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Communities First Act: A Banking and Taxation Measure

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Summary

This report provides an overview of a proposal to provide small-bank regulatory and tax relief via legislation, H.R. 1869/S. 1405, 110th Congress. The measure's official title is specified as either the "Community Banks Serving Their Communities First Act," or the "Communities First Act." Representative Velazquez introduced the legislation on April 17, 2007; the bill was referred jointly to the House Financial Services Committee, the House Ways and Means Committee, and the House Small Business Committee. Senators Brownback, Coburn, and Roberts introduced companion legislation on May 16, 2007; it was referred to the Committee on Finance. Proponents indicate that they have developed the bill to give regulatory and tax relief to community banks. Going further, the proposed act provides a number of non-bank tax benefits. This report presents its major provisions in legislative issue context. It will be updated as events warrant.

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Introduction

Seeking to enhance the ability of community banks to foster economic growth and serve their communities, boost small businesses, increase individual savings, and for other purposes, Representative Velazquez and Senators Brownback, Coburn, and Roberts have introduced a two-part measure, H.R. 1869/S. 1405. The first part addresses the regulatory burdens of small banks, although some changes would benefit lenders of all sizes. The second part addresses the tax comparability of small banks with other small businesses and their tax-exempt competitors, the credit unions. A third part pertains to subchapter S corporations. It additionally provides tax benefits for individuals subject to the alternative minimum tax (AMT), small business investment, young savers, savers owning certificates of deposit, bankers in rural and distressed areas, and certain farms and industrial businesses via the treatment of their debts. This report provides description and analysis of the issues it addresses.

Regulatory Provisions

The Communities First Act is an asset-based banking measure, affording regulatory relief to smaller banks. A small bank is defined as having assets less than $1 billion, to be adjusted annually by the growth rate of total assets of all federally insured depository institutions. Key provisions include

- allowing qualified banks to file a shorter version of the quarterly call reports twice per year (non-consecutive quarters);
- providing an exemption from Section 404 of the Sarbanes-Oxley Act, which requires documentation and auditing of internal controls over financial reporting;
- increasing the debt-to-income ratio allowable for a small bank holding company to pay a corporate dividend and still remain eligible for expedited processing processing from 1:1 to 3:1;
- requiring a community bank impact analysis when a federal banking agency revises or issues regulations of insured depository institutions and;
- establishing a seasoned customer CTR exemption, which would exempt depository institutions from reporting currency transactions for qualified customers.

In addition, the bill would give banks that do not share customer information the option of sending privacy notices to customers only when the bank's privacy policy changes, instead of annually as the Gramm-Leach-Bliley Act requires.[1] The bill would direct regulators to give more leeway for bank borrowers to waive their three-day right of rescission so they might use their loan funds more quickly.

Its benefits above are targeted at banking companies forming the membership base of two trade associations: the Independent Community Bankers of America and America's Community Bankers. These groups believe that banks above the smallest sizes, ranging up to perhaps as much

[1] See CRS Report RS20185, *Privacy Protection for Customer Financial Information*, by M. Maureen Murphy.

as $5 billion in assets, have become disadvantaged by many regulations and taxes. In their view, the smallest institutions and their competitors such as credit unions are exempt from many of these burdens, while the largest financial players can comply at lower costs because of efficiencies of scale from larger operational and income bases. They state that they are currently caught in the middle, so that a merger with a larger institution[2] might be the only alternative to withering away under "regulatory and tax burdens."

Regulators seemingly could provide many regulatory relief elements addressed by this measure by using their existing authority for paperwork reduction and similar streamlining. The Regulatory Flexibility Act of 1980 and subsequent laws require all federal regulatory agencies to consider the economic impact of their rules on small entities.[3] In particular, the Economic Growth and Regulatory Paperwork Reduction Act of 1996 requires that federal financial regulatory agencies identify outdated, unnecessary, or unduly burdensome statutory or regulatory requirements. The agencies must then eliminate unnecessary regulations to the appropriate extent. The regulator of many community banks, the Federal Deposit Insurance Corporation (FDIC), has been coordinating this effort.[4] Thus, some proposals in this measure might not require legislative authorization, since the growth of the financial economy, with the emergence of trillion-dollar banking companies, has led many observers to characterize banks of up to $1 billion in assets be considered as "small" in industry context.[5] As an example of regulatory rather than legislative change under way, the federal banking regulators granted these "intermediate small banks" some Community Reinvestment Act compliance relief in 2005.[6] Proponents of this measure, and even more comprehensive statutory regulatory relief for financial businesses, however, believe that legislation is a better mechanism to gain the changes they desire.

Tax Provisions

The Communities First Act is also a fiscal measure, as the bill contains a series of tax provisions. Some of these provisions are generally applicable to a broad range of taxpayers, some are focused on community banks, and others apply to subchapter S corporations. All of them seemingly would require statutory changes to the Internal Revenue Code of 1986.

Its generally applicable provisions are more significant, in potential cost, than its focused provisions. Perhaps the most important, at least from a revenue cost perspective, is the repeal of the alternative minimum tax for individuals, which has been estimated to cost $842 billion over FY2008-FY2017.[7] A second general provision would permanently extend current Section 179 expensing for small businesses. Another provision would allow the deferral of tax on interest earned on certificates of deposit (CDs) held by individuals until the CD matures, and lowering the top rate of tax on such interest to the capital gains tax rate (currently 15%). Basically this

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[2] See CRS Report RL30516, *Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects*, by Walter W. Eubanks.

