How Will Tax Reform Affect Commercial Banks?

by Thomas M. Buynak

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Introduction

Last year, Congress enacted the Tax Reform Act of 1986, which fundamentally restructures and simplifies the federal income tax system. Beginning in 1987, individuals and corporations face much simpler federal income tax rules that contain lower marginal tax rates.

There is widespread speculation about the effects of such sweeping federal income tax reform. Economists, policymakers, and politicians are debating the extent to which the new tax rules could adversely affect specific economic sectors or groups, particularly capital-intensive industries, certain income classes of individual taxpayers, real estate, and the banking industry.

In the commercial banking industry, the new tax rules will affect banks at a time when the commercial banking system is undergoing profound structural changes that are eroding the industry's ability to consistently generate healthy profits on traditional banking products and services. During the balance of the 1980s and into the 1990s, commercial banks will face several critical issues, including risk-based capital standards, deregulation, broader geographic competition, and possibly increasing competition from nonbank companies like Sears, Roebuck and Company, and Merrill Lynch & Co., Inc.

This article examines how tax reform could potentially affect the future tax liability of commercial banks. The analysis concentrates on Ohio banks and estimates the 1985 taxes they paid under the old corporate federal income tax rules. This benchmark estimate is then compared to a similar estimate made using the new tax rules.

The analysis calculates the tax burden for both small-to-medium and large Ohio banks so that we can detect disproportional effects of the new tax rules, if any, on different-size Ohio banks. It is presumed that large banks ($500 million or more in assets) should be affected more adversely than small-to-medium banks (with assets less than $500 million) because the new corporate tax code eliminates more existing tax preferences for large banks.

I. Old Versus New Corporate Federal Income Tax Rules

Under the new federal corporate income tax regime, commercial banks will lose a substantial amount of their tax preferences, or deductions, that they relied upon to reduce their taxable income. In return, they will face much lower marginal tax rates.

It is the intention of Congress that the new tax code's lower corporate tax rates should not entirely offset the loss of commercial bank tax preferences. Consequently, the typical bank should pay a higher tax bill in 1987. Congress revised the federal income tax code so that approximately $150 billion of federal taxes during the next five years will shift from individuals to corporations. According to Congressional estimates, the commercial banking industry, one of

Do Commercial **Banks Pay** Lower **Federal** Income Taxes **Than** Their **Nonfinancial** Counterparts?

There has been much controversy about whether or not banks have paid a tax liability that is considerably less than that paid by nonfinancial corporations. According to estimates by the Bureau of Economic Analysis of the U.S. Department of Commerce, corporations paid an effective average federal income tax rate in the 23- to 25-percent range from 1980 to 1983.

Studies that estimate the *direct* tax liability of commercial banks find that the banking industry has indeed paid a relatively lower federal tax liability. One recent study estimates the tax liabilities of all profitable banks nationwide during 1985.[1] This nationwide estimate finds that all banks together paid an average 1985 direct-tax rate of approximately 11 percent. An even lower average rate has been estimated by the Joint Committee on Taxation (JCT) for the tax liability of the nation's *largest* banks.[2] The JCT finds that large banks, which presumably are better managers of their tax liability, have either paid no taxes or have paid an extremely low tax rate (less than 5 percent) as a percentage of their net income in recent years. The JCT cautions, however, that this low-tax-rate estimate may understate these banks' true economic tax burden because it fails to include *indirect* taxes paid by them.

Surveys by the Bank Administration Institute (BAI), a bank-sponsored research and educational organization, attempt to adjust for indirect bank taxes.[3] BAI incorporates two types of indirect bank taxes: one is for the opportunity cost of holding non-interest-bearing accounts with the Federal Reserve for monetary policy purposes, and the other adjusts for foregone earnings on lower-yielding tax-exempt municipal obligations. According to BAI's surveys, banks nationwide paid effective tax rates, which include direct and indirect taxes, of between 43 and 52 percent from 1982 through 1984.

The available evidence indicates that banks generally have paid a low rate of direct taxes. However, if we account for indirect bank taxes, it is evident that the economic tax liability of banks at least begins to approach the average tax liability of nonfinancial corporations.[4]

1. See Gelfand, Matthew D., and Gerald A. Hanweck, "The Effects of Tax Reform on Banks," The *Bankers Magazine*, Jan.-Feb 1986, pp. 59-66.

2. See Taxation of Banks and Thrift Institutions, Joint Committee on Taxation, March 9, 1983.

3. See Survey of U.S. Effective Income Tax Rates for the Banking Industry, Bank Administration Institute, 1982-84.

4. See Henderson, Yolanda K. "The Taxation of Banks: Particular Privileges or Objectionable Burdens?" *New England Economic Review*, Federal Reserve Bank of Boston, May/June 1987, pp. 3-18.

