

Community Bank Tax Relief & Simplification Options

A Study Prepared for the
Independent Community Bankers of America
by Grant Thornton LLP

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Grant Thornton 

PREFACE

The Independent Community Bankers of America (ICBA) contracted with Grant Thornton LLP to prepare this report. The ICBA is the only national trade association that exclusively represents the interests of the nation's community banks.

Grant Thornton is the leading global accounting, tax, and business advisory firm dedicated to serving the needs of middle-market companies. The financial services industry, particularly community banks, is a strategic focus of Grant Thornton.

John R. Ziegelbauer, Director of the National Financial Institutions Tax Practice, managed the project and is the principal author of this report. Linda A. Garvelink, Director of Marketing-National Financial Services, edited and published this document with assistance from Dawn Dillon, Senior Associate. Thomas P. Ochenschlager and Rick Wagner participated significantly in the study's preparation.

Thanks also to Kristy Rugg, Senior Marketing Associate, for creating the on-line version of this report that appears on the Independent Community Bankers of America Web site at www.icba.org.

The ICBA staff and bankers of the ICBA Tax Committee and Tax Study Working Group provided significant input into the design and content of the report and were involved throughout the report's preparation. We appreciate the cooperation and courtesies extended to Grant Thornton by the ICBA and their members that participated in the Tax Study Working Group.

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ICBA's COMMUNITY BANK TAX RELIEF AND SIMPLIFICATION OPTIONS

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EXECUTIVE SUMMARY

ICBA Foreword

As our nation debates policy options to foster economic growth, and to enhance saving, investing, and job opportunities, the Independent Community Bankers of America is proud to release its new report on tax relief and simplification options. This study reflects a year-long research effort by the community banking sector to identify the policy options that ICBA believes, if enacted, would boost economic growth by enhancing the viability of community-based financial institutions, small businesses, and improve the ability for *all* Americans to better save and invest. The ICBA will promote these recommendations to foster a more simple and unbiased tax code that will preserve the viability of community-based banks and the vital role they play in the U.S. economy as a critical source of lending for consumers, small businesses and farms.

For generations, independent banking institutions have played a special role in American communities and in thousands of neighborhoods. The bulk of our nation's commercial banks are community banks. Community-based banks remain the underpinning for millions of consumers, family owned businesses, local merchants, small manufacturers and family farms who depend on available local bank lending, rather than the equity markets, for their credit needs. These are the banks that know their customers by name and help finance a community's growth, prosperity, and jobs. Community banks serve as the key source of credit and other financial services to small business – the most prolific job-creating sector of our economy.

Many people experience firsthand the significant role community banks play in the economy on both the local and national level. Unfortunately, over time, federal laws passed without considering the full impact on Main Street have resulted in significant hurdles for community banks and hinder their ability to best serve the needs of their communities. Burdensome regulations and distorted and unfair tax policies continue to jeopardize the viability of community-based banks and the consumers and small businesses they serve.

As the nation's leading voice for community banks, the ICBA has worked with its members nationwide to identify those aspects of the tax code that are unduly burdensome and hurt the long-term economic vitality and financial well-being of the community bank and their customers. Our recommendations are designed to preserve and enhance the financial vigor and diversity in our economy and to promote healthy competition, consumer choice, and economic prosperity. For example, one recommendation is to simplify the multitude of tax-advantaged savings options created in the tax code into one simple and straightforward Universal FREEDOM saving account. Rather than dealing with multiple accounts with multiple rules and regulations, this one universal deposit account can be used for retirement needs, education savings, medical savings, first-time home purchase, or economic hardship.

ICBA's COMMUNITY BANK TAX RELIEF AND SIMPLIFICATION OPTIONS

Enacting these recommendations will help to preserve community banking as an important option for financial services for millions of consumers and small businesses throughout America. This study offers a menu of fresh policy options and straightforward financial products to help Americans best save and invest in a manner that will protect and grow their hard-earned income.

We trust this report will serve as a key aid in the critical tax relief and economic growth policy debate. ICBA looks forward to working with the Administration, Congress, and the financial regulatory agencies in adopting these recommendations.

Respectfully,

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Report Overview

This comprehensive document contains recommendations that, if enacted or adopted, the ICBA believes would improve the viability of community banking and thereby benefit the nation's small businesses and its economy.

Despite the consolidation trend, community banks remain an essential component of this country's financial structure. They are the principal source of credit for the small businesses that are vital to the growth of our economy. Community banks are the financial backbone of hometown America and an essential part of this nation's economy. Community banks serve millions of consumers nationwide with a degree of personal service that is not available from the huge financial conglomerates that dominate our financial services world.

To prepare this report, the ICBA retained Grant Thornton LLP, a leading global accounting firm that specializes in serving community banks, to assist in its efforts to determine the effect of the current tax code on community banks.

The report is divided into two parts, each describing a group of tax relief and simplification topics. Part One contains tax relief and simplification options related to individual investment and savings. Part Two contains tax relief and simplification options of particular interest to community banks and small businesses. Each chapter contains an overview of the existing law, its effect on community banks, the recommended relief, and the projected benefits of the relief. The following is a synopsis of the recommendations contained in each chapter.

PART ONE: INDIVIDUAL INVESTMENT AND SAVINGS TAX RELIEF AND SIMPLIFICATION OPTIONS

Chapter One: Universal FREEDOM Savings Accounts

The establishment of Universal FREEDOM accounts is intended to provide all Americans with the opportunity to establish tax-preferred after-tax savings accounts to help them save for a variety of purposes:

- **F**irst-time home purchase
- **R**etirement costs
- **E**ducation costs
- **E**conomic hardship related to unemployment or other loss of income
- **D**onations to charitable organizations
- **O**ccupation change related expenses
- **M**edical costs

With the Universal FREEDOM account, much of the confusion and guesswork associated with the use of tax-preferred savings vehicles will be alleviated. Individuals will be able to put up to \$15,000 a year in a Universal FREEDOM account and know with certainty that all of the earnings associated with the account will be available for many of their savings objectives.

Chapter Two: Enhance Current Retirement and Education Provisions

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) significantly expanded the amounts that Americans can save for retirement. All savings incentives included

ICBA's COMMUNITY BANK TAX RELIEF AND SIMPLIFICATION OPTIONS

in the EGTRRA are currently scheduled to expire for tax years after December 31, 2010. The following options were included to enhance current retirement and education provisions:

- Make the education and retirement savings provisions of EGTRRA permanent
- Accelerate the availability of Roth § 401(k) plans, and accelerate the contribution increases and catch-up contributions included in EGTRRA for IRAs and § 401(k) plans
- Eliminate income limitations applicable to IRAs, Roth IRA, and Coverdell Education Savings Accounts
- Increase the annual contribution limits for IRAs and Roth IRAs to match § 401(k) type plan contribution limits
- Increase the contribution limitation on Coverdell Education Savings Accounts to match the limits used for IRC § 529 plans

Chapter Three: Lower Tax Rate on Long-Term Deposits

Interest is generally taxed at ordinary income tax rates, and taxed whether received or not. Deferring recognition of interest income on long-term deposits (term of 12 months or more), combined with the use of the long-term capital gains rate to tax that interest income, will increase the savings rates of depositors and enable community banks to make more community investments. Most importantly, however, the provision directly rewards consumers for using savings vehicles that provide investment capital for their local communities.

Chapter Four: Personal Interest and Dividend Income Exclusion

Under current law, individuals must generally include all of the interest and dividend income they receive in their taxable income. Excluding the first \$600 (\$1,200 for joint filers) of interest and/or dividend income from taxable income would directly reward consumers for saving.

Chapter Five: Treat Interest Income and Dividends as Capital Gains

Under current law, individuals must generally include in taxable income all of the interest and dividend income they receive. Interest income and dividend income are treated as ordinary income and taxed at the individual's highest marginal tax rate. In contrast, capital gain income related to assets held more than 12 months (e.g., gain recognized upon the sale of stock) is generally taxed at a top rate of 20 percent. Treating interest income and dividends as net capital gains subject to the long-term capital gains rate of 20 percent will improve the growth prospects for the economy by enhancing the rate of return on various forms of savings and investment. Maintaining parity in the tax rates applied to interest and dividend income is important to the ability of community banks to obtain funds on a competitive basis and provide lending in their communities.

PART TWO:

SMALL BUSINESS TAX RELIEF AND SIMPLIFICATION OPTIONS

Chapter Six: S Corporation Reform

S Corporation status allows closely-held community banks to eliminate double taxation of corporate income, making them more competitive. By ending the payment of taxes on both corporate income and the shareholders' income from the corporation, community banks increase the amount of resources available for community loans and other community investments.

Before making the S Corporation election, banks must meet a number of criteria specified by the law, while attempting to avoid disrupting their operations or disenfranchising shareholders. The following proposed S Corporation reforms offer several options for easing the current requirements and would allow more community banks to take advantage of the tax benefits provided by S Corporation status.

- Increase Maximum Number of S Corporation Shareholders to 150
- Allow IRAs and Partnerships to Own S Corporation Stock
- Exempt Certain Sales of Stock by an IRA to the Owner of the IRA from Prohibited Transaction Treatment
- Allow S Corporations to Issue Certain Preferred Stock
- Change Treatment of Director Qualifying Stock for Purposes of the S Corporation and Qsub Elections
- Exempt Bank Income from Passive Investment Income Tax

Chapter Seven: Repeal Estate Tax and Increase FMV Basis Allowance

Family ownership is an integral part of community banking, and the repeal of the estate tax is important to the continued viability of family-owned community banks. In connection with the repeal of the estate tax, relaxing the limits applied to fair market value basis at date-of-death would significantly reduce the administrative difficulty associated with determining the cost basis of each asset included in an estate.

Chapter Eight: Make Five-Year Net Operating Loss Carryback Permanent

Community banks stand behind their customers and communities in both good times and bad. Increasing the NOL carryback period to five years will help banks that experience significant losses to survive an economic downturn by allowing them to receive refunds of taxes paid in previous years.

Chapter Nine: Expand IRC § 179 Expensing and Accelerate Depreciation

Community banks regularly have to dispose of obsolete computer systems and equipment and replace them with more advanced technology. The five-year depreciation period established for computers in the tax code does not accurately match the serviceable life of the equipment.

