TAX REFORM: WHAT'S AT STAKE FOR COMMUNITY BANKS AND WHAT TO EXPECT IN THE WEEKS AHEAD

ICBA and community banks across the country are closely following congressional action on tax reform. This is a generational opportunity to improve the U.S. tax code to promote growth, provide tax relief and more equitable taxation of the financial services industry, and strengthen middle income families. ICBA is deeply engaged in this process.

The outline below provides community bankers with the latest on: where the bills are in the process; what provisions of tax reform ICBA is tracking; and what ICBA is doing to advance and protect the interests of community banks. For the sake of brevity, ICBA has chosen to limit this list to the tax provisions that are of direct importance to community banks.

STATE OF PLAY

The House passed the Tax Cuts and Jobs Act (H.R. 1) on Nov. 16, the same day the Senate Finance Committee passed its version of the bill. We expect changes to be made to the bill as Senate leadership tries to shore up the 51 votes needed for passage. Controversial aspects of the bill include: its impact on the budget deficit; repeal of the deduction for state and local taxes; repeal of the Obamacare individual mandate; and, significantly for Subchapter S community banks, the taxation of pass-through income (see below). A revised bill could be considered on the Senate floor as soon as the week following Thanksgiving.

The entire process is moving very quickly, with a goal of enacting a bill before Christmas. The bill could still change dramatically between now and the time it is enacted, and individual provisions could look much different.

CRITICAL COMMUNITY BANK PROVISIONS

There are numerous provisions in the House and Senate bills that will have a significant impact on community banks.

ICBA is aggressively voicing our concerns with all members of Congress, especially those who serve on the tax writing committees and in leadership. We are grateful to the thousands of community bankers who have joined in our grassroots efforts.

Click here for a copy of the letter we sent to the Ways and Means Committee following the release of H.R. 1. Below are the principal provisions we are tracking.

CORPORATE RATE

Both the House and the Senate bills would set the corporate rate at 20 percent (down from 35 percent). The House bill would make this change effective immediately, and the Senate bill would delay it for one year to reduce its cost to the government.

ICBA strongly supports a 20 percent rate for all C corporation community banks.

PASS-THROUGH RATE

Both the House and the Senate bills try to reduce the taxation of business income earned by pass-through entities, including S-corporations, partnerships, and sole proprietorships.

The House bill would create a new 25 percent maximum rate for pass-through income. Passive shareholders (who are not active in the business, including directors) would be able to apply this rate to their full share of the business's net income. However, as the bill stands now, active shareholders would be able to apply this rate to no more than 30 percent of their share of the business's income. The remaining 70 percent would be taxed as ordinary income at a maximum rate of 39.6 percent.

The Senate bill would take a different approach. Instead of creating a special rate for pass-through income, the Senate bill would allow shareholders to deduct 17.4 percent of their business income. The bill would tax this income at a maximum rate of 38.5 percent. The bill would also limit this deduction to 50 percent of w-2 compensation paid by the business. The limitation would not affect joint filers with taxable income of less than $500,000 or individual filers with taxable income of less than $250,000. The17.4 percent deduction would sunset at year-end 2025.

ICBA believes this is unfavorable tax treatment of S-corporation community banks and is working to create tax relief equivalent to that provided to C-corporation banks.

ICBA's grassroots campaign on this issue has generated more than 3,500 contacts.

BUSINESS INTEREST DEDUCTION

In the House bill, businesses with gross income of $25 million or less would continue to deduct their interest expense in full. Businesses above this threshold would be limited to deducting net interest expense of no more than 30 percent of "adjusted taxable income" or earnings before interest, depreciation, and amortization (EBIDA). Banks would not be affected because the limitation applies only to net interest expense.

In the Senate bill, businesses with gross income of $15 million or less would face no restriction on their ability to deduct net interest expense. Businesses above this threshold would be limited to deducting net interest expense of no more than 30 percent of earnings before interest and tax (EBIT), a less favorable formula than that offered in the House bill. The Senate bill also provides that any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is exempt from any limitation on interest deduction. In addition, a "farming business" may elect not to be subject to the above limitation on deducting interest.

For the past 18 months or more, ICBA has campaigned to protect the business interest deduction. It was the primary focus of our August tax reform white paper. While we are pleased that the House and Senate bills have attempted to create a carve-out for small businesses and for businesses with relatively low interest expense, we continue to work to improve these exemptions.

TAX DEDUCTION FOR FDIC PREMIUMS

Both the House and Senate bills would phase out this deduction for banks between $10 billion and $50 billion. No deduction would be available for banks over $50 billion.

ICBA is strongly objecting to this provision. FDIC premiums are clearly a business expense as is any other form of insurance premium.

ESTATE TAX

The House bill would double the estate tax exemption to approximately $11 million for individuals and $22 million for couples and fully repeal the tax after six years.

The Senate bill would double the estate tax exemption but would not repeal the tax. The higher exemption level would expire at year-end 2025.

ICBA supports full repeal of the estate tax.

NON-QUALIFIED DEFERRED COMPENSATION

Non-qualified deferred compensation (NQDC) plans are widely used by community banks to supplement the pension income of key employees. The House and Senate bills originally included a provision that would effectively end deferred compensation by taxing it as soon as it is vested. This provision was removed from both bills. ICBA continues to advocate for the preservation of NQDC.

CREDIT UNION AND FARM CREDIT SYSTEM TAX SUBSIDIES

ICBA is disappointed that neither the House nor the Senate bill eliminates or curtails the generous taxpayer subsidies given to credit unions and Farm Credit System lenders. Many of today's credit unions and FCS lenders are multi-billion-dollar entities that compete against much smaller taxpaying community banks. Credit unions are the equivalent of banks and should be taxed equivalently. FCS lenders seek unconstrained lending authorities to siphon away community banks' best consumer and commercial customers in any market. ICBA urges Congress not to miss this opportunity to repeal or modify these egregious tax subsidies.

PRESERVE THE NEW MARKETS TAX CREDIT

The House bill would terminate the new markets tax credit (NMTC). NMTC is a critical tool for ensuring that economic growth reaches low-income urban and rural communities. ICBA is urging Congress to restore this important tax credit.

OTHER PROVISIONS

The House and Senate bills contain numerous other provisions related to the taxation of individuals and families. ICBA encourages all community banks to bring to our attention other provisions of interest or concern.

Please contact Alan Keller (alan.keller@icba.org) or John Hand (john.hand@icba.org) if you have any questions. ICBA will keep you updated as the tax reform process unfolds.