



INDEPENDENT COMMUNITY
BANKERS of AMERICA®

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Community Bank Principles for Tax Reform

On behalf of the more than 5,800 community banks represented by ICBA, we thank Chairman Brady, Ranking Member Neal, and members of the Ways and Means Committee for convening today's hearing on "How Tax Reform Will Grow Our Economy and Create Jobs." Tax reform is a critical and ambitious policy challenge. Done properly, it will strengthen our economy and spur job creation for a generation or more. We are strongly encouraged by the increasing momentum for change and are pleased to offer this statement for the record which describes community bank priorities in any tax reform legislation.

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. Rate relief must be a part of any tax reform package.

Preservation of the Business Interest Deduction is Vital

ICBA strongly opposes any limitation on the deduction for interest paid by business borrowers. Community banks have long enjoyed a strong partnership with America's small businesses and provide approximately half of all small business loans. Community bank credit is a critical – and frequently the only viable – source of capital for small businesses, which typically have very limited or no access to equity capital, especially in the early stages of their development. Moreover, community bank 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.

Eliminating the deduction for net interest expense amounts to double taxation of interest. Interest would be paid from taxable income and taxed a second time as income to the recipient. This would make community bank credit significantly more expensive and thus less available to thousands of small businesses.

The taxation of interest on business borrowing would represent a dramatic change in longstanding U.S. tax policy, the consequences of which are unknown. Community bankers across the country are seriously concerned with the practical, real world implications. In addition to 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 been priced out of consumer lending by tax-subsidized credit unions and lacking the scale to lend to larger businesses.

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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 Obamacare 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, which would create rate parity and ensure that it is preserved under any future rate changes.

Strengthen the Subchapter S Business Model

Any reforms to the tax code should not only preserve the Subchapter S model but strengthen it as well. In particular, Subchapter S banks need new options to satisfy higher demands for capital from their regulators. ICBA-supported bills include the Capital Access for Small Business Banks Act (H.R. 2339), introduced by Rep. Kenny Marchant, which would raise the shareholder limit for Subchapter S banks from 100 to 500 and allow Subchapter S banks to issue preferred shares.

The S Corporation Modernization Act (H.R. 1696), introduced by Reps. Dave Reichert and Ron Kind, and its Senate counterpart, S. 711, introduced by Senators John Thune and Ben Cardin, would, among other provisions, allow Individual Retirement Accounts (IRAs) to invest in S corporation shares. A version of S. 711 was amended to the Retirement Enhancement and Savings Act of 2016, which passed the Finance Committee in September 2016 by a vote of 26 to 0.

The legislation noted above would allow Subchapter S banks to meet regulators' persistent demands for higher capital levels. ICBA urges their inclusion in any tax reform legislation.

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 2016 (H.R. 2205), introduced by Rep. Lynn Jenkins, 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 a mortgage 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 that a similar tax incentive should be extended to other types of community bank lending, including loans to low-to-middle income individuals and small businesses.

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Parity in Taxation of Financial Services Providers

Many of today's tax-exempt credit unions and Farm Credit System (FCS) lenders are multi-billion dollar entities competing against much smaller, taxpaying community banks. 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 and, as a government sponsored enterprise (GSE), enjoys massive tax and funding subsidies.

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. FCS lenders pose a similar threat to agricultural community banks.

The problem gets worse every year as credit unions and FCS lenders continue to leverage their tax exemption to expand. What's more, since 2012 11 banks have been purchased by credit unions. With more deals reportedly in the works, this alarming trend should be addressed before it strengthens and becomes a real threat to the tax base. 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, 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.

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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 withdraw its proposed regulations under Section 2704 of the tax code, which would effectively end the use of such discounts.¹ 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 you 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 our view, tax policy should be neutral and not target 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 again for convening this hearing and for your commitment to growth-oriented tax reform. ICBA looks forward to continuing to work with the committee as tax reform advances.

¹ See ICBA's comment letter at <http://www.icba.org/docs/default-source/public/letters-to-regulators/2016/cl110216.pdf?sfvrsn=0>.

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