- Increase the amount deductible under IRC § 179 from \$25,000 to \$75,000 per year, make computer software eligible for IRC § 179, and index provisions to inflation.
- Make 30 percent bonus depreciation provisions permanent.
- Change computer equipment from 5-year MACRS property to 3-year MACRS property

Chapter Ten: Repeal Alternative Minimum Tax for Community Banks

Exempting community banks with average annual assets of less than \$500 million from the AMT would enhance their viability by eliminating the need to maintain a costly set of additional records.

Chapter Eleven: National Limited Liability Company Bank Charter

The formation of a national limited liability company (LLC) bank charter would help a number of community banks compete more effectively and remain independent. The LLC charter would allow certain closely held community banks to eliminate double taxation of corporate income, making them more competitive in the marketplace.

Chapter Twelve: Exclude 50 Percent of Interest on New SBA Loans

Excluding 50 percent of the interest on SBA loans will encourage increased use of this important source of funding for small businesses. Community banks play a critical role in providing small business lending nationwide; they provide the ideal delivery system to facilitate SBA lending in communities throughout America. This provision strengthens the much-needed small business resources important to our economy.

Chapter Thirteen: Expand New Markets Tax Credit

The untapped economic potential of the markets in the inner cities and rural areas is significant. Expansion of the NMTC program from \$12.5 billion to \$75 billion in new investments for 2003-2007 is one way to attract the capital needed to spur investment and to help investors discover business opportunities in these markets.

Chapter Fourteen: Establish Farm and Ranch Risk Management Accounts

The establishment of Farm and Ranch Risk Management (FARRM) accounts will allow farmers and ranchers to more efficiently weather the economic storms that they face in connection with their business. FARRM accounts with a matching contribution from the government will provide an incentive for farmers and ranchers to save their earnings from good years so that they can be used during down years.

Chapter Fifteen: Increase Muni-Bond Bank Qualified Obligation Limits

Current law requires banks to reduce their allowable deductions for interest expense allocable to tax-exempt obligations. TRA '86 created a special exception to the 100 percent disallowance rule, providing for 20-percent-disallowance treatment of certain qualified tax-exempt obligations (QTEOs). Among other requirements, a tax-exempt obligation is qualified only if the issuer reasonably anticipates that it will not issue more than \$10 million of tax-exempt obligations during a calendar year.

Increasing the annual issuance limitation to \$30 million from the current \$10 million limitation would allow more community organizations to issue "qualified" tax-exempt obligations and would further stimulate community bank investment in local tax-exempt obligations by increasing after-tax yields.

Chapter Sixteen: Simplify Accrual of Interest on Non-Performing Loans

Differences in accounting methods on non-performing loans for tax and regulatory purposes are confusing to community banks and result in costly efforts at compliance, diverting funds from business applications to administrative expenses. Consistent accounting treatment by the IRS and the federal banking regulators of interest income generated on non-performing loans will help community banks better direct resources to the communities they are chartered to serve.

PART ONE: Individual Investment and Savings Tax Relief and Simplification Options

CHAPTER ONE

Universal FREEDOM Savings Accounts

Americans are concerned about saving money to achieve various life goals. How to save adequately for retirement, for a child's education, for a first home, or for a nest egg to combat physical and economic hardships is of chief concern to many individuals.

The recent roller coaster ride taken by investors in the stock market has left many individuals unsure how to accomplish their various savings objectives. Concerns about inflation have waned in recent years, only to be replaced with concerns that savings may erode over time as a result of stock market fluctuations.

To achieve their savings objectives, individuals have a myriad of savings vehicles available to them. Some of these savings vehicles receive federal tax-preferred treatment; others do not.

Tax-preferred savings vehicles usually come in the form of either pre-tax basis accounts (e.g., IRC § 401(k) type plans) or after-tax basis accounts (e.g., Roth IRAs¹ or IRC § 529 Qualified State Tuition Programs² ("§ 529 Plans")). Earnings on tax-preferred accounts generally grow on a tax-deferred basis. Contributions made on an after-tax basis are not taxed again upon distribution, whereas contributions made on a pre-tax basis are generally taxed upon distribution.

Tax-preferred savings vehicles created by Congress generally fit in one of four categories:

1. Pre-tax/tax-exempt accounts,
2. After-tax/tax-exempt accounts,
3. Pre-tax/tax-deferred accounts, or
4. After-tax/tax-deferred accounts.³

¹ The Roth IRA allows for annual nondeductible contributions of up to \$2,000 (\$4,000 if a joint return is filed) or 100 percent of compensation for the year, whichever is lower. The earnings generated in a Roth IRA are not taxed to taxpayers if distributed in a "qualified distribution". Qualified distributions are *never* subjected to federal income taxes. Distributions from a Roth IRA are "qualified" if the Roth IRA has been in existence for at least five years *and* the distributions are made under one of the following conditions:

- After the account holder has reached age 59½;
- After the account holder has died or became disabled; or
- In order to pay certain expenses in connection with a first time home purchase by the Roth IRA owner, his/her spouse, or any child, grandchild, or ancestor of the owner or spouse (\$10,000 lifetime limit).

² Each individual state can establish an IRC § 529 plan. An IRC § 529 plan is a qualified state tuition program that allows individuals to contribute to an education savings plan on an after-tax basis on behalf of designated beneficiaries. Individuals contributing are not subject to any income limitations and the contribution limits are extremely high compared to other tax-preferred savings vehicles.

³ *Pre-tax/tax-exempt accounts* - include savings vehicles such as Archer medical savings accounts. These savings vehicles generally allow taxpayers to exclude a portion of their ordinary income from taxation during the year the contribution to the savings vehicle is made. The earnings in these accounts are allowed to grow on a tax-deferred

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The most advantageous of these four categories would generally be the pre-tax accounts that are tax-exempt. An individual receives an exclusion from income up front at the time of contribution to the account, and earnings and original contribution are never subject to taxation.

The least favorable of these four types would normally be the after-tax, tax-deferred account. Individuals receive a tax deferral on earnings, but the magnitude of that benefit depends on amount of earnings deferred and the tax rate in effect at date of distribution.

The after-tax/tax-exempt and the pre-tax/tax-deferred accounts can have very similar results, depending on key variables such as the individual's tax rate at date of contribution and then at date of distribution. A higher tax rate in effect at the date of contribution generally would favor the pre-tax/tax-deferred accounts. A higher tax rate at distribution date generally would favor the after-tax/tax-exempt accounts. Taxpayers should be indifferent to the account type if their marginal tax rates at contribution and distribution are equal.

Current Law

Traditional savings accounts, certificates of deposit (CDs) and investments in debt securities do not generally receive tax-favored treatment. Interest income on these investments is treated as ordinary income and is generally taxed as the income accrues. Investments in equity securities and other capital assets can receive tax-favored treatment upon disposition (a lower capital gains tax rate), if held for more than twelve months.

The Individual Retirement Account (IRA) and § 401(k) type plans are very popular pre-tax/tax-deferred retirement savings vehicles. The annual contribution limits for 2003 for an IRA is \$3,000, and \$12,000 for § 401(k) type plans for taxpayers under 50.

basis. The earnings and the original contributions are not subject to taxation provided they are used for their qualified purpose.

After-tax/tax-exempt accounts - include savings vehicles such as the Roth IRA, Coverdell Education IRAs, and § 529 plans. These savings vehicles generally allow taxpayers to contribute after-tax savings to a savings vehicle that allows earnings to grow on a tax-deferred basis. The earnings in these accounts are allowed to grow on a tax-deferred basis and are not subject to tax upon distribution provided they are used for the designated qualified expenditures.

Pre-tax/tax-deferred accounts - include savings vehicles such as a deductible Individual Retirement Accounts (IRAs), § 401(k) retirement plans and other deferred compensation plans. These savings vehicles generally allow taxpayers to exclude a portion of their ordinary income from taxation during the year the contribution to the savings vehicle is made. The earnings in these accounts are allowed to grow on a tax-deferred basis. The earnings and the original contributions are taxable to the taxpayer at the time of distribution.

After-tax/tax-deferred accounts - include savings vehicles such as a non-deductible Individual Retirement Accounts (IRAs). These savings vehicles generally allow taxpayers to contribute on an after-tax basis to a savings vehicle that allows earnings to grow on a tax-deferred basis. The earnings on the original contributions are taxable to the taxpayer at the time of distribution.

The Roth IRA is a popular after-tax/tax-exempt savings vehicle that is available to taxpayers that meet certain income limitations.⁴ The annual contribution limit for 2003 for a Roth IRA is \$3,000. Contributions to a Roth IRA are non-deductible, but qualified distributions are generally tax-free.⁵

Individuals who work for an employer that does not offer a § 401(k) type plan are generally limited to the IRA and Roth IRA options for their retirement savings.

Effect of Current Law

Individuals can easily become frustrated when, in evaluating their investment options, they attempt to choose between a pre-tax/tax-deferred option or an after-tax/tax-exempt option. It is often difficult to determine which option is better without the assistance of a professional tax or financial advisor. Also complicating the decision are the numerous income limitations and annual contribution limitations that must be considered, as well as determining whether savings should be put in a retirement savings plan or an education savings plan. Confusion and complication may be the reason many individuals do not take full advantage of the tax-preferred investment options available to them.

Individuals trying to choose between tax-preferred investment options need to understand the consequences of choosing either a pre-tax/tax-deferred or after-tax/tax-exempt option. Not only do they need to know their anticipated top bracket for the year of contribution, but they also must have some idea of what tax bracket may be applied to any taxable distributions they receive in the future. The analysis gets even more complicated when state income taxes are considered.

At first glance, less financially astute individuals may be inclined to think deferring the payment of tax is a good thing. However, in reality, determining the best option often comes down to an analysis of whether it is better to pay the Internal Revenue Service (IRS) now or pay them later. Payment of the tax up front may lead to a much better result later. Use of a pre-tax account is not always the best savings option for individuals who currently find themselves in low income tax brackets to put their savings, especially once they begin to contribute more than the amount their company is going to match.

⁴ Not everyone is eligible to contribute to a Roth IRA. Married individuals filing a joint return can contribute to a Roth IRA if their adjusted gross income (AGI) is not more than \$160,000. If their AGI is more than \$150,000, their contribution begins to be limited (phase-out for single filers and married individuals filing separately and living apart from his/her spouse at all times during the year is between \$95,000 and \$110,000; and the contribution phase-out for married filing separately filers is between \$0 and \$10,000).

