Savings Bank, FSB	2	233,227	0.9%
M & I Bank FSB	1	227,751	0.8%
First National Bank of Nevada	11	224,522	0.8%
First Republic Bank	3	218,475	0.8%
Business Bank of Nevada	4	207,711	0.8%
Farm Bureau Bank FSB	1	192,448	0.7%
Nevada First Bank	1	178,413	0.7%
First National Bank of Marin	1	176,380	0.6%
Wells Fargo Bank, National Association	2	165,685	0.6%
Sun West Bank	4	144,012	0.5%
Irwin Union Bank, F.S.B.	1	139,606	0.5%
First Independent Bank of Nevada	2	128,546	0.5%
Valley Bank	2	121,274	0.4%
Bank of Nevada	2	113,784	0.4%
Great Basin Bank of Nevada	1	86,029	0.3%
Wells Fargo Financial National Bank	1	85,174	0.3%
Red Rock Community Bank	1	83,726	0.3%
Bank of Commerce	2	80,211	0.3%
Heritage Bank of Nevada	1	78,848	0.3%
USAA Savings Bank	1	68,243	0.3%
Nevada Bank and Trust Company	8	66,394	0.2%
Desert Community Bank	1	53,655	0.2%
Washington Federal Savings and Loan Association	2	49,895	0.2%
Nevada Commerce Bank	1	48,919	0.2%
Black Mountain Community Bank	1	46,919	0.2%
Northern Nevada Bank	1	44,291	0.2%
Nevada Security Bank	2	37,782	0.1%
Security State Savings Bank	1	36,650	0.1%
First National Bank of Ely	1	34,368	0.1%
Irwin Union Bank and Trust Company	1	32,978	0.1%
Armed Forces Bank, National Association	2	28,007	0.1%

Exhibit 1
Nevada Bank Market Share Summary (In-state Market)

Institution Name	No. of Offices	Deposits (in \$1,000s)	Market Share
First Savings Bank	1	26,566	0.1%
El Dorado Savings Bank, F.S.B.	1	24,761	0.1%
Marine Bank	1	23,070	0.1%
SouthwestUSA Bank	1	22,325	0.1%
Bank of Las Vegas	1	15,726	0.1%
Town & Country Bank	1	6,085	0.0%
Household Bank (SB), National Association	1	2,847	0.0%
Household Bank (Nevada), National Association	1	2,105	0.0%
Eaglemark Savings Bank	1	500	0.0%
Northern Trust Bank, Federal Savings Bank	1	78	0.0%
Household Bank, FSB	1	1	0.0%
Total	435	27,382,996	100.0%

Exhibit 2
Analysis of Nevada Banking Institutions
Income & Expense Analysis

Income and Expense	Nevada Charter		Wells Fargo		Citibank		First Republic		USAA Savings		Household Bank	
	Bank	Association	Bank	Association	Bank	Association	Bank	Association	Bank	Association	Bank	Association
	Totals		Totals		Totals		Totals		Totals		Totals	
Number of institutions reporting	36		1		1		1		1		1	
Total interest income	\$ 2,765,728		\$ 781,130		\$ 536,752		\$ 247,441		\$ 276,919		\$ 365,141	
Total interest expense	580,180		78,694		131,478		102,472		55,076		78,221	
Net interest income	2,185,548		702,436		405,274		144,969		221,843		286,920	
Provision for loan and lease losses	603,806		274,989		72,817		6,500		76,841		82,518	
Total noninterest income	4,066,834		719,858		1,598,967		42,552		150,769		1,351,012	
Fiduciary activities	4,409		11		-		1,530		-		-	
Service charges on deposit accounts	86,356		56,126		2,763		859		13		-	
Trading account gains & fees	-		-		-		-		-		-	
Additional noninterest income	3,976,069		663,721		1,596,204		40,163		150,756		1,351,012	
Total noninterest expense	2,580,386		494,246		787,488		139,889		138,934		648,741	
Salaries and employee benefits	454,930		60,784		68,104		61,213		769		107,292	
Premises and equipment expense	124,477		27,664		23,480		22,065		175		-	
Additional noninterest expense	2,000,979		405,798		695,904		56,611		137,990		541,449	
Pre-tax net operating income	3,068,190		653,059		1,143,936		41,132		156,837		906,673	
Securities gains (losses)	15,983		3,340		-		14		-		-	
Applicable income taxes	1,099,907		229,363		400,383		14,745		55,534		337,672	
Income before extraordinary items	1,984,266		427,036		743,553		26,401		101,303		569,001	
Extraordinary gains - net	-		-		-		-		-		-	
Net income	1,984,266		427,036		743,553		26,401		101,303		569,001	
Net charge-offs	496,953		272,369		72,817		549		65,608		10,231	
Cash dividends	589,594		367,000		-		-		-		181,506	
Sale, conversion, retirement of capital stock,	37,987		-		-		21,030		-		-	
Net operating income	1,973,807		424,865		743,553		26,392		101,303		569,001	
<i>Share of total</i>	<i>100%</i>		<i>21.5%</i>		<i>37.7%</i>		<i>1.3%</i>		<i>5.1%</i>		<i>28.8%</i>	

Source: FDIC, 2003

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Exhibit 2
Analysis of Nevada Banking Institutions
Income & Expense Analysis

Income and Expense	Nevada Charter		Nevada State		Bank M & I Bank FSB		BankWest of Nevada		Wells Fargo Financial National Bank		First National Bank of Nevada	
	Totals		Bank	M & I	Bank FSB		Nevada		National	Bank	Bank of Nevada	
Number of institutions reporting	36		1		1		1		1		1	
Total interest income	\$ 2,765,728	\$	148,131	\$	47,475	\$	39,026	\$	60,004	\$	17,529	
Total interest expense	580,180		33,479		17,090		8,833		6,095		6,959	
Net interest income	2,185,548		114,652		30,385		30,193		53,909		10,570	
Provision for loan and lease losses	603,806		4,750		1,382		1,538		19,358		1,235	
Total noninterest income	4,066,834		38,535		30,385		3,415		778		28,857	
Fiduciary activities	4,409		2,868		N/A		-		-		-	
Service charges on deposit accounts	86,356		18,348		N/A		1,644		-		1,123	
Trading account gains & fees	-		-		-		-		-		-	
Additional noninterest income	3,976,069		17,319		30,385		1,771		778		27,734	
Total noninterest expense	2,580,386		82,109		50,368		18,583		11,953		16,626	
Salaries and employee benefits	454,930		36,137		16,985		9,921		5,122		5,272	
Premises and equipment expense	124,477		13,418		7,037		3,863		261		2,624	
Additional noninterest expense	2,000,979		32,554		26,346		4,799		6,570		8,730	
Pre-tax net operating income	3,068,190		66,328		9,020		13,487		23,376		21,566	
Securities gains (losses)	15,983		53		9,957		609		(12)		-	
Applicable income taxes	1,099,907		22,607		7,079		4,729		8,335		8,686	
Income before extraordinary items	1,984,266		43,774		11,898		9,367		15,029		12,880	
Extraordinary gains - net	-		-		-		-		-		-	
Net income	1,984,266		43,774		11,898		9,367		15,029		12,880	
Net charge-offs	496,953		4,889		1,085		825		12,258		566	
Cash dividends	589,594		29,500		-		-		10,000		-	
Sale, conversion, retirement of capital stock,	37,987		-		-		-		-		-	
Net operating income	1,973,807		43,739		5,526		8,965		15,037		12,880	
Share of total	100%		2.2%		0.3%		0.5%		0.8%		0.7%	

Source: FDIC, 2003

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