ICBA
Independent Community Bankers of America®

ICBA Principles for Tax Reform

White Paper

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ICBA PRINCIPLES FOR TAX REFORM

The 115th Congress presents a generational opportunity to restructure, modernize and simplify a complex, inefficient and distortionary tax code. There's more at stake in the design of our tax code than the collection of revenue. To a large degree, the tax code determines the nature of our economy and tax reform requires fundamental choices about our economic future. The goal of this paper is to help clarify the choices that lie ahead.

The views and recommendations set forth in this white paper were developed with input from community bankers nationwide. These are practitioners in the field, working with customers, making loans and doing the hard work of sustaining and building the economic livelihood of their communities throughout the business cycle and across generations. Their judgment about what works in the real world of economic decision making has been honed over generations. These community bankers have earned a seat at the table as the tax reform debate unfolds.

Their unique perspective on tax reform is different from that of other stakeholders in this debate because it is centered on strengthening the community bank-small business partnership. This partnership is the foundation of local economic prosperity.

Ultimately, tax and regulatory reform will determine the character of American economic life in future generations. A tax and regulatory system that promotes consolidation, implicitly or explicitly, not only in the financial industry but also across the economy, will result in fewer and larger businesses, less consumer choice and commodified product offerings. Local businesses, decision making and values will continue to be displaced by nationally-owned corporations that are remote from individual communities. Commerce based on one-off transactions will displace relationship-based partnerships. Tax reform, accomplished thoughtfully and in conjunction with regulatory reform, could help to thwart these trends and preserve and strengthen local businesses and communities.

The first imperative of tax reform is tax relief for businesses and individuals that will grow the economy by stimulating savings and investment.[1] In addition, tax reform should eliminate distortionary and outmoded provisions that hinder competitiveness. We must embrace bold thinking that will catalyze local economic growth, job creation and true competition.

1 While this paper focuses primarily on the taxation of corporate and business income, individual income tax reform and relief are no less important.

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 that the economic recovery is robust and broad-based, reaching communities of all sizes and in every region of the country. According to a 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.[2] A historic industry consolidation is rapidly expanding 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.[3] This means more communities are stranded without a dedicated, locally-based community bank to invest in their growth and prosperity. If this disturbing trend is not addressed through responsible tax and regulatory reform, these communities will continue to be challenged in the current economic recovery and in future economic cycles.

LOWER MARGINAL TAX RATES FOR INDIVIDUALS, CORPORATIONS AND BUSINESSES

ICBA strongly believes that tax reform must result in significant marginal rate reductions for American corporations and businesses. Meaningful tax relief will electrify our current sluggish economic recovery and help avert another recession by spurring business investment, hiring and consumer purchasing.

When crafting responsible tax reform, policymakers must be judicious in selecting offsets to "pay for" rate reductions. As discussed further below, certain current tax deductions are fair and warranted and could only be reduced or eliminated at the cost of significant economic harm. The current

2 FDIC Community Banking Study. December 2012.
3 ICBA analysis of FDIC data.

tax code does not provide many deductions or credits for use by community banks, which pay a high effective tax rate relative to other industries. (Effective tax rates measure taxes paid relative to income considering not only the statutory tax rate but also the use of deductions and credits.) However, community banks take a broad view of tax reform, recognizing the importance of deductions and credits that are critical to industries served by community banks and to the broader economy.

There are numerous compelling arguments for lowering corporate marginal tax rates, including that it would strengthen our nation's international competitiveness.[4] For the purposes of this paper, we emphasize that lowering marginal rates, by itself, will resolve or mitigate a number of distortionary features of the current tax code. For example, any supposed bias in favor of debt financing (we argue below that this bias is overstated) is mitigated by lower marginal rates, which reduce the advantage of the corporate interest deduction. Reducing the corporate marginal rate from 35 percent to 20 percent, for example, would reduce the value of all deductions, whether those deductions are warranted or not, by more than 40 percent. The double taxation of equity at both the corporate level and the shareholder level would be mitigated by any reduction in the corporate rate or in the individual rate on dividends or capital gains. Marginal rate reductions, in themselves, make the tax code more neutral and equitable.