⁵ The distribution rules that apply to Roth IRAs are very favorable and provide taxpayers more flexibility in tapping funds in the account prior to retirement. Distributions are assumed to be made in the following order

- Qualified distributions (tax-free);
- Nonqualified distributions--Roth IRA contributions (generally tax-free, technical corrections may break this category into sub-categories); and
- Nonqualified distributions--Roth IRA earnings (generally taxable and subject to early withdrawal penalty).

ICBA's COMMUNITY BANK TAX RELIEF AND SIMPLIFICATION OPTIONS

The effect that tax rates have on the result is illustrated in Exhibit 1, "Pre-Tax/Tax-Deferred Account (e.g. § 401(k) Type Plan) vs. After-Tax/Tax-Exempt Account (e.g., Roth IRA)". Using the table, one can see that an individual currently in the 15 percent tax bracket who anticipates being in either the 15 percent or 25 percent marginal federal tax bracket at the time the savings will be used may find the after-tax plan to be the better alternative.

As Exhibit 1 illustrates, \$10,000 placed in a pre-tax savings account with an annual 6 percent rate of return will grow to \$28,543 by the beginning of 2021. If the entire amount is distributed at that time, at a marginal federal tax rate of 15 percent, the amount available after taxes will be \$24,262. If the marginal tax rate is 25 percent, the amount available will be only \$21,402.

If the individual instead makes a contribution of \$8,500 (\$10,000 less \$1,500 tax at 15 percent) to an after-tax savings account yielding the same annual 6 percent rate of return, the amount will grow to \$24,262 by the beginning of 2021. This result equals the amount available under the pre-tax savings plan for an individual with a 15 percent marginal federal tax rate. However, if the individual's marginal tax rate increased to 25 percent at the time of withdrawal, the available amount under the after-tax plan (\$24,262) would be \$2,860 higher than the available amount under the pre-tax plan (\$21,402).

This example highlights a trap for the unwary. Individuals may actually do themselves considerable financial harm by opting for a pre-tax/tax-deferred savings plan over an after-tax/tax-exempt savings plan if their marginal federal tax rate increases.

Financial advisors spend a great deal of time trying to explain the nuances of pre-tax and after-tax plans to individuals. The biggest problem with the accounts is the difficulty in determining what will provide the best result for a particular individual. Not only is it important to ascertain what type of investments are appropriate, but it becomes important to "guess" what an individual's marginal tax rate will be perhaps twenty or more years down the road.

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Exhibit 1

Pre-Tax/Tax-Deferred Account (e.g., § 401(k) type plan) vs. After-Tax/Tax-Exempt Account (e.g., Roth IRA)

At the beginning of 2003, an individual receives a bonus of \$10,000 and decides to use this money to save for college or retirement. This individual will need the money at the beginning of 2021. The expected annual pre-tax rate of return on the investment = 6.00%.

The following table summarizes the amounts that will be available for the individual to use for the intended purpose at the beginning of 2021, assuming the amount was placed in a pre-tax, tax-deferred account such as a § 401(k) type plan and there are no state income taxes.

Pre-tax/tax-deferred account (e.g., § 401(k) type plan)

Marginal federal tax rate at distribution ⁶ 2021	Amount placed in pre-tax account 2003	Amount available in 2021
0.0%	\$10,000	\$28,543
10.0%	\$10,000	\$25,689
15.0%	\$10,000	\$24,262
25.0%	\$10,000	\$21,402
28.0%	\$10,000	\$20,551
33.0%	\$10,000	\$19,124
35.0%	\$10,000	\$18,553

The following amounts will be available for the individual to use for the intended purpose at the beginning of 2021 assuming the amount is placed in a after-tax, tax-exempt account such as a Roth IRA⁷ plan and there are no state income taxes.

After-tax/tax-exempt account (e.g., Roth IRA)

Marginal federal tax rate at contribution 2003	Amount placed in after-tax account 2003	Amount available in 2021
0.0%	\$10,000	\$28,543
10.0%	\$9,000	\$25,689
15.0%	\$8,500	\$24,262
27.0%	\$7,300	\$20,837
30.0%	\$7,000	\$19,980
35.0%	\$6,500	\$18,553
38.6%	\$6,140	\$17,526

⁶ This analysis assumes that tax rate reductions introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) are not repealed after 2010.

⁷ For purposes of this illustration, the 2003 Roth IRA contribution limitation of \$3,000 is ignored.

Relief Being Sought

To help individuals achieve their savings goals, create a Universal FREEDOM savings account that is open to all Americans, regardless of income level, funded on a after-tax basis with a maximum annual contribution of \$15,000. The maximum contribution to the Universal FREEDOM account would be reduced by any contributions made in the current year to IRAs, Roth IRAs, and § 401(k) type plans. Earnings from the account would generally be tax-free provided the distributions are made for a qualified purpose. Apply distribution ordering rules similar to those applicable to Roth IRAs. Distributions made under any of the following conditions would be qualified:

- **F**irst time home purchase by the account holder, his/her spouse, or any child, grandchild, or ancestor of the owner or spouse;
- **R**etirement needs after the account holder has reached age 59 ½, or after the account holder has died or become disabled;
- **E**ducational expenses;
- **E**conomic hardship expenses, including payments of housing-related expenses when unemployed;
- **D**onations to charitable organizations;
- **O**ccupational re-engineering costs; or
- **M**edical expenses.

Projected Benefit of Relief

With the Universal FREEDOM account, all Americans will have access to easy-to-understand, tax-preferred investment alternatives. No longer will self-employed individuals and individuals working for small employers be relegated to inferior or inadequate savings alternatives.

Investment options for savings will include a broad spectrum of alternatives, including FDIC-insured deposits for those investors who put a portion of their savings in community banks and other federally-insured depository institutions. Furthermore, investors will be able to better monitor the administrative fees charged to their investments.

Much of the confusion and guesswork associated with the use of tax-preferred savings vehicles will be alleviated. Individuals will be able to put money in a Universal FREEDOM account and know with certainty that all of the earnings associated with the account will be available for many of their savings objectives.

CHAPTER TWO

Enhance Current Retirement and Education Provisions

Current Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)⁸ significantly expanded the amounts that Americans can save for retirement. EGTRRA increased the amount that can be contributed each year to § 401(k) plans and § 403(b) plans ("§ 401(k) type plans"), IRAs, and to Roth IRAs. The annual limit for IRAs and Roth IRAs gradually increases to \$5,000 by 2008.⁹ The annual limit for § 401(k) type plans gradually increases to \$15,000 by 2006.¹⁰ These increases for IRAs, Roth IRAs, and § 401(k) type plans are indexed to inflation once they reach the phased-in limits. EGTRRA also added the ability for certain taxpayers age 50 and above to make additional catch-up contributions to their IRAs and/or § 401(k) type plans.

Anyone can contribute to an IRA. However, the contribution will not be treated as deductible if the individual or the individual's spouse is eligible to participate in a pension plan and has adjusted gross income for the year in excess of applicable adjusted gross income limits.¹¹

Not everyone is eligible to contribute to a Roth IRA. Married individuals filing a joint return can contribute to a Roth IRA if their adjusted gross income (AGI) is not more than \$160,000. If their AGI is more than \$150,000, their contribution begins to be limited (phase-out for single filers and married individuals filing separately and living apart from his/her spouse at all times during the year is between \$95,000 and \$110,000; the contribution phase-out for married filing separately filers is between \$0 and \$10,000).

EGTRRA also added a new savings vehicle type, the Roth § 401(k) or Roth § 403(b) ("Roth § 401(k) type plan"). The Roth § 401(k) type plan is a post-tax/tax-exempt account similar to the Roth IRA. The Roth § 401(k) type plan is scheduled to be available beginning in 2006.¹²

Furthermore, EGTRRA significantly expanded the amounts Americans can save in tax-preferred accounts for educational purposes. The annual contribution limit for Coverdell Education Savings Accounts was increased from \$500 to \$2,000 per beneficiary.¹³

⁸ Public Law 107-16

⁹ IRC § 219(b)(5)(B)

¹⁰ IRC § 402(g)(1)(B)

¹¹ IRC § 219(g)

¹² IRC § 402A

¹³ IRC § 530(b)(1)(A)

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However, not everyone is eligible to contribute to a Coverdell Education Savings Account. Married individuals filing a joint return can contribute to a Coverdell Education Savings Account if their adjusted gross income (AGI) is not more than \$220,000. If their AGI is more than \$190,000, their contribution begins to be limited (phase-out for single filers and married individuals filing separately and living apart from his/her spouse at all times during the year is between \$95,000 and \$110,000; the contribution phase-out for married filing separately filers is between \$0 and \$10,000).¹⁴

Another legislative change by EGTRRA significantly altered the treatment of IRC § 529 plans. Prior to 2002, distributions in excess of contributions were taxable to the beneficiary upon distribution for qualified expenditures. After 2001, qualified distributions are not subject to taxation.¹⁵ IRC § 529 plans are established by individual states. These plans are qualified state tuition programs that allow individuals to contribute to an education savings plan on behalf of designated beneficiaries on an after-tax basis. Individuals contributing to IRC § 529 plans are not subject to any income limitations and the contribution limits are extremely high compared to other tax-preferred savings vehicles.¹⁶

All savings incentives included in the EGTRRA are currently scheduled to expire for tax years after December 31, 2010.¹⁷

Effect of Current Law

The sunset provisions in the EGTRRA create uncertainty for individuals who are trying to develop an investment strategy for education and retirement costs. For example, whether distributions from a § 529 plan are treated as taxable or not has a significant effect on the amount of money that will be available to pay college expenses that may come due after 2010. This uncertainty may result in individuals steering clear of the tax-preferred investment until it becomes clear that the desired tax treatment will in fact occur.

Many individuals are eager to fortify their retirement savings through the use of increased contributions to IRAs and/or § 401(k) type plans, as well as the new Roth § 401(k) type plans. The sunset provisions related to increases in future contribution amounts create uncertainty for individuals, which has a negative effect on the long-term viability of these tax-preferred investments.

Furthermore, many people are confused by the different adjusted gross income limitations that apply to IRAs contributions, Roth IRAs contributions, and contributions to a Coverdell Education Savings Account. All too often, individuals find that when they finally have some money to put aside in these accounts, they are no longer eligible because of the income limitations.