BOX 1

the industries Congress has singled out as low taxpayers, will pay approximately $10 billion of the higher corporate tax liability during the next five years (see box 1). According to estimates by the industry itself, commercial banks could pay as much as $20 billion more in federal taxes during the next five years.

Under the old corporate tax rules, a commercial bank could reduce its federal taxable income by claiming several deductions, including interest expenses on the holding of tax-exempt securities, a bad-debt reserve provision, accelerated depreciation, and investment and foreign tax credits (see table 1). The new tax code either repeals these tax preferences or substantially reduces the tax-deductible allowable amounts. The new code also imposes a much more stringent and complicated minimum corporate tax to ensure that no profitable corporation will avoid paying federal income taxes beginning in 1987.

The former top corporate tax rate of 46 percent falls to 34 percent under the new rules. The revised rules also substitute two lower marginal rates on income up to $75,000 for the four previous lower marginal rates on income up to $100,000. A corporate tax rate of 15 percent will now apply to taxable income up to $50,000; a 25 percent rate will apply on income from $50,000 to $75,000. Under the new tax rules, corporations also will pay an additional 5 percent tax, up to a maximum of $11,750, on corporate taxable income from $100,000 to $335,000. A corporation with taxable income greater than $335,000 will pay a flat rate of 34 percent.

Under the new rules, the future tax liability of large banks will be affected more severely than that of small and medium banks because tax reform repeals more deductions for large banks. In particular, large banks not only lose the ability to use the reserve method of tax deduction for bad debt, but also must add their accumulated bad-debt reserves into taxable income during the next four years.

II. Taxes Paid by Ohio Banks Under Old Federal Income Tax Rules

In our study, we estimate the average tax rate of 291 Ohio banks that posted a 1985 profit. Seventeen Ohio banks reporting a loss in 1985 were excluded (there seems to be no systematic reason to explain why the excluded banks reported a loss). The profitable Ohio banks are divided into two groups: one includes 264 small and medium banks; the other includes 27 large banks. We first calculate the *average direct tax rate* for the sampled Ohio banks. This estimated average rate then serves as a benchmark against which we quantitatively simulate how the new tax rules would have affected the 1985 tax liability of these banks.

New Federal Income Tax Rules Affecting Commercial **Banks**

Title	Old Tax Provision	New Tax Provision
Effective Date		General Effective Date: Jan. 1, 1987 Corporate Rate Cuts: July 1, 1987
Corporate Tax Rate	46% top rate, 4 lower rates on income up to $100,000	34% top rate, 2 lower rates on income up to $75,000
Corporate Minimum Tax	15% of the amount of which the sum of tax preference items exceeds the greater of $10,000 or the regular tax liability	20% alternative minimum tax; $40,000 income exemption
Bad-Debt Reserve	Deductible	Eliminates bad-debt tax reserve for banks with more than $500 million in assets
Tax-Exempt Securities	80% of municipal bond interest expense is exempt from federal taxation	100% of municipal bond interest expense is taxed
Net Operating Loss Carryover	Losses carried back 10 years and forward 5 years	Losses carried back only 3 years, but forward 15 years
401(K)s and IRAs	401(K): $30,000 maximum IRAs: $2,000/$250 for nonworking spouse	401(K): $7,000 maximum IRAs: Limits imposed on high-income workers with pensions
Foreign Tax Credit	Credit determined on aggregated foreign income	Less liberal foreign tax credits, with transition provisions
Depreciation	Accelerated	Less generous write-offs, particularly for real estate
Investment Tax Credit	6% to 10%	Repealed

Source: Ernst & Whinney. Tax Reform—1986, *An* Analysis of Provisions Relating to the Financial Services Industry, E&W No. X58055; and Tax Reform—1986, *An* Analysis of the Internal Revenue Code of 1986, E&W No. 66196.

TABLE 1

Because Internal Revenue Service (IRS) tax returns are confidential, we manipulated financial information reported by the sampled Ohio banks in 1985 so that we could, in effect, simulate their 1985 IRS returns. To do this, it was necessary to impose several simplifying assumptions that possibly cause the estimates to deviate from the banks' actual IRS tax returns. Despite this unavoidable shortcoming, the simulated results allow us to make reasonable inferences about the direction and the degree to which each of the tax changes potentially could affect the *typical* small-to-medium or large Ohio bank.

As a final word of caution, we assume that banks, borrowers, other lenders, depositors, and other economic actors behave no differently under the new tax rules than they did in 1986. The banking business, of course, is not likely to remain static. Banks undoubtedly will restructure their balance sheets in order to lessen their burdens in the new tax environment. Banks' balance sheets also will be influenced by induced tax-law changes in loan demand, by changes in investment yields, and by depositors' behavior.

The simulation estimates do not capture these unknown influences, or even the unknown degree of probable effects on banks' balance sheets in the future. Consequently, the simulated effects of the new tax code on Ohio banks are most likely a "worst-case" estimate of additional taxes they will pay.