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. Preserving the deduction for business interest would uphold a longstanding principle of our tax system and avoid any arbitrary increase in the taxable income of thousands of businesses nationwide.[5]

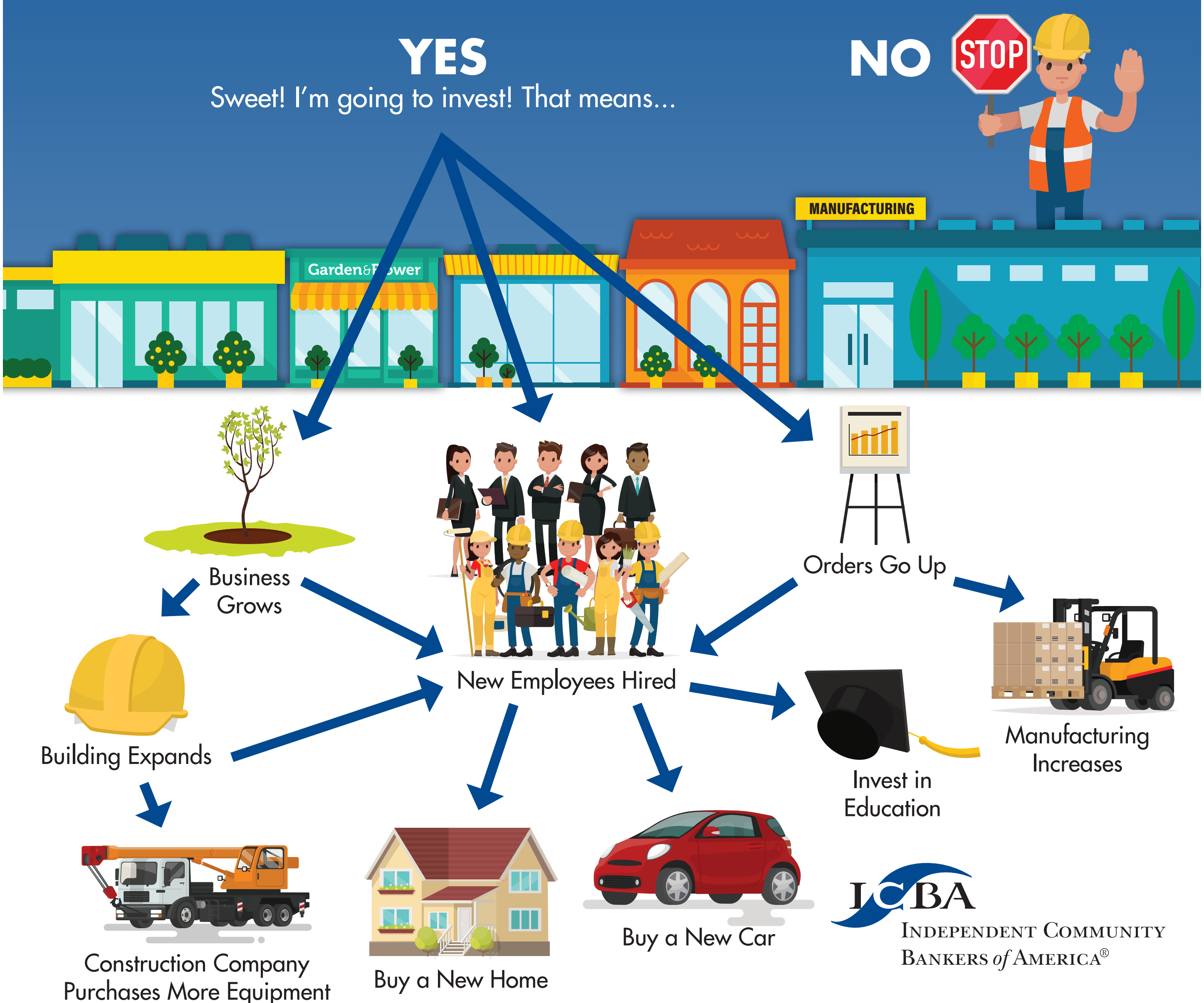
4 The United States has the highest statutory corporate tax rate, the third highest average corporate tax rate and the fourth highest effective marginal tax rate among the Group of 20 nations. "International Comparisons of Corporate Income Tax Rates." Congressional Budget Office. March 2017.

