



INDEPENDENT COMMUNITY  
BANKERS *of* AMERICA

Testimony of

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On behalf of the  
Independent Community Bankers of America

Before the

United States House of Representatives  
Committee on Small Business

Hearing on

**“Economic Recovery: Tax Stimulus Items that Benefitted  
Small Business with a Look Ahead”**

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Chairwoman Velazquez, Ranking Member Graves, Members of the Committee, my name is Michael Menzies. I am the President and CEO of Easton Bank and Trust Company in Easton, Maryland and the Chairman of the Independent Community Bankers of America<sup>1</sup>. Easton Bank is a state-chartered community bank with \$150 million in assets. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on the tax stimulus items in the recovery package and additional tax recommendations to boost our economy.

## Summary of Testimony

- The severe economic recession justified a sizable economic stimulus, including tax relief measures. The ICBA was pleased that the \$787 billion Economic Recovery and Reinvestment Act (ARRA) enacted in February contained several ICBA-backed tax relief measures to help boost small businesses.
- Small businesses are benefitting from key tax relief measures in ARRA, including the first-time homebuyer tax credit, AMT relief, municipal bond initiatives, and small business immediate expensing.
- While the ARRA tax relief measures are helping, economic woes continue to plague the small business sector. To complement the aggressive monetary easing by the Federal Reserve Board, ICBA believes additional targeted fiscal policy action is warranted to boost long-term economic growth.
- ICBA recommends and supports expanded fiscal incentives including small business tax relief, a broad five-year net operation loss carryback, an extended homebuyer tax credit, robust SBA lending programs, and Subchapter S tax reforms.
- Small business access to credit is critical for an economic recovery. Therefore, unduly burdensome and overly aggressive bank exams and onerous new regulations on community banks must be avoided to support small business lending and economic strength.

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<sup>1</sup> *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

*With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than \$908 billion in assets, \$726 billion in deposits, and more than \$619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at [www.icba.org](http://www.icba.org).*

### **Small Business and Community Banks Key to Recovery**

America's small businesses are critical to supporting our economic recovery. Small businesses represent a whopping 99% of all employer firms and employ half of the private sector workers. The more than 26 million small businesses in the U.S. have created 70 percent of the net new jobs over the past decade. With the unemployment rate reaching 9.5 percent, the viability of small businesses is more important than ever. ICBA appreciates this important forum to address tax items that can help small businesses and our recovery. The impact tax policies have on small business is substantial. For most small businesses, after labor costs, taxes are the second most expensive item in their budget.

Community banks are small businesses too and are essential to the success of small firms nationwide. Community banks specialize in small business relationship lending. Community banks stick with their local communities and small business customers in good times and in bad. Community banks serve a vital role in small business lending and local economic activity. For their size, community banks are disproportionately large small business lenders. While community banks represent about 12% of all bank assets, they make 31% of the dollar amount of all small business loans less than \$1 million. Notably, half of all small business loans under \$100,000 are made by community banks.

### **Economic Recovery Package Important**

The severe economic recession justified a sizable economic stimulus, including tax relief measures for individuals and small businesses. The ICBA was pleased the \$787 billion Economic Recovery and Reinvestment Act (ARRA) enacted in February contained several ICBA-backed tax relief measures to help boost small businesses.

While the bulk of the recovery package enacted was focused on spending initiatives, tax relief and reform items included will have a positive impact. Specifically, tax items we see helping the economy include the \$8,000 first-time homebuyer tax credit, the extension of alternative minimum tax relief that prevented 26 million additional taxpayers from paying the AMT, and the tax-exempt municipal bond measures. Additionally, the limited net operating loss reform, the immediate \$250,000 small business expensing, and the major Small Business Administration loan program enhancements enacted are all helping many small businesses ride out this deep recession.

### **Homebuyer Tax Credit**

In order to address a slowing economy, ICBA recommended a first-time homebuyer tax credit in early 2008. A first-time homebuyer tax credit was initially enacted in a 2008 stimulus plan and expanded in the Recovery Act of 2009. The National Association of Realtors reports that an increased number of individuals are shopping for a home based on the homebuyer tax incentive and existing home sales have increased in the past two months. ICBA believes the homebuyer tax credit is having a positive impact in a very difficult housing market.