¹⁴ IRC § 530(c)

¹⁵ IRC § 529(c)(3)

¹⁶ The maximum contribution limit on a cumulative and an aggregate basis is determined based on the contributions needed to provide for the qualified higher education expenses of the beneficiary. The current maximum contribution per beneficiary varies by state program and exceeds \$250,000 in at least one state.

¹⁷ Public Law 107-16 § 901

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Individuals who are not eligible to contribute to a § 401(k) type plan are at a severe disadvantage to their peers who work for an employer that allows its employees to make contributions to a § 401(k) type plan. The annual contribution limits for § 401(k) type plans, when phased-in fully by 2008, are three times the size of the contribution limits for IRAs and Roth IRAs.

Individuals ineligible to make contributions to Coverdell Education Savings Accounts because of the income limitations need to carefully evaluate whether a particular state's IRC §529 plan makes sense for them. In some cases, they may find that using taxable investments is preferable after factoring in the additional state management and load fees that will be charged against their investments in an IRC § 529 plan.

To date, most states have established at least one IRC § 529 plan. Residents of a state are often provided special inducements, such as state tax deductions or state tax credits, to encourage them to use the IRC § 529 plan created by their state. However, investors need to be aware that the administrator of the plan is usually allowed to charge a management fee related to the plan. This fee is often based on a percentage of assets being managed, and a portion of the fee is typically paid back to the state itself. In many cases the fees charged exceed 1 percent per year. Some states also charge sales load fees.

Although IRC § 529 plans are touted as an enormous subsidy for education, individual investors are sharing a significant portion of the tax benefit with the state administrators and advisors. The effect of the extra management fee charged by IRC § 529 plans could easily have been minimal during the booming stock market of the late 1990s, but in today's market it looks to take a big bite out of the amount that will be available for educational purposes.

Relief Being Sought

Make the education and retirement savings provisions of EGTRRA permanent.

Accelerate the availability of Roth § 401(k) plans, and accelerate the contribution increases and catch-up contributions included in EGTRRA for IRAs and § 401(k) plans.

Eliminate income limitations applicable to IRAs, Roth IRA, and Coverdell Education Savings Accounts.

Increase the annual contribution limits for IRAs and Roth IRAs to match § 401(k) type plan contribution limits.

Increase the contribution limitation on Coverdell Education Savings Accounts to match the contribution limits for IRC §529 plans.

Projected Benefit of Relief

Making the education and retirement savings provisions of EGTRRA permanent and accelerating the increased contribution limits for tax-preferred accounts will remove the uncertainty currently facing many individuals trying to develop savings plans to address their needs for retirement and education.

Removing the income limitations on IRAs, Roth IRA, and Coverdell Education Savings Accounts will decrease the level of confusion related to these tax-preferred accounts and will significantly expand their utilization.

Increasing the annual contribution limits for IRAs and Roth IRAs to match § 401(k) type plan contribution limits is long overdue; amending this inequity will provide individuals working for small businesses with the opportunity to accumulate substantial retirement savings using tax-preferred accounts.

Increasing the contribution limits for Coverdell Education Savings Accounts to match the limits used for IRC § 529 plans will provide a significant boost for individuals trying to save for college expenses. The high fees associated with the state sponsored IRC § 529 plans will not eat up the earnings accumulated on their savings in a Coverdell Education Savings Account. Individuals will also find it easier to put their education savings in less risky investments such as certificates of deposit to ensure that savings do in fact accumulate earnings.

CHAPTER THREE

Lower Tax Rate on Long-Term Deposits

Current Law

Under current law, individual taxpayers must generally include all of the interest income they receive in ordinary taxable income.¹⁸ The original issue discount (OID) rules generally require the recognition of interest income on long-term Certificates of Deposits (CDs) regardless of whether the taxpayer is able to withdraw the interest earned on the CDs.

In contrast, long-term investments in equities are eligible for the reduced capital gains tax rates if the asset is held more than twelve months.

Effect of Current Law

Core deposits are an efficient source of funding and also represent a key element of the community bank's mission to provide safe and sound deposit accounts for customers. As a form of core deposit, long-term CDs provide community banks with a stable source of funds that can be redeployed through loans to small businesses in the local community. CDs are generally eligible for FDIC insurance, subject to deposit insurance rules related to the application of the \$100,000 maximum.

Individuals are frustrated by the effect the high tax rates have on the after-tax rate of return on CDs. Treating interest income on long-term CDs as current ordinary income results in a federal tax payment of up to 38.6 percent of the interest recognized. Long-term CDs are particularly problematic for individuals because many taxpayers dislike having to pay tax on phantom income (income they must recognize but do not have current access to).

Many individuals use long-term CDs in non-taxable accounts such as Individual Retirement Accounts (IRAs) or Coverdell Education Savings Accounts that do not generate a current tax liability.

Relief Being Sought

Defer recognition of interest income on long-term CDs (CDs with a term of 12 months or more) until maturity for individual taxpayers.

Reduce top tax rate applied to interest income on long-term CDs (CDs with a term of 12 months or more) to equal the long-term capital gains rate for assets held more than 12 months.

¹⁸ One exception to this relates to interest income earned on certain tax-exempt investments as defined under Internal Revenue Code §103.

Projected Benefit of Relief

One of the greatest competitive strengths of community banks is fervent and consistent saving by their customers. However, over the years, community banks have fallen behind in the competition for the even the current low level of personal savings due to the easy accessibility of other savings and investment instruments with higher annual yields.

Grant Thornton's 2002 Ninth Annual Survey of Community Bank Executives found that while 94 percent of community banks currently view core deposits as an important source of funding, the percent drops to 88 percent looking three years ahead.¹⁹ Part of this drop is attributable to the challenges community banks face in generating new core deposits.

Improving the after-tax rate of return on a long-term CD, eligible for FDIC insurance, will encourage people of all economic levels to deposit more funds in their local banks. Increasing the level of core deposits will improve community banks' vitality and their ability to economically and efficiently serve their communities.

A reduced tax rate for long-term CDs will directly benefit community banks both by increasing the savings rates of their depositors and by enabling community banks to make more community investments. Most importantly, however, the reduced tax rate directly rewards consumers for using savings vehicles that provide investment capital for their local communities.

¹⁹ Grant Thornton's 2002 Ninth Annual Survey of Community Bank Executives

CHAPTER FOUR

Personal Interest and Dividend Income Exclusion

Current Law

Under current law, individuals must generally include all of the interest and dividend income they receive in their taxable income.²⁰

Effect of Current Law

America's all-time low personal savings rate directly affects community banks' ability to fund their activities with core deposits. Core deposits are an efficient source of funding and also represent a key element of the community bank's mission to provide safe and sound deposit accounts for customers.

Low personal savings result in a smaller pool of available capital for the new and expanding businesses that create much of the U.S. job market. This reduced pool of capital adversely affects the amount of funds available to community banks for reinvestment in their communities.

Relief Being Sought

Exclude the first \$600 (\$1,200 for joint filers) of interest and/or dividends from taxable income.

Projected Benefit of Relief

One of the greatest competitive strengths of community banks is fervent and consistent saving by their customers. However, over the years, community banks have faced fierce competition for personal savings due to the easy accessibility of other savings and investment instruments with higher annual yields. Based on current savings rates, community banks fully expect to be forced to reduce their reliance on core deposits.²¹

Improving the effective return on personal savings accounts and investments in the stock market will encourage people of all economic levels to deposit more funds in their local banks and make more investments in the stock market.

The personal interest exclusion directly benefits community banks by increasing the savings rates of their depositors and thereby enabling community banks to make more community investments. Most importantly, however, the exclusion directly rewards consumers for saving.

²⁰ Interest income earned on tax-exempt investments under IRC § 103 is an exception to this rule.

²¹ Grant Thornton's 2002 Ninth Annual Survey of Community Bank Executives found that while 94% of community banks currently view core deposits as an important source of funding, the percent drops to 88% looking three years ahead.

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CHAPTER FIVE

Treat Interest Income and Dividends as Capital Gains

Current Law

Under current law, individuals must generally include in taxable income all of the interest and dividend income they receive. Interest and dividend income is treated as ordinary income and taxed at the individual's highest marginal tax rate. In contrast, capital gain income related to assets held more than 12 months (e.g., gain recognized upon the sale of stock) is generally taxed at a top rate of 20 percent.²²

Effect of Current Law

Core deposits are an efficient source of funding and also represent a key element of the community bank's mission to provide safe and sound deposit accounts for customers. Core deposits provide community banks with a stable source of funds that can be redeployed through loans to small businesses in the local community.

Individuals are frustrated by the effect the high tax rates have on the after-tax rate of return on deposits. Treating interest income on deposits as current ordinary income results in a federal tax payment of up to 38.6% of the interest recognized.

Earnings distributed to shareholders of those profitable community banks unable to make the S corporation election are subject to two layers of taxation: once at the corporate level, with a top federal rate of 35 percent; and again upon dividend distribution, at the individual shareholder level, with a top federal rate of 38.6 percent. This double taxation can result in over 60 percent of earnings being paid as federal tax, before state taxes are even considered.²³

The current law results in a very inefficient allocation of resources for a C corporation community bank. Shareholder earnings are often retained when they are not needed, just to avoid the imposition of the second layer of taxation. This lock-up of corporate earnings occurs in all industries and hinders the flow of capital back and forth from investors and companies looking to make new investments that will create new jobs.

The current treatment of dividends also contributes to the sale of many community banks. Investors eager to realize a cash return on their investment may decide to sell their stock instead of forcing the company to make tax-inefficient distributions of company earnings. The gain on sale of a company's stock is generally taxed at the much lower long-term capital gain rates.

²² The top rate on certain assets is 18% if held more than 5 years - Internal Revenue Code Section 1(h)(2).

²³ Total federal tax of 60.09% = Federal corporate tax on earnings of 35% + federal shareholder level tax on dividend of 25.09% (38.6% * 5%).

Relief Being Sought

Treat interest income and corporate dividends as net capital gains subject to the long-term tax rate afforded to capital assets held more than 12 months. Individuals will be taxed on interest income and corporate dividends at a maximum rate of 20 percent (10 percent to the extent the taxpayer would have been in the 15 percent rate bracket if the dividend had been considered ordinary income.).