5 Jonathan Talisman. "Do No Harm: Keep Corporate Interest Fully Deductible." Tax Notes, 2013. We recommend the article in full. In addition to the points made in this paragraph, Talisman notes that (i) debt and equity are not substitutes for one another and warrant different tax treatment; (ii) the personal tax advantages of holding equity (deferral of taxation and preferential tax rates) offset, in whole or in part, any corporate tax bias in favor of debt; (iii) any supposed debt bias appears exaggerated; in fact, non-financial companies were not over-leveraged in the recent financial crisis; and (iv) eliminating the corporate interest deduction would make the United States an outlier among industrialized nations, among other arguments.

The Business Interest Tax Deduction Creates a Multiplier Effect

Should I invest in my small business? Well, it all depends...

Can I deduct the interest on my loan?



The Preservation of the Interest Deduction is Important to the Success of Main Street Businesses

The business interest deduction is not a marginal provision of the tax code and 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 any reductions in income tax liabilities that result from special provisions or regulations that provide tax benefits to particular tax payers.”[6]

No Double Taxation — of Interest or Dividends

Eliminating the deduction for net interest expense would amount to double taxation of interest. Interest would be paid from taxable income and taxed a second time as income to the recipient. Some would argue that this double taxation is necessary for the sake of creating equal tax treatment of debt and equity (dividends are not deductible and are double taxed) and eliminating the supposed debt bias in the current tax code.

This rationale fails to recognize the fundamentally different nature of debt and equity.[7] However, insofar as there is merit in creating tax parity between debt and equity financing, the preferred means is not double taxation of interest but a tax exemption for dividends paid by corporations, which is known as corporate integration. ICBA has long supported ending the double taxation of corporate earnings and is encouraged that corporate integration proposals are part of the current tax reform debate.

Small Business Impact

Given the strong partnership between community banks and small businesses, farmers and ranchers, ICBA is particularly concerned with maintaining the business interest deduction which is so important to 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 more than half of all U.S. employment and nearly two thirds of all employment growth.[8]

What sets community banks apart is their first-hand knowledge of the borrower, the community and the local economy. Community bank small

6 “Estimates of Federal Tax Expenditure for Fiscal Years 2016 Through 2020.” Joint Committee on Taxation. January 30, 2017.

7 See Talisman.

8 “Small Business Trends.” U.S. Small Business Administration.

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."[9] In a recent small business survey by the regional Federal Reserve Banks, community banks obtained the highest lender satisfaction scores, scoring higher than credit unions, Community Development Financial Institutions, large banks and online lenders.[10]

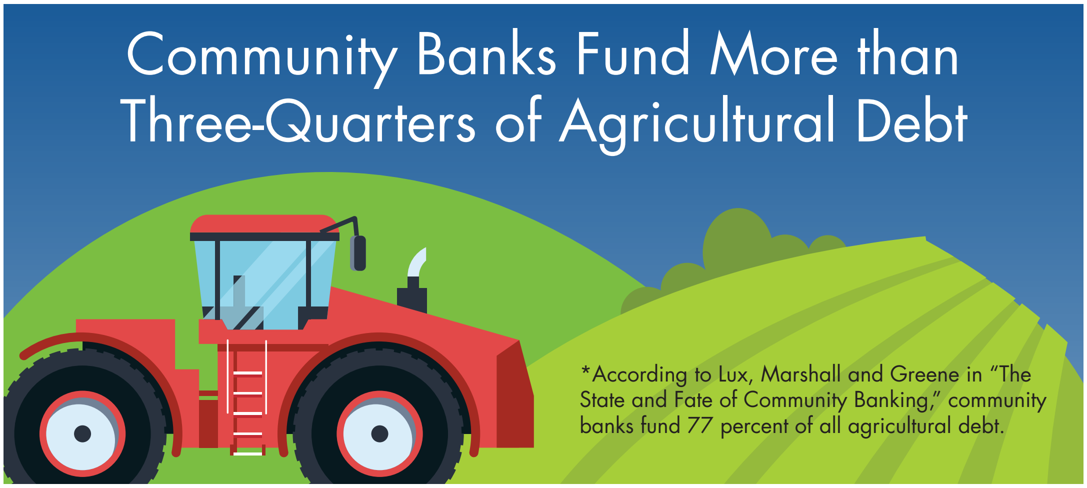
Community bank credit is a critical and frequently the only viable source of capital for small businesses, small farmers and ranchers, which typically have very limited or no access to equity capital, especially in the early stages of their development. According to a recent Federal Reserve survey, more than 70 percent of employer small firms have outstanding debt. Outside equity plays a much smaller role in small business financing. Among employer small businesses that sought financing within the last 12 months, only 10 percent sought outside equity.[11] Sixty-four percent of firms that sought financing (in the form of either debt or outside equity) did so for expansion or new opportunities. Increasing the after-tax cost of debt financing by altering the interest deduction would strand new investment opportunities and the community growth potential they carry. Small businesses that rely on debt for working capital (such as accounts receivable and inventory) — 45 percent of employer small businesses that sought financing within the last 12 months — would face a threat to their viability.