[3] See CRS Report RL32356, *Federal Regulatory Reform: An Overview*, by Curtis W. Copeland.

[4] See FDIC statement at http://www.egrpra.gov/WhatWeDoing.html.

[5] See FDIC testimony at http://www.fdic.gov/news/news/speeches/archives/2005/others/spjun2105.html.

[6] The text of this joint ruling, published in the *Federal Register*, is available at http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050719/attachment.pdf.

[7] Joint Committe on Taxation, *Present Law and Background Related to the Individual Alternative Minimum Tax,* March 5, 2007. See, CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

provision applies to CDs with a maturity of a year or more. The fourth general provision permits Roth IRA accounts for children under the age of 25. A fifth provision would allow interest on agricultural loans, and home loans in rural areas (defined by the Secretary of Agriculture) with population of less than 2,500 to be excluded from income. The bill also includes an increase in the cap for certain small issue private activity bonds from $10 million to $30 million, where there is a limited amount of associated capital expenditures.[8] Finally, the bill allows certain banks and similar financial institutions to elect to be taxed as partnerships rather than corporations, a treatment that is generally beneficial because partnerships pay only the individual level tax, while corporations pay a corporate tax and their shareholders then pay taxes on dividends and capital gains at the individual level.

The measure contains provisions more narrowly focused on community banks and holding companies. For banks with assets of $5 billion or less, the bill would allow a credit for 20% of tax liability for corporations (up to $250,000) and an exclusion of 20% of income for subchapter S (small corporations that elect to be taxed as partnerships), up to $1,250,000. It would increase these percentages to 50% and double the ceilings for qualified banks in distressed areas. Banks with less than $5 billion in assets would not have to pay alternative minimum tax.

The measure also contains provisions focused on subchapter S corporations. It would increase the S Corporation shareholder limit from 100 to 150 and change the treatment of bad debt reserves for S Corporations that convert from C Corporations. The measure would also allow S Corporation banks to issue preferred class stock and exclude the bank's qualifying directors' shares from counting toward their shareholder limit.

While the Independent Community Bankers of America has said that it supports this bill which, they believe, would provide regulatory relief for community banks and tax reform to small businesses, individuals, and community banks, the scope of some of the bill's tax provisions is, however, quite broad, and extends beyond reducing the taxes of these banks.[9] The repeal of the individual alternative minimum tax and the interest provision could be particularly costly. As mentioned above, repealing the AMT is estimated to cost $842 billion over FY2008-FY2017. In addition, the interest provision would provide a powerful incentive to shift interest-earning assets into CDs eligible for preferential taxation. In 2003, $127 billion of interest was reported on tax returns. In addition, some receipts reported as dividends reflect interest earned through mutual funds. The revenue loss resulting from a large shift of this interest into eligible CDs could be in the billions of dollars.

Under the proposal, the tax on many types of investments financed by debt would become negative (i.e., a subsidy rather than a tax.) For example, on agricultural loans, the farmer could deduct the interest, which offsets any tax on the return this filer pays, leading to a zero effective tax rate at the individual farmer level. The deduction of interest is entirely appropriate in an income tax system. However, the tax is probably already negative at the farmer level because it is nominal interest that is deductible (that is, debt finance is somewhat subsidized due to inflation) and because the owner has deducted some investment on a farm when incurred. (Overall, the firm level tax on debt financed investment tends to be negative during inflationary periods, and it is more negative for those businesses with significant tax benefits.) In addition, however, the bank

[8] These are bonds that finance private development, as opposed to bonds for government purposes such as schools. See CRS Report RL31457, *Private Activity Bonds: An Introduction*, by Steven Maguire.

[9] "Bank Group Applauds Senate Bill To Ease Community Bank Burdens", *Daily Tax Report*, May 17, 2007, p. G-9.

could exclude the interest received, but deduct any interest paid to depositors in the bank. Thus, at the bank level (ignoring any yield spread) there is a subsidy (negative tax) provided at the current tax rate. Allowing the bank to deduct interest payments is appropriate, but only if the interest received is taxable. Finally, the one level at which some tax might be collected is at the individual level, but here, the tax is deferred and the rate reduced.

The provisions with cliffs (a benefit allowed only for firms under a certain size) could create powerful disincentives for growth around the cliff. The measure phases out most tax benefits aimed at small businesses as their size becomes larger.

Outlook

Additional proponents of tax provisions may include certain communities, farmers, manufacturers, investment bankers offering municipal bonds, and recipients and issuers of deposit interest on CDs. Additional supporters of banking relief proposals are likely to include federal and, especially, state supervisors of banks smaller than the cliff sizes of the measure, plus industry trade associations whose membership includes banks of all sizes and "holding companies" owning them. Opponents may include credit unions, which are not pleased with this measure because banks would get tax benefits while continuing to attack tax benefits of credit unions.

The Department of the Treasury may object to the measure's bank-related tax breaks, since it has often opposed many tax relief proposals for bankers and their customers. The measure would alter the tax climate for economic sectors beyond banking, and could thus face additional objections from those not benefitted and those—including the Treasury—concerned over nonbank-related revenue losses.

Similar legislation was introduced in the 109th Congress and hearings were held by the House Financial Institutions Subcommittee on May 19 and June 9, 2005, and by the Senate Banking Committee on June 21, 2005, that explored banking regulatory relief.

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