However, the housing sector remains a troubled spot for the economy and can use additional support. ICBA strongly supports additional targeted housing tax incentives to arrest the downward spiral in the housing market. One of the largest underlying

problems preventing an economic recovery remains declining home prices. Housing and household related spending typically accounts for 20 percent of the nation's Gross Domestic Product (GDP). Plunging home values are putting record numbers of borrowers' underwater and fueling record foreclosures. Millions of small businesses are suffering the fallout from the dramatic decline in the housing market.

The broad credit markets have been severely damaged by the sharp decline in housing prices and real estate collateral. Some 45% of small business loans outstanding are collateralized by real estate. Small business owners in particular often rely on their homes for collateral and widely use home equity loans and lines of credit. Without further fiscal policy assistance to address the struggling housing sector, additional declines in the credit availability for small businesses will jeopardize their ongoing viability.

Financial institutions in general have already experienced more than \$600 billion in real estate related asset writedowns and credit losses in this recession. Bank regulators are aggressively forcing further write-downs on real estate, forcing banks to raise even more capital or curtail lending. When lenders lack capital, they are unable to lend to small business and consumers, exacerbating the economic downturn. Additionally, declining home values and rising foreclosures increase stress in the credit markets by jeopardizing the value of a range of mortgage-backed securities and crimping liquidity.

The vicious downward cycle in the housing sector must be stopped. The current homebuyer tax credit is working but is set to expire in November. This is too soon and the credit may be too limited to boost the housing market back to robust levels. ICBA respectfully recommends that Congress increase the first-time homebuyer tax credit to \$15,000; allow it to be used by all homebuyers -- not just first-time buyers, and to extend it through 2010. The housing market must be stabilized and growing in order to achieve a sustained economic recovery. Stabilizing real estate prices will better allow small businesses to use their real estate values as collateral for credit. An extended and expanded homebuyer-tax credit will help.

### **Flexibility for S Corporations**

The Recovery Act did include positive ICBA-backed S Corp. reforms for the built in gains (BIG) tax treatment. The Recovery Act allowed \$415 million to reduce the BIG tax holding period to seven year from ten. ICBA supports enactment of further reforms in the bipartisan "S Corp. Modernization Act of 2009," H.R. 2910 introduced by Reps. Ron Kind (D-WI) and Wally Herger (R-CA) in the House and S. 996 introduced by Sens. Blanche Lincoln (D-AR) and Orrin Hatch (R-UT) in the Senate. Specifically, this legislation would make permanent the temporary seven-year BIG tax holding period enacted in the Recovery Act and expand S Corp. IRA shareholder availability.

ICBA believes additional tax reform would go a long way in helping the nation's most prevalent type of small business corporation. More than four million small businesses are structured as Subchapter S corporations including one-third of all banks. S Corp.

community banks are well-positioned to help boost lending throughout communities across America.

However, many onerous rules and obstacles prevent S corporation small businesses and community banks from reaching their full potential. For small businesses, raising capital is critical to the start-up, survival, and growth of the business. Given today's tight capital markets, attracting funds is critical for small business. However, arbitrary and restrictive limits on Subchapter S businesses jeopardize their ability to raise capital.

Specifically, current tax law restricts the number and types of individuals or entities that may own S corporation stock. S corporations may not have more than 100 shareholders, new IRA shareholders, and can only have one class of stock outstanding. ICBA believes these restrictions should be immediately reformed to spur more private sector solutions for small businesses to attract capital as Treasury is injecting taxpayer funds as capital into banks. In order to increase the options for small businesses to raise capital from the private sector, ICBA recommends:

- Increasing the maximum number of allowable S corporation shareholders to 150 from 100;
- Allowing IRAs as eligible S corporation shareholders;
- Permitting the issuance of preferred stock for all S corporations; and
- Preventing punitive IRS Subchapter S "TEFRA" change.