The probable adverse effects of the new tax rules on banks' tax liability also will be

Estimated 1985 Tax Liability of Ohio Banking Organizations Under the New Federal Income Tax Code
(dollars in millions)

	Under Old Tax Rules		Under New Tax Rules	
	Small & Medium Banks[a]	Large Banks[b]	Small & Medium Banks[a]	Large Banks[b]
1. Pre-Tax Income	$284.8	$730.5	$284.8	$730.5
2. Taxable Income	$103.9	$314.4	$114.0	$437.1
3. Regular Tax Liability	$43.2	$144.1	$ 35.9	$148.3
4. Tax Credits	$5.5	$19.2	—	—
5. Add-On or Minimum Taxes	$ 0.4	$ 0.5	$ 9.4	$ 7.3
6. Net Tax Liability	$ 38.1	$125.4	$45.3	$155.6
7. Average Tax Rate (ATR)	13.3%	17.1%	15.9%	21.3%
ATR of All Ohio Banks	16.1%		19.8%	

a. Ohio banks with assets less than $500 million.
b. Ohio banks with assets greater than $500 million.

Source: Consolidated Report of Condition and Income, December 31, 1985.

TABLE 2

mitigated because banks, to a large degree, merely serve as a conduit through which they intermediate tax benefits to their customers by extending them more favorable rates or terms on loans and leases—assuming that a competitive marketplace for these banking products exists. As we will discuss shortly, the consequence of eliminating certain tax advantages will put upward pressure (that is, for less-favorable terms) on loan and lease rates, yielding higher average revenues that will offset the elimination of banks' tax preferences. However, higher lease rates could lead to lower sales volume.

The new tax rules, moreover, phase out the deductibility of interest on consumer debt over a four-year period, except for consumer debt that is secured by a home mortgage. A likely result of this action may be a widespread restructuring of consumer debt. Under the new tax rules, many homeowners have an incentive to rely on home-equity credit lines, rather than on traditional consumer credit like auto loans, as the tax-advantaged method to finance their purchases. Many commercial banks will have a comparative advantage as suppliers of home-equity credit lines because they typically have experience in both mortgage financing and open-end credit lending.

In 1985, the 291 profitable Ohio banks reported net income of approximately $1.02 billion. Because banks do not report taxable income, it was necessary to estimate taxable income from the banks' year-end 1985 Reports of Condition and Income. A reasonable estimate of taxable income can be derived if we subtract the major tax deductions that banks can use to reduce their taxable income. Most of the difference between taxable and net income is attributed to tax-exempt income on municipal obligations; to foreign, state, and local income and excise taxes; and to lower-taxed capital gains—which are subject to a 28 percent tax rate. Banks also are permitted to deduct a tax reserve for loan losses that differs from their book bad-debt reserve. A reasonable estimate of the 1985 tax bad-debt reserve is approximately 55 percent of the 1985 book bad-debt reserve.[1]

By reducing banks' net income by these tax deductions and after adjusting net income for differences between book and tax bad-debt reserves, we should get an unbiased estimate of Ohio banks' 1985 taxable income.

We estimate that Ohio banks had 1985 federal taxable income of approximately $418 million (see table 2). Ohio banks paid an estimated regular tax liability of approximately $187 million in 1985, which was partially offset by tax credits of almost $25 million. Banks also paid an estimated add-on tax of approximately $1 million. The combined net federal tax liability of the Ohio banks—that is, regular taxes, plus add-on taxes, minus tax credits—amounted to almost $164 million in 1985, which is an average tax rate of 16.1 percent.

The average tax rate paid by small- and medium-size Ohio banks (13.3 percent) under the old tax rules was lower than that of the large Ohio banks (17.1 percent). One reason that small- and medium-size Ohio banks paid a lower average tax rate is because they reported a relatively lower level of estimated taxable income. The lower taxable income of small- and medium-size Ohio banks is attributed mostly to the fact that they hold a higher percentage of their assets (as compared to large banks) in the form of municipal obligations. Another reason is that there was little difference between the effect that tax credits had on mitigating the tax liability of either large, medium, or small Ohio banks. In other words, small- and medium-size Ohio banks relied on tax credits to the same approximate relative degree that large banks relied on tax credits to reduce their federal income tax liability.

1 Our estimate of the tax reserve deduction is based on the results of a U.S. Treasury bank tax model. See Neubig, Thomas S. and Martin A. Sullivan, "The Effect of the Repeal of the Reserve Method on Loan-Loss Reserves and Loan Charge-Offs," 1987 Tax Analysts, Tax Notes, April 27, 1987, Special Report, pp. 401-403.

III. Principal Tax Provisions Affecting Commercial Banks

Tax-Exempt Securities. Under the old tax rules, commercial banks could deduct 80 percent of interest expenses that were incurred to carry tax-exempt securities in their asset portfolios. As a consequence, there was a strong incentive for commercial banks to hold municipal securities to reduce their federal tax burden.