Projected Benefit of Relief

Decreasing the tax rate on both interest income and corporate dividends will provide an incremental pool of capital that would be available for new and expanding businesses, thereby creating jobs without creating a bias in the Internal Revenue Code that leads people to invest in riskier equities.

The greater pool of capital available to shareholders for new or re-investment will also enable companies to make the investments that would increase the productivity of their existing operations. Improvements in productivity lead to higher real wages for workers that, in turn, lead to a general increase in the standard of living.

Improving the after-tax rate of return on interest income received on deposits eligible for FDIC insurance will encourage people of all economic levels to deposit more funds in their local banks. Increasing the level of core deposits will improve community banks' vitality and their ability to economically and efficiently serve their communities.

A reduced tax rate for interest income received on deposits will directly benefit community banks both by increasing the savings rates of their depositors and by enabling community banks to make more community investments. Most importantly, however, the reduced tax rate directly rewards consumers for using savings vehicles that provide investment capital for their local communities. Community banks that would like to remain independent will likewise benefit from a reduced tax rate on dividends, since investors will be less likely to force the sale of a community bank to realize a tax-efficient return.

Maintaining parity in the tax rates applied to interest and dividend income is important to the viability of community banks because of the effect that an imbalance would have on the cost of obtaining funds.

PART TWO: Small Business Tax Relief and Simplification Options

CHAPTER SIX

S Corporation Reform

Background

Although S Corporation status has been an option for most small businesses for many years, financial institutions were not eligible to make the election until the Small Business Job Protection Act changed the law in 1996. That Act included a provision that made financial institutions eligible to elect S Corporation status for tax years beginning after 1996.²⁴

An S Corporation is a flow-through structure for tax purposes; S Corporation shareholders are taxed on their portion of the corporation's taxable income, regardless of whether or not they receive a cash distribution. Subsequently, when an S Corporation does make actual distributions, those distributions generally are not taxable, as long as they do not exceed the cumulative income of the S Corporation less previous distributions.

S Corporation status allows closely-held community banks to eliminate double taxation of corporate income, making them more competitive. By ending the payment of taxes on both corporate income and the shareholders' income from the corporation, community banks increase the amount of resources available for community loans and investments.

According to Federal Deposit Insurance Corporation (FDIC) Call Report Data as of September 30, 2002, almost 20 percent of insured commercial banks and FDIC-supervised savings banks ("FDIC insured banks") are currently S Corporations. Of the 9,414 FDIC-insured banks in the United States on September 30, 2002, 1,858 had elected S Corporation status, thereby generally eliminating double taxation of their income.²⁵

S Corporation status	Number	Percentage
FDIC insured banks (S Corporations)	1,858	19.7%
FDIC insured banks (C Corporations)	7,556	80.3%
Total FDIC-insured banks	9,414	100.0%

Although a significant number of community banks already have made the conversion to S Corporation status, the results of Grant Thornton's Ninth Annual Community Bank Survey indicated that an additional 16 percent of all the banks surveyed were exploring the possibility of making the S Corporation election sometime after 2002.²⁶

²⁴ Public Law 104-188

²⁵ Statistics derived from FDIC call report data compiled by PlanSmith's FIRE Inc.

²⁶ Grant Thornton LLP, Ninth Annual Survey of Community Bank Executives

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Before making the S Corporation election, banks must meet a number of criteria specified by the law, while attempting to avoid disrupting their operations or disenfranchising shareholders. Obstacles most often mentioned by community bankers include:

- Limitations on the number of shareholders,
- Limitations on the types of shareholders,
- Limitations on options for raising capital (e.g., inability to issue preferred stock),
- Possible application of the passive investment income tax, and
- Uncertainty regarding the treatment of director's shares.

Currently, largely due to the restrictions listed above, most S Corporation banks tend to be smaller in size. As of September 30, 2002, total assets of banks electing S Corporation status exceeded \$226.5 billion, with an average size of \$121.9 million. The total bank S Corporation assets represent approximately 2.7 percent of the \$8,271.8 billion total assets of the 9,414 FDIC-insured banks.²⁷

Electing S Corporation status eliminates the corporate level taxation of income; this result makes S Corporations in some respects similar to credit unions, which also are not subject to the corporate level taxation of income. However, total assets held by National Credit Union Administration (NCUA)-insured credit unions as of September 30, 2002, \$555.6 billion, is still more than twice the amount of assets held by banks electing S Corporation status as of September 30, 2002, \$226.5 billion.

S Corporation status	Total assets (billions) @9/30/02	Percentage of FDIC-insured banks
FDIC insured banks (S Corporations)	\$ 226.5	2.7%
FDIC insured banks (C Corporations)	<u>\$8,045.3</u>	<u>97.3%</u>
Total for FDIC-insured banks	<u>\$8,271.8</u>	<u>100.0%</u>
Total for NCUA-insured credit unions	<u>\$ 555.6</u>	

Congress can ensure that small businesses, especially more community banks, can efficiently take advantage of S Corporation status to effectively compete in today's economy by passing legislation to implement the S Corporation ideas that follow:

- Increase Maximum Number of S Corporation Shareholders to 150
- Allow IRAs and Partnerships to Own S Corporation Stock
- Exempt Certain Sales of Stock by an IRA to the Owner of the IRA from Prohibited Transaction Treatment
- Allow S Corporations to Issue Certain Preferred Stock
- Change Treatment of Director Qualifying Stock for Purposes of the S Corporation and Qsub Elections
- Exempt Bank Income from Passive Investment Income Tax

²⁷ Statistics derived from FDIC 9/30/2002 call report data as compiled by Plansmith's FIRE Inc.

Increase Maximum Number of S Corporation Shareholders to 150

Current Law

The Small Business Job Protection Act increased the maximum number of eligible S Corporation shareholders from 35 to 75 for tax years beginning after December 31, 1996.²⁸

Effect of Current Law

In many cases, community banks have made a decision to ensure that their institutions are relatively widely owned, often by members of the communities they serve. The provision of the S Corporation rules limiting the number of shareholders to no more than 75 forces these community banks to make a decision to disenfranchise shareholders and to limit ownership to avoid double taxation.

Banks with more than 75 shareholders that decide to make the S Corporation election must force out some of their shareholders – even when they would otherwise prefer to be more broadly held. Unfortunately, a by-product of the decision to reduce the number of shareholders is that small shareholders usually bear the brunt of any forced buyout situation to minimize the costs of the buyout.

Forced buyouts are the primary means for reducing the number of shareholders; other alternatives, including the use of a reverse stock split or the formation of a new holding company, are generally very expensive. In addition to the accounting, legal, regulatory, and valuation costs associated with these strategies, the courts in many states have historically been sympathetic to minority shareholders and have relied on inflated valuations of banks to determine appropriate compensation.

Relief Being Sought

Increase the maximum number of allowable S Corporation shareholders to 150.

Projected Benefit of Relief

If the number of allowable shareholders is increased, more community banks will become eligible to make the S Corporation election and, at the same time, can continue to be relatively widely owned by members of their communities. Increasing the maximum number of shareholders reduces the likelihood that minority shareholders will need to be forced out of a community bank to meet S Corporation criteria.

²⁸ IRC § 136(b)(1)(A)

Allow IRAs and Partnerships to Own S Corporation Stock

Current Law

Present law restricts the types of individuals or entities that may own S Corporation stock.²⁹ For tax years beginning after December 31, 1997, acceptable S Corporation shareholders generally include:

- Any individual, except for a nonresident alien;
- Estates;
- Certain trusts;
- Certain tax-exempt organizations; and
- Employee stock ownership plans (ESOPs).

Prior to 1997, many closely-held financial institutions formed Family Limited Partnerships (FLPs) as part of a plan to keep their community banks independent. This strategy was popular prior to the law change allowing banks to become S Corporations and prior to the repeal of the estate tax.

Effect of Current Law

Eliminating ineligible shareholders has been a significant barrier to community banks otherwise interested in making the election. In many cases, due to capital constraints, banks find it virtually impossible to eliminate the significant amount of stock owned by Individual Retirement Accounts (IRAs).

Relief Being Sought

Allow partnerships consisting of eligible S Corporation shareholders to hold S Corporation stock. Treat each partner in a partnership as a separate shareholder for purposes of determining the number of shareholders.

Allow traditional IRAs as eligible S Corporation shareholders. Tax IRA shareholders on the S Corporation earnings allocated to the IRA shareholders in a manner consistent with the treatment of S Corporation earnings allocated to ESOPs.

Projected Benefit of Relief

Community banks interested in making the S Corporation election will no longer need to encourage their traditional IRA and partnership shareholders to sell their shares either to the community bank or to third parties who are eligible S Corporation shareholders.

Expanding the list of eligible S Corporation shareholders will provide significant relief to community banks and eliminate the high cost of buying out ineligible shareholders. In some cases, buyout costs put a severe strain on a community bank's capital.

²⁹ IRC § 1361(b)(1)

Exempt Certain Sales of Stock by an IRA to the Owner of the IRA from Prohibited Transaction Treatment

Current Law

The sale of IRA assets to a “disqualified party” is a prohibited transaction as defined in Internal Revenue Code (IRC) § 4975.³⁰ The owner of the IRA is considered a disqualified party and is prohibited from purchasing the community bank’s stock from the IRA. The sale of plan assets to a disqualified party is prohibited no matter what price the owner is willing to pay the IRA for the stock.

IRAs that participate in prohibited transactions taint the entire fund and the tax exemption is lost. The account ceases to be an IRA on the first day of the taxable year in which a prohibited transaction occurs.³¹

The Department of Labor may grant exemptions, on a case-by-case basis, from the prohibited transaction rules when an IRA wishes to sell stock to a disqualified party.³² However, applications must be submitted for each individual case and are time consuming and expensive.

Effect of Current Law

IRAs frequently own community bank stock, resulting in a significant obstacle to banks that would like to make the S Corporation election. If a community bank decides to convert to S Corporation status, it must re-purchase the stock from the IRA. Often, the owner of the IRA does not want to give up the future benefit of stock ownership, and would like to purchase the stock from the IRA rather than having the community bank redeem the stock.

