July 17, 2017

The Honorable Orrin Hatch
United States Senate
Washington, D.C. 20510

The Honorable Ron Wyden
United States Senate
Washington, D.C. 20510

Dear Chairman Hatch and Ranking Member Wyden:

On behalf of the nearly 5,000 community banks represented by ICBA, which are organized in a variety of forms including mutual, C and S corporations, I write in response to the Chairman’s invitation to provide feedback on tax reform.

The 115th Congress presents a unique opportunity to restructure, modernize and simplify a complex and inefficient tax code. The community bank perspective on tax reform is the perspective of the customers and communities they serve – small businesses, farmers and ranchers, local governments that fund vital infrastructure projects and pay teacher, police, and firefighter salaries, as well as individual and families that purchase homes and save for college and retirement. What’s good for communities is good for community banks. Their prosperity is inextricably linked.

The views and positions set forth in this letter are designed to strengthen communities, promote local economic growth, and spur job creation nationwide for generations.

Community Banks and the American Economy

The economic life of thousands of American communities depends on customized financial products and services that only community banks provide. Community banks are playing a vital role in ensuring the economic recovery is robust and broad-based, reaching communities of all sizes and in every region of the country. According to a 2016 report by the Federal Deposit Insurance Corporation (FDIC), more than 20 percent of our nation’s 3,100 counties are exclusively served by community banks.\(^1\) An historic industry consolidation is rapidly expanding

\(^1\) FDIC Community Banking Study. December 2012.
the number of communities without a local bank. Today there are 1,700 fewer community banks in the United States than there were in 2010. This means more communities stranded without a dedicated, locally-based community bank to invest in their growth and prosperity. These communities will be challenged in the current economic recovery and in future economic cycles.

**Lower Marginal Rates Needed for Individuals, Corporations, and Businesses**

ICBA strongly supports tax rate relief for American individuals, corporations, and businesses. Significant tax relief will provide a much-needed boost to a sluggish economic recovery and possibly help stave off another recession by spurring consumer purchasing, business investment, and hiring.

As Chairman Hatch noted in a recent speech on the Senate floor, the United States has the highest statutory corporate tax rate and the fourth highest effective tax rate (the actual rate paid after deductions and credits) among the Group of 20 nations.\(^2\) A significantly lower corporate rate is critical to our international competitiveness and our national prosperity. Rate relief must be a part of any tax reform package.

**Preservation of the Business Interest Deduction is Vital for Small Businesses**

*Defining Taxable Income*

Since the beginning of the modern income tax nearly 100 years ago, the tax code has allowed businesses to fully deduct interest expense as an ordinary and necessary cost of doing business. Our corporate tax system taxes profits – revenues or receipts minus expenses, which include the cost of borrowing. Deducting interest expense is consistent with U.S. Generally Accepted Accounting Principles (GAAP) as well as International Accounting Standards. Eliminating the deduction for business interest would run contrary to a longstanding principle of our tax system and effectively and arbitrarily increase the taxable income of thousands of businesses nationwide. The business interest deduction is not a peculiar feature of the U.S. tax system: It exists in all of the world’s advanced nations, across diverse tax systems and economic models.\(^3\) The business interest deduction is not a marginal provision of the tax code, and as such has never been identified as a “tax expenditure” by the Joint Committee on Taxation or the Treasury Department, which both publish annual lists of tax expenditures. The interest deduction clearly does not meet the Joint Committee’s definition of a tax expenditure: “Tax expenditures include

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any reductions in income tax liabilities that result from special provisions or regulations that provide tax benefits to particular tax payers.”

Small Business Impact

Given community banks’ strong partnership with small business and farmers and ranchers, ICBA is particularly concerned about the impact the elimination or limitation of the interest deduction will have on these borrowers.

America’s community banks are prolific small business lenders, playing an outsized role in funding small businesses and the jobs they create. While community banking organizations represent 17 percent of all U.S. bank assets, they make more than half of all small business loans. These small businesses, in large part funded by community bank credit, account for over half of all U.S. employment and nearly two thirds of all employment growth.