The new tax rules disallow 100 per. cent of the interest charge for carrying municipal obligations *acquired* after August 7, 1986. There is one exception: under the new tax rules, a municipality still will be permitted to sell up to $10 million of bonds to a financial institution per year, and the financial institution can apply the old interest expense disallowance rule (20 percent) to the bonds.

Commercial banks are an integral part of the municipal bond market, and currently hold approximately one-third of outstanding municipal obligations. Unless tax-exempt yields rise substantially closer to yields on taxable securities to compensate for the less-favorable tax status of municipals, banks will accumulate smaller future holdings of tax-exempt securities under the new tax rules. In all likelihood, the tax-law changes will hasten banks' exit from the tax-exempt municipal securities market, accelerating a trend that began in the mid-1970s.

One alternative to holding municipal obligations as a tax-sheltering device has been leasing receivables. Since 1981, large banks in particular have substituted leasing to varying degrees for tax-exempt securities as a more effective way in which to shelter income. Under the old tax rules, banks were allowed a high degree of leveraging of investments in physical assets because of liberal depreciation schedules and investment tax credits (ITCs). Faster depreciation write-offs and ITCs magnify the net after-tax yields for asset leasing. In fact, the tax advantages of leasing have made it a profitable substitute for direct lending by banks.

Small banks engage in virtually no leasing activity because they do not have the large and diverse portfolios to absorb the greater risk and lower liquidity associated with leasing receivables. A small bank, moreover, is less able to price its leasing products competitively because leasing normally requires a large volume to economically justify the expense of a specialized leasing staff.

Repealing the deduction for municipal-securities-interest expense will, other things being equal, raise taxable income for the typical commercial bank, unless other tax-shelter adjustments are made to offset elimination of the deduction. The relatively large amount of municipal bonds held by small and medium banks is their primary means for sheltering taxable income. It is likely that these banks have a higher percentage of municipal holdings because they primarily service local governments, whose debt is frequently purchased and held mostly by local financial institutions. In contrast, larger banks are located in large cities whose municipal debt is traded publicly.

On the surface, it appears that large banks might be relatively less affected than small and medium banks by the loss of the municipal-interest-expense deduction because large banks have more tax-sheltering alternatives available to them. For example, large banks could in part substitute leasing activity for municipals as a way to shelter taxable income. But leasing becomes less attractive as a shelter under the new tax code because the code repeals ITCs and revises depreciation schedules for physical assets.

In table 3, we report the simulation results of how each tax provision potentially

Simulated Effects of New Federal Income Tax Rules on Ohio Banking Organizations

Tax Provision	Percentage Change in 1985 Tax Liability: All Banks	Small & Medium Banks[a]	Large Banks[b]
Repeal Interest Expense Deduction for Tax-Exempt Municipal Bonds[c]	4%	5%	4%
Repeal Bad-Debt Deduction	7%	5%[d]	8%
Tax Bad-Debt Accumulated Reserve			
(10% of reserve)	12%	11%[d]	12%
(40% of reserve)	48%	44%	49%
Repeal Investment Tax Credit	13%	14%	13%
Replace Foreign Tax Credit as a Deductible Expense	0.8%	0%	1%
Alternative Minimum Tax	10%	25%	6%
Lower Corporate Rates	-15%	-14%	-15%
Composite Effects of New Tax Rules[e]	29%	30%	29%

a. Ohio banks with assets less than $500 million.
b. Ohio banks with assets greater than $500 million.
c. Estimated effects of disallowance of municipal interest expenses with the new tax law's grandfathering provisions.
d. The new tax code exempts this class of banks from these tax provisions.
e. The composite effects of the new tax code include the foreign tax credit transition rule, the grandfathering of tax-exempt municipal interest expense, and the exclusion of small- and medium-size banks from repeal of the bad-debt tax reserve.

Source: Consolidated Report of Condition and Income, December 31, 1985.

TABLE 3

could affect the tax liabilities of Ohio banks. In interpreting the results, it should be pointed out that the simulated effects of each tax-reform provision estimate how each tax change potentially could alter the Ohio banks' federal income tax liability, assuming all other provisions of the old tax law remain in effect. After isolating the effects of each individual tax provision, we simulate what potentially could happen to tax burdens when we impose all the new tax rules simultaneously on the Ohio banks.

The adverse effect of eliminating the deduction for municipal-securities-interest expense on Ohio banks' tax liabilities is lessened considerably because the new tax rules grandfather municipal bonds acquired before August 8, 1986. If the new tax law had disallowed the municipal-securities-interest-expense deduction entirely, the tax liability of all Ohio banks in 1985 would have increased by 42 percent—and even more for small- and medium-size Ohio banks (49 percent)—assuming that no other tax code provisions were changed (see table **3).** Because small- and medium-size Ohio banks, on average, hold a higher percentage of their assets as municipal obligations, they will incur a slightly higher relative tax liability from this single tax law change.

