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May 15, 2013

The Honorable Dave Camp
Chairman
Committee on Ways and Means
U.S. House of Representatives

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
U.S. House of Representatives

Dear Chairman Camp and Ranking Member Levin:

Thank you for the opportunity to comment on the Ways and Means Committee Small Business Tax Reform Discussion Draft. We appreciate your leadership on this critical issue. The Independent Community Bankers of America (ICBA) represents the nation's 7,000 taxpaying community banks which are organized in a variety of forms, including mutuals, and C and S corporations. As small businesses themselves, community banks understand the needs of small businesses and are prolific lenders to the small business community. In fact, community banks under \$10 billion in assets are responsible for approximately 60% of all small business loans between \$100,000 and \$1 million. Providing common sense reforms to the small business community will be a critical component of comprehensive tax reform and an important step to improving the economy.

A number of the provisions provided in Option One of the discussion draft would help give the approximately 2300 S corporation community banks greater flexibility in their tax planning as well as help them raise additional capital. For example, permitting non-resident aliens to be S corporation shareholders through a U.S. electing small business trust (ESBT) would give many community banks an additional source of capital. Another helpful provision permanently reduces to five years the amount of time a converted S corporation must pay the highest corporate tax rate on certain built-in-capital gains.

In addition to those listed in the discussion draft, ICBA supports a number of other important S corporation reforms, including:

- Increasing the S corporation shareholder limit to 200
- Allowing S corporations to issue preferred shares
- Allowing individual retirement accounts (IRAs) to invest in S corporations

With bank regulators consistently calling for higher capital levels, it is critical that

community banks have additional avenues to raising more capital. The shareholder limit for S corporations has been increased over time, but has remained at 100 since 2004 despite higher capital needs. Allowing S corporation community banks to raise capital from additional shareholders would not only satisfy regulatory demands for more capital, but also give community banks more capital to lend to small businesses in their communities.

Further, S corporations are barred from issuing more than one class of stock and thus cannot issue preferred stock. Allowing S corporations to issue a second class of preferred stock would provide greater flexibility to raise capital without diluting current shareholder ownership interests. It would also give many community banks an additional group of investors to attract.

Likewise, granting holders of IRAs the ability to invest in S corporations would help many community banks raise additional capital in order to satisfy regulatory demands. As you know, this idea is included in H.R. 892, the S Corp Modernization Act of 2013, introduced by Representatives Dave Reichert (R-WA) and Ron Kind (D-WI). In fact, the American Jobs Creation Act of 2004 allowed C corporation banks with shares held in an IRA to convert to S corporations. However, pursuant to this legislation, once a bank has made the conversion to an S corporation, any new investments by IRA holders are strictly prohibited. Due to this restriction, bank owners who have funds tied up in IRAs are prevented from using those funds to recapitalize their banks.

Option Two of the discussion draft seeks to repeal current law Subchapter K and Subchapter S to create a new single, unified pass-through structure. As the discussion draft correctly notes, often times, two similar transactions may receive vastly different tax treatments due to the form of business elected by the business owner. This option recognizes access to the capital markets as the distinguishing characteristic between pass-through and C corporation tax treatment. Option Two represents a significant change to current tax law for the small business community and we look forward to additional study and analysis.

Principles for Tax Reform

As an association representing a mix of S and C corporations, we believe it is critical to reform both the corporate and individual tax codes together and to keep the tax rates at similar, low levels. Reform of the corporate code alone would create an even larger gap between the corporate and individual rates. In addition, by reducing or eliminating business deductions, corporate-only reform could dramatically increase the effective tax rate paid by pass-through corporation owners on their individual tax returns, including shareholders in the 2300 Subchapter S banks and their small business customers. ICBA and other small business trade groups commissioned an Ernst & Young study on the macroeconomic impact of increasing tax rates on high-income taxpayers.¹ The study

¹ “Long-run macroeconomic impact of increasing tax rates on high-income taxpayers in 2013.” Drs. Robert Carroll and Gerald Prante. An Ernst & Young LLP report prepared on behalf of the Independent Community Bankers of America, the National Federation of Independent Business, the S Corporation

found that higher tax rates on high income individuals, including shareholders in pass through corporations, will result in the long run in a smaller economy, fewer jobs, less investment and lower wages.

In addition, ICBA would strongly oppose any curtailment of the ability of businesses to deduct interest. Many small businesses prefer debt financing and do not have access to equity markets. ICBA also believes tax reform should work to increase private savings and investment. The current tax code discourages or even punishes savings and investment with double or even triple taxation. A superior tax system would promote savings not punish it.

Finally, any serious tax reform effort should consider the credit union industry's controversial tax exemption. Credit unions are becoming harder and harder to distinguish from the taxpaying banks with which they directly compete. Their efforts to raise the statutory cap on credit union commercial lending would further blur that distinction though, according to a recent analysis by Ike Brannon of the Capital Policy Analytics Group, the credit union industry's claims of economic growth and job creation that would result from this policy change are highly questionable.²

Most importantly, the credit union tax exemption comes at a significant cost to taxpayers. The most comprehensive estimate to date, done by the independent Tax Foundation, valued the tax subsidy at \$31.3 billion over 10 years³. The Debt Reduction Task Force of the Bipartisan Policy Center, chaired by former Senator Pete Domenici and former OMB Director Alice Rivlin, recommended eliminating the tax exemption for credit unions. The Joint Committee on Taxation, the Office of Management and Budget, and the Congressional Budget Office (CBO) have all identified the credit union subsidy as a growing tax expenditure.

Again, thank you for the opportunity to comment on the discussion draft. We appreciate your leadership and thoughtful approach to tax reform.

Sincerely,

/s/

Camden R. Fine
President & CEO

CC: Members of the U.S. House Ways & Means Committee

Association, and the United States Chamber of Commerce. July 2012. Available at <http://www.icba.org/files/ICBASites/PDFs/taxstudy.pdf>

² "An Analysis of the Impact of Expanding the Ability of Credit Unions to Increase Commercial Loans." Ike Brannon, Capital Policy Analytics. November 2012.

URL: <http://www.icba.org/files/ICBASites/PDFs/MBLAnalysis.pdf>

³ "Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions." Tax Foundation. February 28, 2005. URL: <http://taxfoundation.org/article/competitive-advantage-study-federal-tax-exemption-credit-unions>