Relief Being Sought

Allow owners of IRAs holding the stock of a community bank making the S Corporation election to purchase the subject securities from the IRAs at fair market value. This change can be accomplished by amending IRC § 4975 or IRC § 408 to alleviate the penalty associated with an IRA selling one of its assets to its owner.

Projected Benefit of Relief

The relief provisions will make it easier for community banks interested in making the S Corporation election to eliminate ineligible IRA shareholders. Community banks will not have to use their capital to buy back stock held in IRAs.

³⁰ IRC § 4975(c)(1)(A); IRC § 408 (e)(2)(A)

³¹ IRC § 408(e)(2)

³²(PTE 98-59) 63 FR 69326, 12/16/98 (25 BPR 2673, 11/16/98).

Allow S Corporations to Issue Certain Preferred Stock

Current Law

Present law only allows S Corporations to have one class of stock outstanding.³³ C Corporations that want to make the S Corporation election must eliminate any second class of stock prior to the effective date of the S Corporation election. Issuance of a second stock class by an S Corporation terminates its S Corporation status.

Effect of Current Law

Community banks must maintain certain minimum capital ratios to be considered well-capitalized institutions for regulatory purposes. As a community bank grows in size, its earnings alone may not provide sufficient capital to fund its growth. Banks needing more capital can normally raise additional capital by issuing common stock, preferred stock, or, in some cases, trust-preferred securities.

Many community banks avoid issuing additional common stock to fund growth so that they can protect their status as an independent community bank. Instead, they frequently use preferred stock to fund growth so that the existing owners retain control. Preferred stock helps prevent unwelcome takeover attempts initiated by big banks from outside the community. However, S Corporations are not allowed to issue preferred stock without terminating S Corporation status because preferred stock is considered a second class of stock.

This provision directly threatens the viability of small banks in the United States. Without options for raising capital other than broad-based common stock issuance, which could make the community bank a takeover target, community bank growth is hindered and banks' service to their communities is impeded. Lack of capital not only affects bank growth, it directly affects the growth potential for the small communities primarily served by small banks.

Relief Being Sought

Exempt convertible or "plain vanilla" preferred stock from the "second class of stock" definition used for S Corporation purposes.

Projected Benefit of Relief

Allowing bank S Corporations to issue preferred stock will contribute to the well-being of small banks, allowing them to avoid double taxation of income and to fund future growth. Preferred stock provides a solution for community banks that want to encourage broader community investment in the bank but also need to protect their S Corporation status, family ownership positions, or to ward off takeovers by large banks that are not necessarily committed to the local community. Preferred stock also offers members of the local community an alternative investment option.

³³ IRC § 1361(b)(1)(D).

Change Treatment of Director Qualifying Stock for Purposes of the S Corporation and Qsub Elections

Current Law

Because an S Corporation may have only one class of stock outstanding,³⁴ in most cases, the S Corporation election is terminated if the bank issues a second class of stock. For purposes of this rule, voting and non-voting common stock are considered a single class.

A director of a national bank is generally required by the Office of the Comptroller of the Currency (OCC) to own stock in the bank to ensure that the individual has a sufficient financial interest in the bank to be vigilant in protecting the bank's interests.³⁵ A number of states have similar requirements for state chartered banks.

In some cases, stock issued by community banks or their holding companies to bank directors may be subject to an agreement to dispose of the shares upon termination of the holder's status as a director at the same price the individual acquired the shares. This type of director qualifying stock is issued solely to comply with the federal or state regulatory requirements.

The IRS could arguably determine that qualifying director stock subject to restrictions like this represents a second class of stock, thereby preventing or terminating the S Corporation election.

Effect of Current Law

Many banks with restricted director's stock have undoubtedly made the S Corporation election despite the uncertainty surrounding the treatment of director qualifying stock. A number of banks are waiting for definitive IRS guidance on this issue.

Relief Being Sought

Do not treat director qualifying stock, subject to substantial economic restrictions, as a second class of stock for S Corporation purposes when issued by bank S Corporations or by bank subsidiaries of an S Corporation bank holding company. Make all changes retroactively effective to tax years beginning after December 31, 1996.

Projected Benefit of Relief

More banks will make the S Corporation election when the uncertainty surrounding the treatment of director qualifying stock is eliminated. The bank would be able to make decisions about bank director stock ownership based on business strategies and ownership objectives rather than IRS interpretation.

³⁴ IRC § 1361(b)(1)(D)

³⁵ 12 U.S.C. § 72

Exempt Bank Income from Passive Investment Income Tax

Current Law

S Corporations with accumulated C Corporation earnings and profits are subject to a 35 percent tax on "passive investment income" exceeding 25 percent of gross receipts for any year.³⁶ A company's S Corporation status is terminated if the 25 percent limit is exceeded for three consecutive years.³⁷ Passive investment income generally includes: royalties, rents, dividends, interest, annuities and gains on sales of stock and securities.³⁸

Passive investment income does not include gross receipts directly derived from the active and regular conduct of a lending or finance business.³⁹ Internal Revenue Service (IRS) Notice 97-5 generally provides that gross receipts directly derived in the ordinary course of a banking business are not passive investment income for purposes of the passive investment income tax. Income from the following assets are considered part of the active and regular conduct of a banking business (i.e. income and gain from these assets will not be considered passive investment income): loans, participations, or REMIC regular interests;⁴⁰ equity investments needed to conduct business (FHLB stock etc.);⁴¹ assets pledged to a 3rd party to secure deposits or business;⁴² and investment assets needed for liquidity or loan demand.

Effect of Current Law

Many banks find it desirable to invest excess funds in government securities when loan demand decreases. The current ambiguity in the rules regarding passive investment income could encourage bankers electing S Corporation status to invest in riskier and less liquid assets than they would prefer so that they do not inadvertently terminate their S Corporation status because they are later deemed by an IRS agent to have too much passive investment income.

Determining the amount of investment assets needed for liquidity or loan demand can be very subjective. Banks interested in S Corporation status would prefer not to gamble that an IRS agent may disagree with their determinations.

Relief Being Sought

Exempt bank income from the passive investment income tax imposed by IRC § 1375, effective for tax years beginning after December 31, 1996. Define bank income as all income from any corporate entity that qualifies as a bank under IRC § 581 and from any 100-percent-owned subsidiaries of a bank.

³⁶ IRC § 1375(a)

³⁷ IRC § 1362(d)(3)(A)

³⁸ IRC § 1362(d)(3)(C)(i)

³⁹ IRC § 1362(d)(3)(C)(iii)

⁴⁰ All loans and REMIC regular interests owned, or considered to be owned, by the bank regardless of whether the loan originated in the bank's business. Securities described in § 165(g)(2)(C) are not considered loans.

⁴¹ Assets required to be held to conduct a banking business (such as Federal Home Loan Bank or participation certificates issued by a Federal Intermediate Credit Bank which represent nonvoting stock in the bank).

⁴² Assets pledged to a 3rd party to secure deposits (e.g. assets pledged to qualify as a depository for state funds).

Projected Benefit of Relief

This proposal will simplify the investment decision-making process of bank S Corporations currently faced with the potentially significant and uncertain treatment of passive investment income. Banks that have made the S Corporation election will be free to make risk management and cash management decisions based on good banking practices instead of being influenced by the prospect of an aggressive IRS agent. More eligible community banks will change to S Corporation status.

S Corporation Reform -- Summary

S Corporation status reduces the problem of “double taxation” of both corporate profits and distributions to the shareholders. However, many community banks find that current barriers to S Corporation status are too great to overcome.

The limit on the number of S Corporation shareholders is a significant barrier to many community banks. Often, community bank ownership has passed from generation to generation, expanding with each generation. It does not take many generations of family growth for community banks to exceed the S Corporation stockholder limit. The alternative is to force shareholders out, often a costly and emotional proposition.

Restrictions on S Corporation stock ownership are, in general, some of the most difficult hurdles for community banks to overcome. Often investors have put some of their retirement funds into local community bank stock. Present law says that banks with IRA investors are ineligible for S Corporation status, thereby disadvantaging non-IRA shareholders who would like to make the election.

To assure the vitality of small banks, legislation and regulations must ensure that community banks can grow. Community banks must have options for generating new sources of capital without jeopardizing their S Corporation status or setting them up to become a takeover target. Without the ability to issue preferred stock, as C Corporation community banks are able to do, S Corporations are at a competitive disadvantage in raising capital.

Stock issued by community banks to their directors might be treated by the IRS as a second class of stock, thereby prohibiting the issuing community bank from opting S Corporation status. The ironic issue related to directors' stock is that the community bank issued the stock to assure the director has an economic interest in the bank and, in turn, will protect the bank's interest. However, having second class of stock issue eliminates one structure option for the community bank – S Corporation status.

Cash management decisions should be based on sound banking practices, not by worries over keeping S Corporation status intact. The current uncertain application of the passive investment income rules to income from certain investments has the effect of discouraging some banks from making the S Corporation election.

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CHAPTER SEVEN

Repeal Estate Tax and Increase FMV Basis Allowance

Current Law

Estate taxes are currently scheduled to be repealed in 2010 and then reinstated in 2011. Under the estate and gift tax laws, an individual has been allowed to transfer, exempt from tax, up to \$675,000 worth of property.⁴³ The Economic Growth and Tax Relief Reconciliation Act of 2001⁴⁴ ("EGTRRA of 2001") increased the exemption from \$675,000 to \$3.5 million, phased in according to the following schedule.⁴⁵

<u>Year of Death</u>	<u>Estate Tax Exemption Equivalent</u>
2002-2003	\$1,000,000
2004-2005	\$1,500,000
2006-2008	\$2,000,000
2009	\$3,500,000

Under current law, through the end of 2009, heirs that receive property from a decedent are generally not required to carry over the decedent's income tax basis for that property for income tax purposes. Rather, their basis for the property is generally equal to the fair market value at the date of the decedent's death.

The current law is scheduled to change in 2010 when the estate tax is repealed. At that time the availability of date-of-death fair market value basis will be severely limited. Only property up to \$1.3 million in value will be eligible for a date-of-death basis, regardless of who inherits it. An additional bequest of \$3 million to a surviving spouse, however, will also qualify for a date-of-death basis.⁴⁶

Effect of Current Law

Succession planning begins early in most family-owned banks. Long-time community bankers take great satisfaction in knowing that future generations will continue to own and manage the banks that they built and grew. Unfortunately, current provisions of estate tax law often force community bankers to focus on ownership issues to the exclusion of what is in the best interest of the bank or its community.