However, under the grandfathering provisions of the new tax law, we assume that Ohio banks will retain at least 90 percent of their present municipal-securities-interest-expense deduction in 1987. According to our simulated results, Ohio banks would have had a tax liability in 1985 that was only 4 percent higher than if they had included 10 percent of securities interest expense in their taxable income. Our simulations do not allow for the substitution of the maturing tax-exempt assets into higher-yielding taxable assets. The higher portfolio returns from taxable interest-bearing assets will boost before-tax income and will provide an offset to higher taxes.[2]

Loan-Loss Reserves, Under the old tax rules, commercial banks, like other corporations, can deduct contributions to a bad-debt reserve for tax purposes, rather than deduct debts when they become uncollectible. Unlike other corporations, however, banks must report a loan-loss provision ***for regulatory purposes*** that differs from the amount reported for tax purposes. The level of the regulatory reserve, which in recent years has exceeded the amount that is tax deductible, is based on examiners' appraisal of the quality of each bank's loan portfolio.

The old tax law required that a commercial bank determine its bad-debt reserve deduction for tax purposes by using one of two methods: the ***experience*** method or the *percentage* method. Under the ***experience*** method, a bank bases its loan-loss deduction on the average loan losses of the previous six years. Under the ***percentage*** method, a bank deducts provisions to a loan-loss reserve equal to 0.6 percent of eligible loans outstanding.

Under the new tax rules, large banks will be permitted to take deductions for bad debts only when loans become partially or wholly worthless. Many bank tax observers believe that this will accelerate charging off bad debts by large banks.[3] Even ignoring the tax consequences that repealing the bad-debt reserve provision will have for large banks, there might be prudent reasons, according to these observers, for retaining the bad-debt reserve for ***all*** banks. The rationale for this argument is that most banks operate under accrual accounting standards and, as a consequence, bank income is taxed whether or not it is received. If loans are charged off only when they become uncollectible, a bank would mismatch its expenses and income. This mismatch could be avoided by establishing a proper bad-debt reserve that represented the present value of economic losses already embedded in a bank's loan portfolio. However, neither tax accounting rules nor generally accepted accounting principles (GAAP) adjust future losses to their present values.

Under the new tax code, large banks (banks with assets over $500 million) also must recapture their existing bad-debt reserves by reporting them as income over the next four years —10 percent in 1987, 20 percent in 1988, 30 percent in 1989, and 40 percent in 1990.[4] The new

2 See O'Brien, James M. and Matthew D. Gelfand, "Effects of the Tax Reform Act of 1986 on Commercial Banks." O'Brien and Gelfand's results allow for the substitution of maturing tax-exempt bonds into taxable interest-bearing obligations. According to their simulations, the higher taxable yields would substantially offset the significant increase in bank taxes.

3 Proponents of the loan-loss reserve method of accounting for bad debts contend that if commercial banks were allowed to charge off loans only when they become bad, we might recreate the pre-1921 atmosphere of dispute between banks and the Internal Revenue Service (IRS). Prior to 1921, when banks had to write off bad loans either in full or not at all, there were constant disputes between banks and the IRS about the timing of the deduction for bad loans. It has recently been argued that this claim is incorrect. To the contrary, the repeal of the tax bad-debt reserve method will eliminate the incentive to accelerate loan chargeoffs. See Neubig, Thomas S. and Martin A. Sullivan, (1987).

4 Commercial banks have two other options for recapturing existing reserves under the new tax rules. One option permits a bank to recapture more than 10 percent in 1987 and then recapture the remaining reserve as follows: 2/9 in 1988, 113 in 1989, and 419 in 1990. The other option permits a bank to retain the reserve method for existing loans and to reduce the balance as loans are charged off (referred to as the cut-off method). Under the cut-off method, a bank can still deduct for tax purposes net charge-offs in excess of the reserve amount.

tax rules exempt a large bank from this recapture of bad-debt reserves only when it is *in trouble*—defined as being when a bank's nonperforming assets exceed 75 percent of its equity capital.

If we ignore the exemption of small- and medium-size banks under the new tax rules, *all* Ohio banks would have paid 7 percent more in 1985 taxes if they had written off bad loans instead of taking a bad-debt tax reserve deduction. Also, if all banks were subject to a recapture of 10 percent of their accumulated bad-debt reserve in 1985, their 1985 tax liability would have risen by approximately 12 percent.

With the small- and medium-size banks exempted, however, the estimated tax liabilities for the loss of bad-debt tax reserve and the loan-loss recapture would have been approximately 8 percent and 12 percent, respectively, for the large banks (assets over $500 million)—which are subject to exclusion of the bad-debt reserve deduction under the new tax rules.