### **Increase the maximum number of S corporation shareholders to 150**

Bank regulators are demanding banks raise additional capital given the current economic slowdown. Unfortunately, arbitrary and restrictive limits on the number of allowable Subchapter S shareholders can jeopardize the ability of S corporations to raise capital. Notably, other business forms such as limited liability corporations (LLCs) and partnerships have no restrictions on the number of shareholders. When the S corporation rules were first enacted, the maximum number of shareholders was ten. Throughout the period 1976-1982 Congress increased the number to 35. The Small Business Job Protection Act increased the maximum number of eligible S corporation shareholders from 35 to 75 for tax years beginning after December 31, 1996. The American Jobs Creation Act of 2004 increased the number of eligible shareholders from 75 to 100. However, similar pass-through tax structures have no shareholder limits at all. Today, the rigid Subchapter S shareholder limits are out of sync with the modern capital and operating needs of small businesses.

Reflecting their nature, many community banks were created by involving a large number of shareholders in a community to raise capital. This helps assure that the institutions are widely owned by members of the local communities they serve. The provision of the S corporation rules limiting the number of shareholders to no more than 100 often forces community banks that wish to become an S corporation to disenfranchise shareholders, severely limiting ownership and its ability to raise capital in the future.

ICBA recommends increasing the maximum number of allowable S corporation shareholders to 150. ICBA believes that increasing the number of allowable shareholders will permit more

community banks to make the S corporation election, raise additional capital and, at the same time, continue to be widely owned by members of their communities.

### **Allow new IRAs as eligible S corporation shareholders**

Many of the nation's banks need to raise additional capital if they are going to be able to increase lending. Current law restricts the types of individuals or entities that may own S corporation stock. S corporation community banks seeking to raise capital may not allow new IRA shareholders. Traditional and Roth IRA stock are permitted only to the extent that that IRA stock was held on or before October 22, 2004. Subchapter S community banks are put at a disadvantage relative to other less restrictive business forms in their ability to attract capital due to the rigid IRA shareholder restriction.

ICBA recommends that new IRA investments in a Subchapter S bank be allowed regardless of timing. IRA shareholders should be allowed to participate in Subchapter S corporations. ICBA believes this will grant more community banks the needed flexibility in attracting IRA shareholder capital from existing owners and new shareholders. Having adequate bank capital is critical to ongoing small business lending.

### **Allow community bank S corporations to issue certain preferred stock**

Current law only allows S corporations to have one class of stock outstanding. C corporations that want to make the S corporation election must eliminate any second class of stock prior to the effective date of the S corporation election. Likewise, issuing a second stock class by an S corporation terminates its S corporation status. Community banks must maintain certain minimum capital ratios to be considered a well-capitalized institution by their regulators. As a community bank grows in size, its earnings alone may not provide sufficient capital to fund its growth and to continue providing new loans. Banks needing more capital can raise additional capital by issuing common stock, preferred stock, or, in some cases, trust-preferred securities.

Many community banks avoid issuing additional common stock to fund growth so they can protect their independent status and serve their local community lending needs. Instead, they frequently use preferred stock to fund growth and retain control. However, S corporation banks are not allowed to issue commonly used preferred stock because preferred stock is considered a second class of stock. This prevents small community banks from having access to an important source of capital vital to the economic health and stability of the bank and the community it serves.

ICBA recommends exempting convertible or "plain vanilla" preferred stock from the "second class of stock" definition used for S corporation purposes. This would help more community banks become eligible to make the S corporation election as well as help those that currently are S corporations seeking to raise additional capital. Allowing community bank S corporations to issue preferred stock would allow them to reduce the burden of double taxation like other pass-through entities and, at the same time, fund future growth. To provide community banks one more important option in attracting capital to fund business operations and serve their communities.

Small businesses including community banks are dealing with frozen capital markets and the near-impossibility of raising new capital. Immediate adoption of the S Corp. reforms listed above would go a long way in creating additional private sector capital-raising options.

### **Prevent the Sub S “TEFRA” disallowance proposed IRS change**

The Recovery Act did include a beneficial ICBA-advanced municipal bond measure to increase qualified bank-owned muni bond issuances from \$10 million to \$30 million annually. This will allow more community banks to help finance local projects at competitive funding levels.