What sets community banks apart is their first-hand knowledge of the borrower, the community, and the local economy. Community bank small business lending simply cannot be duplicated by a bank based outside the community. As noted in a recent study by scholars at Harvard’s Kennedy School of Government, in certain lending markets, there is no effective substitute for the “skills, knowledge, and interpersonal competencies of many traditional banks.”

Community bank credit is a critical – and frequently the only viable – source of capital for small businesses and small farmers and ranchers, which typically have very limited or no access to equity capital, especially in the early stages of their development. According to a recent Federal Reserve survey, over 70 percent of employer small firms have outstanding debt. Increasing the after-tax cost of debt financing by altering the interest deduction would harm the viability of these small businesses.

Debt Financing Critical for Small Farmers and Ranchers – Especially in a Time of Crisis

The American farm sector is currently experiencing a generational threat in the form of low commodity prices. Farmers today operate on razor thin margins, dedicating substantially all of their production income to debt service and living expenses. In these challenging times, access to affordable debt often makes the difference between survival and failure, not only for the farmers but for the thousands of communities built around agriculture. Loss of the interest deduction would raise the cost of credit and aggravate the difficulties facing farmers and ranchers and farm communities.

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Community banks fund 77 percent of all agricultural debt. Farmers use debt to purchase land as well as production inputs. They borrow to buy seed and fertilizer at the beginning of the season, and sell their crops at end of the season. Operating loans help farmers work through seasonal fluctuations. This seasonal credit crunch is exactly the type of cash flow problem that operating debt is designed to address. Losing the interest deduction would significantly change the economics of farming and cause undue harm to the way of life of thousands of citizens of Middle America.

*Debt Financing Supports Local Ownership and Control*

Moreover, credit allows small business owners to invest and grow their businesses without diluting their control. Many small businesses are closely held to retain control over strategic decision making and direction. Outside equity capital would change the essential character of these businesses.

The taxation of interest on business borrowing would represent a dramatic change in longstanding U.S. tax policy, the potentially significant consequences of which are unknown. Community bankers across the country are seriously concerned with the practical, real world implications. In addition to the adverse impact on borrowers, the proposal also represents a threat to the ongoing viability of thousands of community banks that specialize in small business lending, having often been priced out of consumer lending by tax-subsidized credit unions and typically lacking the scale to lend to larger businesses.

*Single-Layer Taxation of Corporate Income*

The preferred way to create parity between debt and equity financing of investments is by creating a tax exemption for dividends paid by corporations. ICBA has long supported ending the double taxation of corporate earnings to rationalize our tax code. We are encouraged that recent corporate integration proposals that would create a tax exemption for dividends paid are gaining momentum.

*Strengthen the Subchapter S Business Model for Community Banks and Other Small Businesses*

Any reforms to the tax code should not only preserve the Subchapter S model but strengthen it as well. Subchapter S corporations are “pass-through entities.” They are not taxed at the entity level; rather, net income is taxed at the shareholder level at individual tax rates. The subchapter S corporation provides single-layer taxation while still affording the liability protection of a C corporation. Subchapter S has been part of the tax code since 1958. Today, a broad cross-section of American industries organize under Subchapter S, employing 33 million American workers or about one quarter of all American workers.

ICBA was successful in our effort to make Subchapter S available to banks in 1996, to increase the number of allowable shareholders, and to improve other terms. The Subchapter S model has

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8 Lux, Marshall, and Robert Greene. “The State and Fate of Community Banking.”
served community banks and small businesses well but is in need of modernization to serve the next generation of businesses. In particular, Subchapter S banks need new options to satisfy higher demands for capital from regulators. ICBA’s recommendations include:

**Higher Shareholder Limit Needed**

The limit on the number of shareholders should be raised from 100 to 200. A modernized shareholder limit would allow Subchapter S community banks to raise equity capital by reaching out to a broader population of potential investors. In addition, a higher shareholder limit would allow many C corporation community banks that are above the current shareholder limit to convert to S corporations, providing them with tax relief and more resources to serve their communities.

**Authority to Issue Preferred Shares**

Under current law, Subchapter S businesses may issue only one class of shares with equal rights to distributions and equal voting rights. Authority to issue preferred shares would allow S corporations to raise new capital without diluting control. This would help community banks retain one of the key characteristics of their business model, local ownership.