If the new tax code had not exempted small- and medium-size banks, the recapture of 10 percent of accumulated loan-loss reserves and the nondeductibility of a bad-debt tax reserve would have affected these banks slightly less than the effect that these provisions had on the tax liability of large Ohio banks. The progressive recapture of the accumulated bad-debt reserve into taxable income, moreover, will have a significant effect on the tax liability of large banks in 1989 and 1990. If Ohio's large banks (assets greater than $500 million) had captured 40 percent of the bad-debt reserve into 1985 taxable income, this would have boosted their tax liability by almost 50 percent (see table 3, Tax bad-debt accumulated reserve, capturing 40 percent of reserve.)

Investment Tax Credits and Depreciation Write-offs. Because of ITCs and accelerated depreciation write-offs, banks have found it advantageous, from a tax perspective, to add lease receivables as a partial substitute for municipal securities and direct loans. In 1981, Congress allowed businesses to accelerate the recovery of their investments under the accelerated cost recovery system (ACRS) because the inflationary environment at that time distorted the real cost of capital. However, the inflation rate has improved significantly in recent years. As a consequence, ACRS amounts to a generous tax break because it depreciates an asset completely much sooner than the end of the asset's actual useful life. The new tax rules correct this distortion by slowing the rate of depreciation write-offs.

The elimination of ITCs, first authorized in 1962 and raised to 10 percent in 1975, will severely undercut the tax incentives of banks to engage in leasing receivables. The slowing of ACRS will have a similar, but less severe, slowing effect on the leasing activities of commercial banks. The likely response of commercial banks to the elimination of ITCs and to less-liberal depreciation write-offs should be a repricing and possible reduction of their leasing activities. On the other hand, because banks lose their interest deductions for tax-exempt bonds, they will have an incentive to reinvest some of their cash flow into leasing. Lease receivables presently represent only a small percentage of total bank assets and, on balance, the new tax rules will not cause commercial banks to add a significantly higher percentage of their assets to leasing activities.

In 1985, Ohio banks claimed almost $22 million of ITCs to reduce their tax liabilities. If they were not allowed to deduct ITCs in 1985, their tax liability would have risen approximately 13 percent.

Foreign Tax Credits. The new tax rules impose limitations on foreign tax credits (FTCs). Tighter rules on FTCs will affect primarily multinational banking organizations, particularly the New York-based money center bank holding companies. Some New York multinational banking organizations receive more than 50 percent of their reported net earnings from foreign operations or foreign assets.

Under the old tax rules, commercial banks could claim a tax credit against U.S. corporate income tax liabilities that was directly proportionate to foreign taxes that they paid. Otherwise, banks would have been taxed twice on their foreign income, once abroad and once at home. The foreign tax credit is limited to the amount of U.S. federal income taxes that, in effect, would be paid to the U.S. government on a bank's foreign income.

Because commercial banks were required to report only aggregated foreign income under the old tax rules, they could maximize their FTCs. Under the old tax rules, a U.S.-domiciled bank with international operations could originate foreign loans in a high-tax country (where the tax rate exceeded the U.S. tax rate) and in a low-tax country (where the tax rate fell below the U.S. tax rate). Because the old tax rules allowed banks to average (or aggregate) loans from both foreign countries, a bank could claim total foreign taxes as a credit on its U.S. income taxes.

Under the new tax code, commercial banks will face a new limitation on how much they will be allowed to average their tax credits from low- and high-tax foreign countries. However, there is a transition rule to allow a phase-out of the old tax rules over five years on loans extended to 33 countries (generally the high-tax countries) that currently are receiving financial assistance under written agreements with the International Monetary Fund.

The new tax provisions on FTCs will have little effect on the 1987 tax liabilities of most Ohio banks because these banks generally have low amounts of foreign assets as a percentage of total banking assets. Only the largest Ohio banks reported FTCs in 1985. Even if we estimated a worst-case situation in which FTCs are deducted from income instead of deducted from tax liability, the simulated effect on large Ohio banks' tax liability would be minor, adding only 1 percent to their 1985 tax liability.

Alternative Minimum Tax. Commercial banks now pay what amounts to an add-on tax of approximately 15 percent of the amount by which selected preference items or deductions exceed either $10,000 or a bank's net tax liability.[5] The selected preference items include capital gains, accelerated depreciation, and excess loan-loss provisions. The purpose of this add-on tax is to counteract the effect that tax-preference items have on reducing taxable income.

In 1985, add-on taxes represented, on average, less than $1 million of the net tax liability of all sampled Ohio banks (see table 2, line 5). Our estimations of add-on taxes for Ohio banks are low because they exclude capital gains and excess accelerated depreciation as part of the add-on tax base. Neither category can be estimated with any reasonable accuracy from available financial data. However, this does not result in seriously underestimating the add-on taxes of Ohio banks, because capital gains and excess accelerated depreciation are typically small additions to the add-on tax base of most Ohio banks. It is worth noting that banks report all securities gains, regardless of the length of time held by them, as ordinary income for tax purposes.