ICBA wants to highlight a counterproductive IRS proposed rule that would greatly threaten the strength of Subchapter S banks and municipal bond offerings. The proposed IRS rule would reverse long-standing tax treatment and precedent on the use of “bank qualified” bonds that are permissible investments for banks. Banks are allowed to invest in bank qualified tax-exempt bonds in order to help cities and towns served by community banks finance needed local projects such as schools, water treatment plants, firehouses and hospitals in an affordable way. As the Recovery Act seeks to expand municipal construction projects and boost economic activity, this is no time to for the IRS to jeopardize bond financing. The proposed regulation should be withdrawn.

Unfortunately, the IRS proposed a new regulation that would contradict an existing statute. (IRS Proposed Regulation §1.1363-1(b) (IRS-REG-158677-05).) The community banking industry has in good faith relied on the statute and informal IRS guidance in applying the so-called “TEFRA tax disallowance” for Subchapter S banks that hold bank qualified bonds for the past seven tax years or more. The existing practice by S corporation banks, that the 20% TEFRA disallowance terminates three years after the S election, is soundly based on existing law. The IRS should not have the authority to override a statute with a regulation. The ICBA believes this proposed regulation is unwarranted, and if further advanced, would be tremendously damaging to Subchapter S banks, their taxpaying shareholders and the communities they serve. The ICBA strongly opposes the proposed regulation and has respectfully urged the IRS to promptly withdraw it.

### **Expand the Loss Carryback to Five Years or More**

ICBA supported an expanded net operation loss (NOL) provision in the Recovery Act. While a NOL provision was included, it was severely limited to businesses with \$15 million or less in gross receipts. ICBA recommends enacting an expanded NOL that would allow more small business to preserve their cash flow and ride out the recession.

One-third of banks nationwide, more than 2,657, reported a loss in their latest FDIC quarterly banking profile. Allowing community banks and small businesses with \$10 billion in assets or less to simply spread out their current losses to preserve capital to leverage for lending would help entire communities weather the deep recession. Expanding the current Net Operation Loss Carryback (NOL) period to five years or more from two years will help free up small business resources now to help support investment and employment at a time when capital is needed most. Expanding the NOL to a five-year carryback simply allows businesses to accelerate the use of allowable NOL deductions that can be claimed in future years under current law anyway.

A recent report by the Congressional Research Service helps support the ICBA-backed net operating loss tax relief. The May 27 CRS report notes most economists agree that U.S. companies would benefit from a longer net operating loss carryback than the current two years period. The CRS report says the carryback period should last through the typical business cycle (six years) to help smooth the peaks and valleys in income

ICBA supports the bipartisan “Net Operating Loss Carryback Act,” H.R. 2452 introduced by Reps. Richard Neal (D-MA) and Patrick Tiberi (R-OH) in the House and S. 823 introduced by Sens. Max Baucus (D-MT) and Olympia Snowe (R-ME) in the Senate. This act would allow a five-year NOL carryback which would provide businesses with additional cash flow they can use to stay afloat during the recession.

### **Preserve 35% Top Marginal Tax Rate on Subchapter S Income**

Maintaining cash flow is vital to the ongoing survival of any small business and taxes are typically the second highest expense for a business after labor costs. As pass-through tax entities, Subchapter S taxes are paid at the individual income tax level. Marginal income tax rates do play a critical role in a small business’ viability, entrepreneurial activity, and choice of business form. Today more than half of all business income earned in the United States is earned by pass-through entities such as S corporations and limited liability corporations. Therefore, increases in the individual income tax rates will have a dramatic impact on small businesses.

ICBA believes it is important to consider maintaining parity between the top corporate and individual income tax rates in the Code. Currently, many tax increase proposals are being floated to cover hundreds of billions in proposed health care reforms, including tax hikes that would fall disproportionately on small business income. During this difficult economic period, at a minimum, the current top tax rate of 35% should be preserved on both small business Subchapter S income and C corporation income, not increased. This will afford lenders and investors more confidence in extending small business capital.

### **Finalize SBA Secondary Market Programs**

Madam Chair, the Small Business Committee helped include more than \$700 million in beneficial SBA loan program incentives in the Recovery Act. Some community bankers are now making more SBA loans than they had done last year and SBA lending is now starting to recover from extremely depressed levels. Additionally, there has been some recent thawing in the SBA secondary market as the prices paid for SBA loans has increased slightly. However, the overall weak secondary market for small business loans continues to impede the flow of credit to small business.