> This is how Joe Thomas of Bay Bank in Columbia, Md., describes the importance of the interest deduction in his market:
>
> *With limited available equity, our small business clients rely upon bank debt to finance new investments (facilities, machinery and software). If a proposed investment meets their threshold rate of return, the investment goes forward, and the small business will hire additional employees that will drive local personal consumption and investment. The investment also generates revenue for the vendor and the vendor's vendors. There is a multiplier effect that ripples through the local economy and helps lift prosperity in the region. But if a business cannot deduct its interest expense, it will face a significantly higher after-tax cost of capital. Many proposed investments will fail to meet businesses' threshold rate of return. Small business investment and expansion will shrink, and our local market will fail to meet its potential.*

9 Lux, Marshall, and Robert Greene. "The State and Fate of Community Banking." Mossavar-Rahmani Center for Business and Government at the Harvard Kennedy School. February 2015.

10 "2016 Small Business Credit Survey: A Report on Employer Firms." Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, St. Louis, and San Francisco.

11 Ibid.



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 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 also 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, ranchers and farm communities.

Community banks fund 77 percent of all agricultural debt.[12] 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 timing mismatch 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.

> Lynn Peterson is an agricultural banker at CorTrust Bank in South Dakota:
>
> *Over the last 25 years we have watched farming go from manual labor to highly technical, efficient and safe operations, all made possible by the availability of affordable bank debt. If farmers lose the business interest deduction, they will have very little interest in further modernizing, expanding or creating efficiencies in their operations. This will lead to the decay of the farm operation and the further decline of rural America. The interest deduction gives the farmers the incentive and confidence to invest in their businesses.*

12 Lux, Marshall, and Robert Greene. "The State and Fate of Community Banking."

Debt Financing Supports Local Ownership and Control

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 deductibility of interest on business borrowing would represent a dramatic change in longstanding U.S. tax policy, the potentially significant consequences of which are not fully known. Community bankers across the country are deeply 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.

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 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.[13] Subchapter S corporations are "pass-through entities." They are not taxed at the entity level; 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.

13 "Pass-Through Businesses: Data and Policy." Tax Foundation. January 17, 2017.

ICBA successfully made Subchapter S incorporation available to banks in 1996, to increase the number of allowable shareholders and to improve other terms. The Subchapter S model has served community banks and small businesses well but is in need of modernization to serve the next generation of businesses. Most importantly, Subchapter S banks need new options to satisfy higher demands for capital from regulators.

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. This prohibition excludes a significant source of funds that should be available to S corporation community banks to help 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-Wash.) and Ron Kind (D-Wisc.), and its Senate counterpart, S. 711, introduced by Senators John Thune (R-S.D.) and Ben Cardin (D-Md.), would among other provisions allow 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 Corporation Modernization Act of 2016, which would allow IRAs to hold shares in S corporation community banks.

Greg Deckard of State Bank Northwest in Spokane, Wash.:

New capital options for community banks like mine are critical to the prosperity of the communities we serve and help preserve the independence of community banks for future generations. The ability to tap funds held in IRAs — mine, my directors' and others' in my community — will translate into more funds to invest in my community and maintain patient, long-term capital.

Parity in the Taxation of Different Entity Forms

More than 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-Fla.), that 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. Such tax incentives would also help to create parity and strengthen competition between community banks, credit unions and Farm Credit System lenders which (as described below) are aggressively using their significant tax advantages to expand their market share in consumer, small business and farm lending.