Tax reform repeals the present add-on tax and replaces it with a new alternative minimum tax (AMT) that imposes a strict minimum tax of 20 percent. To compute the AMT, a bank must add together its regular taxable income and certain tax preferences that represent its alternative minimum income. After exempting $40,000 of this amount, a bank must multiply its alternative income by 20 percent; its tax will be the greater value either of its regular tax or of the AMT. The tax preferences include bad-debt reserves in excess of the deduction based on the experience method (small- and medium-size banks only); interest income on private-purpose, tax-exempt bonds issued after August 7, 1986; and 50 percent of book-value income that is not already subject to the minimum tax that will include, for the most part, tax-exempt income for banks.

Our simulations indicate that the AMT will have less effect on large Ohio banks than on small- and medium-size Ohio banks. The elimination of tax preferences ensures that the large Ohio banks will pay at least the minimum tax amount. Our simulations indicate that the AMT would represent only 8 percent of all Ohio banks' total tax liability. However, for small- and medium-size banks, the AMT will represent a significantly higher proportion (almost 21 percent) of their estimated 1985 tax liability under the new tax provisions.

During the next four years, the recapture of existing loan-loss reserves by large banks will gradually boost their taxable income. Consequently, large Ohio banks will almost assuredly, on average, pay the top marginal tax rate. For small- and medium-size Ohio banks, the AMT will be a much larger percentage of net taxes for two reasons: (1) these banks retain more tax preferences and (2) they have relatively more book-income adjustment as a result of their relatively larger holdings of municipal securities.

Net Operating Loss Carry-overs. Under present tax law, corporations may carry over current net operating losses (NOLs) to offset tax liabilities in past and future years. Most corporations are allowed to carry losses back three years and to carry them forward 15 years (losses must be carried back first). Banks, however, are allowed to carry NOLs back 10 years and forward five years. Banks received favorable treatment of NOIs at a time when Congress was reducing the reserve allowance that was permitted for bad debts. Consequently, if a bank incurred an unusually large debt write-off, favorable treatment of NOIs would reduce the financial strain on the bank.

The new tax code retains existing NOL rules for pre-1987 losses. NOIs arising in 1987 and thereafter will be subject to the same rules that apply now to other nonfinancial corporations. However, existing NOL rules will be retained for some losses occurring after 1987, but prior to 1994.

The special NOL rules that now apply to depository institutions provide a cushion against large current losses. Under present NOL rules, a bank receives a tax savings immediately because operating losses are carried back 10 years to reduce past tax liabilities. Moreover, the prospect of future earnings against which carry-forwards could be offset is not certain for many banks. The effect of adopting the new rules is that carry-overs would reduce future tax liabilities more than past tax liabilities. What this means is that the new NOL rules will provide less assistance to financially ailing banks.

401(K) and IRA Programs. A section 401(K) plan is an employer-sponsored program under which employees can defer a portion

5 See Ernst & Whinney, Tax Reform—1986, An Analysis of Provisions Relating to the Financial Services Industry, p. 18.

of their pay in investment accounts until retirement under that provision of the Internal Revenue Code. IRAs are deposits in individual retirement accounts that are deductible from current income.

Under the new tax code, high-income taxpayers who are covered by a pension plan would forgo the tax deduction for an IRA. However, individuals who are not covered by employer-maintained retirement plans, including 401(K) plans, are subject to the old tax code as it applies to IRA deductions. The new tax rules also reduce the maximum annual contribution that an individual can make to a 401(K) plan.

Annual IRA contributions will probably decline because of the new tax-code restrictions on IRAs, and banks will partially lose a stable, long-term source of deposits. The drop-off in IRAs could be offset if a supplier of IRA accounts, like a bank, could successfully encourage more lower- to middle-income individuals to use IRA accounts. Today, commercial banks and savings and loans together control almost one-third of the approximately $225 billion IRA market.

Opponents of the IRA tax changes contend that small banks could be forced out of the IRA market under the new IRA restrictions. This could occur, they argue, if the new IRA changes required banks to install sophisticated computer software to distinguish between deductible and nondeductible IRA contributions. This is not likely to happen, however, because small banks could easily purchase the necessary computer software.

IV. Conclusion

The intent of the new corporate income tax rules is to raise the federal tax liability of commercial banks. According to our simulation results, the new tax rules would have ***reduced*** Ohio banks' 1985 tax liabilities by approximately 15 percent if only the lower corporate tax rates were in effect at that time (see table 3). When the composite effectsof the new tax rules are simulated simultaneously, however, the tax liabilities of all Ohio banks would have ***increased*** by almost 30 percent in 1985 under the new tax rules. This computes to an average tax rate for all Ohio banks of almost 20 percent, as compared to an actual average rate of 16.1 percent. The average tax rate of Ohio's larger banks will increase from 17.1 percent to 21.3 percent; for small- and medium-size Ohio banks, the higher average tax rate of 15.9 percent compares to an actual estimated average rate of 13.3 percent.