Furthermore, estate and gift taxes are especially onerous for community bankers because the interests they hold in their banks often represent a significant and illiquid portion of their estates. The low exemption amount can force community bank families to sell their interests in their "family" banks to meet estate tax obligations.

⁴³ IRC § 2010(a)

⁴⁴ Public Law 107-16

⁴⁵ IRC § 2010(c)

⁴⁶ IRC § 1022(b)

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The scheduled phase-in of the exemption amount and of the repeal over several years makes estate planning difficult. Community bank owners are compelled to annually restructure their overall estate objectives to protect their heirs' interests in the family-owned bank.

Significant administrative difficulties are created by the current law provision that will limit date-of-death basis beginning in 2010. Heirs will be forced to spend considerable time ascertaining cost basis for assets previously held by the decedent. Estates with net taxable assets in excess of \$1.3 million (\$4.3 million in the case where there is a surviving spouse) will be subject to this administrative nightmare.

Relief Being Sought

Permanently repeal estate taxes beginning in 2010.

Increase the availability of fair market value basis at date-of-death to include property up to \$5 million in value regardless of who inherits it, and increase to \$10 million the amount of additional bequest available to a surviving spouse.

Projected Benefits of Relief

If the estate tax is repealed, heirs will no longer be forced to sell a family-owned bank to satisfy federal estate taxes. Consequently, family-owned banks will remain an integral part of the banking industry far into the future. Community bankers will continue to fully serve their communities and effect orderly transitions to management by the next generation.

Relaxing the limits applied to fair market value basis at date-of-death would significantly reduce the administrative difficulty associated with determining the cost basis of each asset included in an estate.

CHAPTER EIGHT

Make Five-Year Net Operating Loss Carryback Permanent

Current Law

The Job Creation and Worker Assistance Act of 2002⁴⁷ (the "2002 Tax Act") increased the NOL carryback period to five years effective for NOLs generated in tax years that end in 2001 or 2002.⁴⁸ The carryback period again reverts to two years for tax years ending after 2002.

Effect of Current Law

The scheduled reduction in the NOL carryback period from five years back to two years is already causing problems for banks as they prepare their 2002 financial statements. In some cases, the shorter carryback period results in an additional charge to the earnings and Tier I capital of profitable banks when they need to establish a deferred tax asset valuation allowance for regulatory purposes. A deferred tax asset can be included in Tier I capital only if it is realizable within 12 months of the reporting date. Diminished Tier I capital limits a bank's ability to make loans to businesses and other customers that participate in their local economy.

Banks must follow Statement of Financial Accounting Standards No. 109 "Accounting for Income Taxes" (SFAS 109) when determining the amount of deferred tax assets they may include in their financial statements.⁴⁹ To avoid establishing a valuation allowance against the deferred tax asset, the bank must be able to demonstrate that it can realize a deferred tax asset by recovering taxes paid in prior years, offsetting the deferred tax asset against deferred tax liabilities or by generating sufficient future taxable income. The return of the short two year carryback period in 2003 will make satisfying this requirement much more difficult.

The shorter NOL carryback period is especially onerous to banks because bank regulators also limit the amount of a deferred tax asset that a bank can include as Tier I capital that is dependent on the generation of future taxable income.⁵⁰

⁴⁷ Public Law 107-147

⁴⁸ IRC § 172(b)(1)(H)

⁴⁹ The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 109 "Accounting for Income Taxes" (SFAS 109) in February, 1992. Under the standard, a company must report deferred tax assets arising from tax carryforwards and deductible temporary differences. The company must, however, also establish a reserve to adjust the recorded asset to the amount that will more likely than not be realized. Tax carryforwards are deductions or credits that a company cannot use for current tax purposes, but may carry forward to reduce taxable income or taxes payable in a future period. Temporary differences arise when a company records transactions in one period on the company's books and recognizes them in another period, or periods, on its income tax return. A company may only realize deferred tax assets arising from deductible temporary differences by

- recovering taxes paid in prior years,
- offsetting taxable temporary differences, or
- earning sufficient future taxable income.

⁵⁰ The banking regulatory agencies adopted the provisions of SFAS 109 for reporting in quarterly Consolidated Reports of Condition and Income (Call Reports) beginning January 1, 1993. [Federal Deposit Insurance Corporation (FDIC) 12 CFR Part 325 RIN 3064-AB20, Capital Maintenance, 60 FR 8182; and Department of the

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Increases in anticipated losses are recognized much earlier for financial statement and regulatory purposes than for tax purposes. The mere deterioration of a loan portfolio results in a charge to the books, but a loan must actually be worthless before a tax bad debt deduction can be recognized.

Relief Being Sought

Make the five-year net operating loss carryback period permanent for years after 2002.

Projected Benefit of Relief

Community banks stand behind their customers and communities in both good times and bad. Increasing the NOL carryback period to five years will help banks that experience significant losses to survive an economic downturn by allowing them to receive refunds of taxes paid in previous years. The additional carryback refund will also help banks support their communities in economic hard times.

CHAPTER NINE

Expand IRC § 179 Expensing and Accelerate Depreciation

Community banks strive to keep up with the latest technology in payment, loan, marketing, and service options for their customers. At the same time, business customers look to their community banks to help them effectively participate in electronic commerce. Consumers are demanding more electronic and technology-based services such as Internet banking and electronic bill payment services. Furthermore, community banks are working to improve their productivity by using technology more effectively.

Technology investments are not optional for community banks. To remain viable, they must offer more advanced services to facilitate e-commerce and to satisfy the growing demand for financial transactions via the Internet and for other technology-based services.

Current Law

Costs incurred by small businesses to purchase new computers and other hardware are subject to normal depreciation rules. IRC § 167(a) allows depreciation due to exhaustion, wear and tear, and obsolescence on certain types of property used in a trade or business or for production of income. Computers are considered five-year property and are depreciated under the Modified Accelerated Cost Recovery System (MACRS).

Assets acquired after September 10, 2001 and before September 11, 2004 are generally eligible for an additional thirty percent first-year bonus depreciation allowance, provided they are placed in service before January 1, 2005. This bonus depreciation allowance is only available to property with a MACRS recovery period of 20 years or less.⁵¹

Current Law - Computer Equipment as MACRS 5-year property

<u>Tax Year</u>	<u>Percent deducted each year including bonus depreciation</u>	<u>Percent deducted each year with no bonus depreciation</u>
1	44.000%	20.000%
2	22.400%	32.000%
3	13.440%	19.200%
4	8.064%	11.520%
5	8.064%	11.520%
6	4.032%	5.760%
Totals	<u>100.000%</u>	<u>100.000%</u>

IRC § 179 provides a partial exception to the general depreciation rules for taxpayers that place in service less than \$200,000 of qualifying property; these taxpayers may elect to deduct up to

⁵¹ IRC § 168(k)

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\$24,000 (\$25,000 for taxable years beginning in 2003 and thereafter) of the property placed in service during the year.⁵²

Effect of Current Law

Community banks routinely purchase and upgrade computer equipment to improve the efficiency of processing transactions and to provide new services to their customers. Even though computers provide operating efficiency, they are expensive with relatively short useful lives, rarely equal to or greater than the five-year period established for federal tax purposes.

Community banks regularly have to dispose of obsolete computers and replace them with more advanced technology. The five-year depreciation period established for computers in the federal tax code does not accurately match the serviceable life of the equipment.

Relief Being Sought

- Increase the amount deductible under IRC § 179 from \$25,000 to \$75,000 per year for years beginning after 2002, make computer software eligible for IRC § 179, and index these amounts to inflation.
- Make 30 percent bonus depreciation provisions permanent.
- Change computer equipment from 5-year MACRS property to 3-year MACRS property.

Amending the Internal Revenue Code to establish computer equipment as three-year property under MACRS would result in the following percentages of asset cost deducted each year, calculated with and without bonus depreciation:

Proposal - Computer Equipment as MACRS 3-year property

<u>Tax Year</u>	<u>Percent deducted each year including bonus depreciation</u>	<u>Percent deducted each year with no bonus depreciation</u>
1	53.331%	33.330%
2	31.115%	44.450%
3	10.367%	14.810%
4	<u>5.187%</u>	<u>7.410%</u>
Totals	<u>100.000%</u>	<u>100.000%</u>

Projected Benefit of Relief

Accelerating the deduction of qualifying property expenditures will help community banks better serve the needs of their communities and meet the demands of their customers for new services.

Accelerated depreciation deductions for computer equipment will also encourage community banks and other small businesses to improve productivity by enhancing the use of technology to improve standard operations. A shorter tax life for computer equipment more accurately matches actual lifetime usefulness and provides for a more reasonable recovery of the cost.

⁵² Qualifying property is generally defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

CHAPTER TEN

Repeal Alternative Minimum Tax for Community Banks

Current Law

Current law generally imposes an alternative minimum tax (AMT) on a C Corporation to the extent the corporation's minimum tax liability exceeds its regular tax liability. This minimum tax is imposed at a rate of 20 percent on corporate alternative minimum taxable income in excess of a phased-out \$40,000 exemption amount.⁵³ Alternative minimum taxable income (AMTI) is the corporation's regular taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items.

The Taxpayer Relief Act of 1997 (1997 Tax Act) repealed the AMT for certain small corporations. For these purposes, a corporation initially qualifies as a "small corporation" if it has average annual gross receipts of \$5 million or less each year for the three-tax-year period (or, if shorter, the period of existence⁵⁴) ending with its first tax year beginning after December 31, 1996. Once a corporation is recognized as a small corporation, it will continue to be exempt from the AMT as long as its average annual gross receipts do not exceed \$7.5 million.⁵⁵

Effect of Current Law

As originally enacted by the 1997 Tax Act, the \$5 million and the average annual gross receipts test were intended to provide much needed relief for small corporations, but this test gives little consideration to institutions such as community banks. A community bank's gross receipts consist primarily of interest income, and community banks with assets of only \$50 million often generate gross receipts in excess of \$5 million. The computation of AMTI is a burden on small community banks; many cannot afford to have internal staff well versed in this highly specialized area of taxation.