ICBA supports the Enhancing Credit Opportunities in Rural America Act of 2017 (H.R. 2205), introduced by Rep. Lynn Jenkins (R-Kan.), which would make interest earned on loans secured by agricultural real estate 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 in a rural area with a population of 2,500 or less. ICBA believes 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.

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 of serving customers of modest means with a common bond among them. 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 more than 1,000. There are more than 250 credit unions with assets greater than $1 billion. The largest holds approximately $75 billion in assets.[14] The largest FCS lender is $91 billion and collectively the FCS holds nearly one quarter trillion-dollars in assets.[15]

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.[16] This increase in lending comes at the direct expense of taxpaying community banks. The NCUA'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 NCUA has effectively blocked commercial bank 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

14 ICBA analysis of NCUA data.

15 ICBA analysis of Farm Credit Administration data.

16 Background to NCUA Member Business Lending Rule. Federal Register. Volume 81 at page 13,530.

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 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 an 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 valuation 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 proposed regulations under Section 2704 of the tax code, which would effectively end the use of such discounts.[17] Notwithstanding the status of these proposed regulations, ICBA's preferred solution is full repeal of the estate tax. We urge Congress to use tax reform to accomplish this long held goal. ICBA thanks Ways and Means Chairman Kevin Brady (R-Texas) and Senator John Thune (R-S.D.) for their leadership in estate tax repeal.

17 "Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest." Internal Revenue Bulletin: 2016-36. September 6, 2016.

PRESERVE MORTGAGE INTEREST DEDUCTION

Community bank mortgage lending is vital to the strength and breadth of America's housing market. Community banks represent approximately 20 percent of the mortgage market, but more importantly, their mortgage lending is often concentrated in rural areas and small towns, which are not effectively served by large banks. For many rural and small-town borrowers, a community bank loan is the only option to help families buy a home.

The mortgage interest deduction puts homeownership within reach of many of the families served by community banks by creating a critical purchase incentive. Any change to the deduction would abruptly reduce home values. Homeowners with little equity may find themselves underwater, which would lead to delinquencies, defaults and foreclosures and further drive down home values and lender collateral.

Community banks would disproportionately bear the impact of collateral devaluation because they are more likely than other lenders to hold the mortgages they make in portfolio. Many residential properties in the small and rural communities served by community banks don't qualify for sale in the secondary market. They may sit on a large plot of land, be mixed-use in nature, or irregular in other ways. They frequently lie outside of city limits. These are not suburban properties and for this reason they often lack adequate comparable sales and don't fit the inflexible requirements of the secondary market. In addition, the borrowers may be farmers or small business owners whose debt-to-income ratios fall outside of secondary market parameters, despite their personal net worth and means to repay the loan. Community banks specialize in serving such borrowers, often with non-conforming loans held in portfolio.

Community banks must have stable collateral values to make the portfolio lending model work. A significant devaluation would expose many community bankers to financial distress and jeopardize the critical role they play in the housing market. For the reasons set forth above, ICBA urges Congress to preserve the mortgage interest deduction.

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 that specifically target the commercial banking sector or its 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 never be used to punish a specific industry sector. Sector-specific taxes distort the market and generate counterproductive outcomes.

CLOSING

Tax reform requires bold thinking, shrewd, calculated tradeoffs and careful analysis of the consequences. The U.S. tax code has not undergone comprehensive reform since 1986, and the tax code built in the 115th Congress, if the work is completed, may well be in place for the next 30 years or more, setting the framework for our national economic life. The stakes are high and the choices to be made are critical and long-lasting. It is imperative that the task be done with all due care and thoughtfulness.

As Congress takes up this generational challenge, ICBA urges policymakers to heed the collective wisdom of thousands of community bankers serving communities in diverse economic circumstances. Some serve flourishing communities, poised for breakout growth. Others are struggling to reach their potential, due to the lingering impact of the financial crisis or the strain of low energy or agricultural commodity prices. The tax policy recommendations outlined in this white paper reflect the consensus views of these community bankers, grounded in the real world of relationship lending and commercial analysis. These recommendations will grow local economies, promote local prosperity and unlock job creation for a generation.

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