However, even though taxes paid by Ohio banks will likely be higher, their profitability may be largely unaffected to the extent that they can offset the higher tax expense by adjusting their lending, service prices, and other activities. Banks would pay higher taxes, but net profits could be largely unaffected because of higher pre-tax income.

Ohio's larger banks will pay progressively higher average tax rates in 1988 and in subsequent years (assuming they make no portfolio adjustments) because the new tax rules phase in several tax-increasing provisions. Large banks will gradually lose the transition rules for FTCs for developing countries and must progressively recapture existing bad-debt reserves into current income, particularly in 1989 and 1990. The loss of FTCs is of little consequence to Ohio's larger banks. However, the recapture of loan-loss reserves will boost large banks' taxable income significantly in 1989 and 1990.

The adverse effect of losing the bad-debt reserve on large banks' tax liabilities is reduced because, regardless of the Tax Reform Act of 1986, the percentage method of calculating the bad-debt provision will be eliminated after 1987, in accordance with a 1969 statute. That is, in 1988, all banks must adopt the experience method of calculating their annual loan-loss provision.

Nonetheless, the elimination of large banks' loan-loss provision for tax purposes remains a controversial issue. The traditional view of loan-loss reserves contends that its removal for tax purposes could have potentially serious consequences because such action would weaken the safety and soundness of our commercial banking system. Removal of loan-loss reserves would presumably reduce the margin of safety available to banks for coping with unexpected financial shocks.[6] Advocates of reinstating the tax deductibility of the loan-loss provision contend that it is not a tax shelter for commercial banks. Instead, the loan-loss reserve should be viewed as a proper method for commercial banks, either large, medium, or small, to amortize losses that now are embedded in their loan portfolios, and to build up reserves against potential financial strains in the future. Removing the tax deduction for a loan-loss provision for large banks gives these banks less incentive to build reserves to protect themselves against potential losses.

Those who favor eliminating the loan-loss provision argue that its loss as a tax deduction will have little effect on the safety and

6 At present, bank regulators are encouraging banks to build up their bad-debt reserves because segments of the banking industry are afflicted with problems from their foreign, energy, and farm loans.

soundness of the banking system? They emphasize the fact that tax-purpose reserve positions do not determine GAAP reserve measures. In a bank's financial statements, it reports a loan-loss reserve that estimates expected future losses in its loan portfolio. For tax purposes, a bank has two choices in calculating its deductible loan-loss provision: (1) it can deduct its actual losses, or (2) it can deduct a maximum percentage of its eligible loans or deduct the average of current loan losses and previous five-year losses. Since tax and accounting rules for bad-debt reserves differ, the reserve method would not change a bank's provision for bad debt in its financial statement.

Given this, the effect on a bank's safety and soundness of a tax-related elimination of the loan-loss provision is pertinent only to the extent that it reduces after-tax income. Moreover, the elimination of the loan-loss provision, or even the recapture of existing loan-loss reserves per se is not the relevant issue, but rather how the new tax law's combined provisions will affect total after-tax bank income. To the extent that after-tax bank income is largely unaffected by the tax provisions, there would be little effect on the soundness of the banking system.

Proponents of eliminating loan-loss-reserve deductibility further claim that bank soundness will not be impaired because the removal of any tax incentives to bolster loan-loss reserves will merely cause an accounting adjustment without causing any change in a bank's primary capital. A bank's primary capital provides a cushion of protection against loan losses. Primary capital is the sum of funds accumulated through share issuance and accumulated net earnings after dividends are paid. Those who oppose the elimination of the tax deduction of loan-loss reserves argue that it is an item that directly affects bank soundness. Proponents of eliminating the loan-loss reserve point out that the reserve is essentially an accounting tool that provides information on the expected losses incurred in a bank's loan portfolio.

For regulatory purposes, primary capital equals equity capital, plus the loan-loss reserve. Although the level of loan-loss reserves should reflect potential loan losses, a bank has some latitude to add or subtract from its loss reserves. If there are tax incentives favoring loan-loss reserves, then a bank would find it desirable to adjust its accounting statements to report a larger provision. It would be desirable from the bank's perspective to increase the reserve provision by making an accounting adjustment to its equity capital so that the bank did not increase its primary capital.

If a higher level of primary capital is desired by a bank, it has two options: issue additional equity or capita-qualifying notes, or reduce dividends. Whether a bank issues additional equity or capital-qualifying notes, however, will depend critically on market conditions and on the bank's financial condition, and is not a consequence of how the bank reports its accounting statements. It follows that if tax incentives to add book loan-loss reserves are eliminated, a bank would adjust its accounting statements and would not alter its capital position.

7 For a complete discussion of this view, see O'Brien, James M. and Matthew D. Gelfand, "Effects of the Tax Reform Act of 1986 on Commercial Banks," 1987 Tax Analysts, Tax Notes, February 9, 1987, Special Report #1.

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