**IRA Investments in Subchapter S Corporations**

Subchapter S of the tax code prohibits individual retirement accounts (IRAs) from holding shares in an S corporation. Many S corporation community bank owners would like to be able to tap IRAs to inject capital into their banks to meet regulator demands for higher capital levels under the Basel III Capital Accords and other regulations. In addition, many C corporation community banks with IRA shareholders are prohibited from converting to S corporations, unless they buy out their IRA shareholders, which is impractical. The S Corporation Modernization Act (H.R. 1696), introduced by Reps. Dave Reichert (R-WA) and Ron Kind (D-WI), and its Senate counterpart, S. 711, introduced by Senators John Thune (R-SD) and Ben Cardin (D-MD), would, among other provisions, allow Individual Retirement Accounts (IRAs) to invest in S corporation shares. The Retirement Enhancement and Savings Act of 2016, which passed the Finance Committee in September 2016 by a vote of 26 to 0, was amended to include a provision from the S Corp Modernization Act of 2016 which would allow IRAs to hold shares in S corporation community banks.

**Parity in the Taxation of Different Entity Forms**

Over 2,000 community banks, approximately one third of the total, are organized under Subchapter S of the tax code. Under current law, the pass-through income of Subchapter S banks is taxed at the top individual rate of 43.4 percent including Affordable Care Act taxes, while corporate income is taxed at a top rate of 35 percent. ICBA has long held the view that rate parity, which would ensure that one business form is not disadvantaged relative to another, should be an important goal of tax policy. ICBA strongly supports the Main Street Fairness Act (H.R. 116), introduced by Rep. Vern Buchanan (R-FL), which would create rate parity and ensure that it is preserved under any future rate changes.
Expand Access to Credit with Tax Incentives for Targeted Community Bank Lending

Carefully designed tax incentives for community bank lending would lower credit costs for targeted borrowers and help community banks diversify their loan portfolios and comply with the Community Reinvestment Act. For example, ICBA strongly supports the Enhancing Credit Opportunities in Rural America Act of 2017 (H.R. 2205), introduced by Rep. Lynn Jenkins (R-KS), which would provide that interest earned on loans secured by agricultural real estate is tax exempt. This exemption would also apply to interest earned on mortgages secured by a single-family home that is the principal residence of the borrower, provided the home is located in a rural area with a population of 2,500 or less. ICBA believes a similar tax incentive could be extended to other types of community bank lending, including loans to low-to-middle income individuals and small businesses.

Parity in Taxation of Financial Services Providers

Many of today’s tax-exempt credit unions and Farm Credit System (FCS) lenders are multibillion dollar entities competing against much smaller, taxpaying community banks. The National Credit Union Administration (NCUA) has enabled many credit unions to grow their membership and their markets well beyond their statutory mission. In just the last four years, the total assets of federally insured credit unions have grown by nearly $70 billion and membership has grown by more than 10 million, while the total number of credit unions has declined by over 1,000. There are over 250 credit unions with assets over $1 billion. The largest holds approximately $75 billion in assets. The largest FCS lender is $91 billion, and collectively the FCS holds nearly one quarter trillion-dollars in assets.

Credit unions are also aggressively expanding into business lending. According to the NCUA, total business lending by credit unions ballooned from $13.4 billion in 2004 to $56 billion in September 2015, an annualized growth rate of 14 percent. This increase in lending comes at the direct expense of taxpaying community banks. The National Credit Union Administration’s new, highly permissive (and, we believe, illegal) rules will allow credit unions to further expand into commercial lending and effectively remove any meaningful limit on their field of membership. These new rules will further blur the distinction between credit unions and community banks, as would proposals to allow credit unions to raise supplemental capital and thereby cease being member-owned entities. Many community banks that serve urban and suburban areas have already been squeezed out of consumer lending by tax-subsidized credit unions. Now, community bank commercial lending is also under threat.

What’s more, community bankers are alarmed by an additional threat: the recent trend of credit unions leveraging their tax subsidy to purchase community banks and “buy” market share. At the same time, the National Credit Union Administration has effectively blocked commercial bank

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10 ICBA analysis of NCUA data.
11 ICBA analysis of Farm Credit Administration data.
12 Background to NCUA Member Business Lending Rule. Federal Register. Volume 81 at page 13,530.
purchases of credit unions by establishing a nearly impossible process. This trend should be addressed before it strengthens and becomes a real threat to the tax base.