Several ICBA-backed programs have been launched to help unfreeze the frozen secondary market for pools of Small Business Administration (SBA) guaranteed loans, including the Term Asset-Backed Securities Loan Facility (TALF) and a new SBA secondary market facility. The TALF, conducted through the Federal Reserve and U.S. Treasury, was intended to extend billions in nonrecourse loans to holders of high-quality

asset-backed securities (ABS) backed by consumer and small business loans in a bid to free up the frozen ABS market.

Specifically, the TALF program for SBA secondary market loan pools is very close to success. Unfortunately, one obstacle requiring third-party direct competitor primary dealers to be middlemen has completely stalled the program. SBA loan poolers will not turn over their customers to their direct competitors, nor have the primary dealers engaged in the program to date. ICBA recommends either eliminating the primary dealer middlemen in the process or allowing the Federal Reserve Bank of New York to work as the intermediary with the existing SBA loan poolers.

Similarly, the new SBA secondary market program is close to success but the debate over potential additional fees to operate the program has stalled its launch. ICBA recommends using the enacted substantial funded budget authority to run the program in combination with user fees so as not to hamper the program with unworkable double fees.

The SBA loan program enhancements in the Recovery Act to reduce fees and increase the guaranty levels are working. ICBA believes with additional minor adjustments, the targeted SBA secondary market programs will help keep money flowing to consumers and small businesses providing the intended results.

### **Overzealous Bank Regulation Hurting Small Business Lending and Recovery**

Monetary and fiscal stimulus will not achieve its intended benefit if banks are forced to pull-in their lending due to overly restrictive regulations. The flow of bank credit is essential to a strong economy. Unfortunately pro-cyclical bank regulatory policies continue to jeopardize credit availability for many small businesses. ICBA believes the bank regulatory pendulum has swung too far and is crushing many community banks' ability to lend to deserving small businesses. Community banks did not cause the current financial crisis fostered by the missteps of the too-big-to-fail banks. Unfortunately, bank regulators are often applying crippling regulatory exams and policies across-the-board.

Community bankers nationwide continue to report to ICBA about overzealous and unduly, overreaching examiners second guessing bankers and appraisers and demanding overly aggressive write-downs and reclassifications of viable and performing commercial real estate loans and other assets. Examiners are requiring write-downs or classification of performing loans due to the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have not been criticized before; and substituting their judgment for that of the appraiser.

Other bankers are concerned that otherwise solid loans are being downgraded simply because they are located in a state with a high mortgage foreclosure rate. This form of stereotyping is tantamount to statewide redlining that is unjustified in today's economic climate and could ultimately lead to capital problems at otherwise healthy banks.

This examination environment is exacerbating the contraction in credit for small businesses as community bankers must avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital. While it is expected and understandable that examiners will be more thorough and careful during a credit downturn, excessively tough exams that result in potentially unnecessary loss of earnings and capital can have a dramatic and adverse impact on the ability of community banks to provide small business loans and the ability to support economic growth.

### **Regulatory Restructuring Concerns**

The Administration and Congress are also advancing proposals to restructure the financial regulatory system, causing community bankers great concern about the potential impact. Any restructuring of our financial regulatory system should first recognize the fact that the current system that applies to community banks has worked appropriately and the highly-regulated community banking sector did not trigger the current financial crisis. Therefore, ICBA believes any plan should not unnecessarily disrupt community banking and small business credit.

ICBA believes reforms should focus on filling in regulatory gaps by regulating unregulated institutions and instruments, such as credit default swaps, off balance sheet schemes, and providing more effective regulation of under-regulated entities in the financial services sector, such as non-FDIC insured mortgage companies and mortgage brokers. Regulatory restructuring should address the systemic risk taxpayers just witnessed caused by the nation's largest too-big-to-fail institutions and focus efforts on eliminating future systemic risk.

### **Conclusion**

The tax and small business lending items passed in ARRA in February are having a positive impact on our economy. Additional tax policy reforms and rational banks regulation make sense in order to help small businesses and the economy reach full potential. ICBA pledges to work with the Small Business Committee to ensure the nation's small businesses receive positive tax treatment and have the access to capital they need to invest, grow, and to provide jobs and economic growth. Thank you.