FCS lenders pose a similar threat to agricultural community banks. Leveraging their significant tax and funding advantages as a government sponsored enterprise (GSE), FCS lenders siphon the best loans away from community banks. The FCS is the only GSE that competes directly against private sector lenders at the retail level. FCS was chartered by Congress to serve bona fide farmers and ranchers, but has in recent years sought numerous non-farm lending powers in an effort to compete directly with commercial banks for non-farm customers.

The FCS now has assets of over $320 billion, has over $250 billion in gross loans and had over $7.5 billion in net interest income at yearend 2016. If FCS were classified as a commercial bank, they would be the 7th largest bank in the U.S. by asset size. Yet, the FCS effective tax rate was only 4.2% at yearend 2016.

The problem gets worse every year as credit unions and FCS lenders continue to leverage their tax exemptions and other advantages to expand. Tax reform presents a once-in-a-generation opportunity to correct a historic injustice in the taxation of financial services providers. Credit unions and FCS lenders are becoming the equivalent of banks and should be taxed equivalently.

Repeal Estate Tax

ICBA supports full, permanent repeal of the estate tax as a threat to the intergenerational transfer of many community banks and small businesses served by community banks. Many community banks have been held and operated within families for as many as four generations. This close family and cross-generational association is critical to the identity, the business model, and the competitive advantage of community banks in an evolving financial system in which it is becoming more challenging for them to preserve their independence.

The estate tax jeopardizes the succession of community banks from generation to generation. A family estate should never be forced to sell its interest in a community bank to pay a transfer tax. Forced sales of once family-owned community banks to other community banks or, frequently, to larger regional or national banks, coupled with a recent surge in regulatory burden and tax advantaged competitors accelerate the current trend toward consolidation in the banking sector. Consolidation reduces competition and results in fewer product offerings, lower rates on deposits, higher rates on loans and higher fees and harms consumers and local businesses. The loss of widely-used discounts for minority interests in a business and for lack of marketability would only increase estate tax liability and exacerbate consolidation. In this regard, ICBA urges the Treasury Department to formally withdraw its proposed regulations under Section 2704 of the tax code, which would effectively end the use of such discounts.

13 Federal Farm Credit Funding Banks, Financial Highlights:
https://www.farmcreditfunding.com/ffcb_live/financialInformation.html?tab=highlights
14 Farm Credit, First Quarter 2016, Quarterly Information Statement of the Farm Credit System, pg 16.
Notwithstanding the status of these proposed regulations, ICBA’s preferred solution is full repeal of the estate tax. We urge you to use tax reform to accomplish this long held goal.

**Preserve Exemption for Municipal Bond Interest**

Community banks are proud to support their communities by investing in state and local government debt. In this regard, ICBA urges Congress to preserve the current law tax exemption for interest earned on municipal debt. The loss of curtailment of this important exemption would depress municipal bond pricing for all investors, raise borrowing costs for state and local governments, and reduce resources for vital public services and infrastructure.

**Opposition to New Commercial Bank Taxes**

ICBA has consistently opposed new taxes or fees specifically targeting the commercial banking sector or their customers. In recent years, Congress has considered proposals for asset-based taxes, curbing the deductibility of Federal Deposit Insurance premiums, and transactions-based taxes, among others.

In our view, the tax code should not be used to punish a specific industry sector. Sector-specific taxes distort the market and generate counterproductive outcomes. Even when such taxes exempt community banks, they set a troubling precedent: Once the tax code is opened up to target a specific sector it is difficult to contain the size, scope, and broader application of the tax.

**Closing**

Thank you for your commitment to growth-oriented tax reform and for invitation to share community banks’ views on this critical topic. The tax policies outlined above will empower community banks and other small businesses to jumpstart a sluggish economic recovery and create jobs and prosperity in our communities. We look forward to working with you as the tax reform process unfolds.

Sincerely,

/s/

Camden R. Fine
President & CEO