Relief Being Sought

Replace the \$5 million average annual gross receipts threshold for banks with a rule that applies the AMT only to banks that are considered large banks under IRC § 585(c)(2) (i.e., total average annual assets of more than \$500 million). For purposes of this provision, define community bank as any institution that satisfies the definition of a bank under IRC § 581.

Projected Benefit of Relief

Exempting community banks that are not large banks (average annual assets of more than \$500 million) from the AMT enhances their viability by eliminating the need to maintain a costly set of additional records. This change also complies with the original spirit of the AMT repeal for small businesses made in 1997.

⁵³ IRC § 55(b)(1)(B); IRC § 55(d)(2)

⁵⁴ IRC § 448(c)(3)

⁵⁵ IRC § 55(e)(1)

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CHAPTER ELEVEN

National Limited Liability Company Bank Charter

Current Law

The Federal Deposit Insurance Corporation (FDIC) is currently considering a proposed amendment to the FDIC's regulations to clarify that a State bank chartered as a limited liability company (LLC) would be considered "incorporated" for purposes of determining its eligibility for federal deposit insurance.⁵⁶

At least four states (Maine, Nevada, Texas, and Vermont) currently authorize their state-chartered banks to organize as a limited liability company (LLC). The principal benefit of the LLC structure is to provide owners with the opportunity to elect partnership treatment for Federal income tax purposes.

However, Treasury regulation § 301.7701-2(b)(5) currently treats a state chartered business entity conducting banking activities as a corporation for tax purposes if any of its deposits are insured under the Federal Deposit Insurance Act. As a corporation, such an entity is not eligible to elect partnership treatment for federal income tax purposes.

The conversion of an existing federally or state chartered financial institution to an LLC charter would generally be taxable under current law. Assets of the bank would be deemed distributed to the shareholders and then subsequently deemed re-contributed to the LLC. The difference between the fair market value of all assets (including goodwill) and the tax basis of the assets would be subject to a corporate level tax.

Effect of Current Law

State bank LLC charters are not currently used because of the uncertainty regarding the availability of FDIC deposit insurance. An additional hindrance to a state bank chartered as an LLC is the current Treasury regulation that would treat them as a corporation for Federal income tax purposes if FDIC deposit insurance were provided.

Banks unable to make the S Corporation election are subject to double taxation of income, once at the corporate level and again at the shareholder level when distributions are made. This double taxation makes it difficult for them to compete and to remain independent. LLC status, with corresponding partnership treatment for Federal income tax purposes, would help community banks overcome these problems.

⁵⁶ Part 303 Proposal Amendment - Insurance of State Banks Chartered as Limited Liability Companies

Relief Being Sought

Create a national limited liability company bank charter that is eligible for deposit insurance and able to elect partnership status for tax purposes.

Allow existing privately-held banks to convert their state or federal charters to a federal LLC charter in a tax-free transaction.⁵⁷ Create an LLC-level tax structure similar to the corporate built-in gains tax provisions under IRC § 1374 imposed upon C Corporations that convert to S Corporation status.

Projected Benefit of Relief

The formation of a national limited liability company (LLC) bank charter would help a number of community banks compete more effectively and remain independent. The LLC charter would allow certain closely held community banks to eliminate double taxation of corporate income, making them more competitive in the marketplace.

By ending the payment of taxes on both corporate income and the shareholders' income from the corporation, community banks increase the amount of resources available for community loans and other community investments.

The national bank LLC charter would be most attractive to community banks that are unable to make the S Corporation election due to one or more of a number of obstacles such as:

- Limitations on the number of shareholders,
- Limitations on the types of shareholders, or
- Reduced access to capital (e.g., inability to issue preferred stock).

LLC-chartered banks could continue to be relatively widely owned, reducing the likelihood that minority shareholders will need to be forced out of a community bank as they sometimes are to meet S Corporation criteria. Banks otherwise interested in converting to the LLC charter would not be forced to eliminate ineligible shareholders. An LLC-chartered bank will also find it easier to pass on ownership to subsequent generations without fear of adverse consequences related to too many owners.

To assure the vitality of small banks, legislation and regulations must ensure that community banks can grow. Community banks must have options for generating new sources of capital without setting themselves up to become takeover targets.

⁵⁷ Publicly traded partnerships are treated as corporations per IRC § 7704(a).

CHAPTER TWELVE

Exclude 50 Percent of Interest on New SBA Loans

Current Law

The Small Business Administration (SBA) 7(a) and 504 guaranteed loan programs play an important role for thousands of small businesses nationwide by providing an alternative means for accessing needed capital and credit.

The SBA can guaranty up to 85 percent of loans of \$150,000 and less, and up to 75 percent of loans above \$150,000 (generally up to a maximum guaranty amount of \$500,000) for applicants that meet credit and eligibility standards.⁵⁸ Interest rates are negotiated between the borrower and the lender but are subject to SBA maximums linked to the Prime Rate. Interest rates may be fixed or variable.⁵⁹

To offset taxpayer costs of SBA loan programs, the SBA charges lenders a guaranty and a servicing fee for each approved loan. The lender may then pass on these fees to the borrower. The fee amount of the fees is determined by the loan guaranty amount.⁶⁰

Processing fees, origination fees, application fees, points, brokerage fees, bonus points, and other fees that banks ordinarily charge to loan applicants are generally prohibited for SBA loans.

Effect of Current Law

Community banks use the 7(a) and 504 loan programs extensively to provide much-needed financing to thousands of small businesses nationwide. However, the rising origination costs are beginning to make SBA loans less attractive to community banks and to the borrowers.

⁵⁸ The SBA reduced the maximum guaranty amount from \$1,000,000 for loans originated on or after October 1, 2002 until the FY 2003 appropriation is passed into law.

⁵⁹ Fixed rate loans of \$50,000 or more must not exceed Prime Plus 2.25 percent if the maturity is less than 7 years, and Prime Plus 2.75 percent if the maturity is 7 years or more. For loans between \$25,000 and \$50,000, maximum rates must not exceed 3.25 percent if the maturity is less than 7 years, and 3.75 percent if the maturity is 7 years or more. For loans of \$25,000 or less, the maximum interest rate must not exceed Prime Plus 4.25 percent if the maturity is less than 7 years, and 4.75 percent, if the maturity is 7 years or more.

⁶⁰ Effective December 22, 2000, when the loan amount is \$150,000 or less, the guaranty fee will be 2 percent of the guaranteed portion. Lenders are permitted to retain 25 percent of this fee (50 basis points). This is only applicable to loans of \$150,000 or less. For loans more than \$150,000 but up to and including \$700,000, a 3 percent guaranty fee will be charged. For loans greater than \$700,000, a 3.5 percent guaranty fee will be charged. In addition, all loans will be subject to a fifty basis point (0.5%) annualized servicing fee, which is applied to the outstanding balance of SBA's guaranteed portion of the loan.

Relief Being Sought

Exclude from taxable income 50 percent of the interest income recognized on new SBA loans of \$250,000 or less originated after December 31, 2002.

Projected Benefit of Relief

Excluding 50 percent of the interest on SBA loans will encourage increased use of this important source of funding for small businesses. Community banks play a critical role in providing small business lending nationwide; they provide the ideal delivery system to facilitate SBA lending in communities throughout America. Given the current fragile state of our economy, this is the time to strengthen needed small business resources.

Providing needed capital resources to small businesses will help strengthen economic growth and foster much needed job creation. Thriving small businesses and a growing economy will, in turn, provide greater payroll and business income tax revenue to the federal government.

CHAPTER THIRTEEN

Expand New Markets Tax Credit

Current Law

The Community Renewal Tax Relief Act of 2000 established the new markets tax credit (NMTC) program.⁶¹ The purpose of this program is to attract new private capital to facilitate economic and community development in low- and moderate-income areas.⁶²

The NMTC program provides an incentive to investors (including individuals, businesses, and investment funds) in the form of a 39 percent tax credit over a seven-year period. Investors will be eligible to claim a tax credit equal to 5 percent for each of the first three years of an investment and 6 percent for each of the next four years.⁶³

To qualify for the NMTC, an investor must make a qualified equity investment in a qualified community development entity (CDE). The CDE can be any domestic corporation, partnership or LLC that has as its primary mission to serve and provide investment capital for low-income communities. To qualify as a CDE, the entity must also maintain accountability to such communities and must be certified by the Community Development Financial Institutions Fund of the U.S. Treasury Department.

The NMTC is expected to generate \$15 billion in new investments over the period 2002-2007. In addition to the \$2.5 billion of investments available in 2002, \$1.5 billion of eligible investments will be added in 2003, \$2.0 billion in each of 2004 and 2005, and \$3.5 billion in each of 2006 and 2007.⁶⁴

Effect of Current Law

The NMTC is flexible and can be used for traditional investments such as loans to businesses (both first mortgage and mezzanine debt), equity investments in businesses, investments in real estate, and the purchase of loans, as well as non-traditional investments such as community health centers, day care centers, and other community facilities.

The Treasury Department recently announced that applications for the initial allocation of credit authority totaled over \$25.8 billion in potential equity investments.⁶⁵ This amount was over ten times the \$2.5 billion in equity investments available for the first year of the program.

⁶¹ Enacted by § 1(a)(7) of the Consolidated Appropriations Act of 2001 (Public Law 106-554)

⁶² Low-income community is defined as any census tract with one of the following characteristics: 1) the poverty rate for the tract is at least 20 percent; 2) for tracts outside of metropolitan area, the median family income does not exceed 80% of the statewide median family income; or 3) for tracts inside a metropolitan area, the median family income does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income. IRC § 45D(e)(1)

⁶³ IRC § 45D(a)(2)

⁶⁴ IRC § 45D(f)

⁶⁵ The Community Development Financial Institutions (CDFI) Fund Press Release dated September 17, 2002.

Relief Being Sought

Expand the amount of new investments available under the NMTC program from \$12.5 billion to \$75 billion for the period 2003-2007.

Projected Benefit of Relief

The untapped economic potential of the markets in the inner cities and rural areas is significant. Expansion of the NMTC is one way to attract the capital needed to spur investment and to help investors discover business opportunities in these markets. The significant interest in the first round of competition for the allocation of the available equity investments indicates that investors are willing to participate in a much larger NMTC program that will provide our inner cities and rural areas with a much needed economic boost.

CHAPTER FOURTEEN

Establish Farm and Ranch Risk Management Accounts

Current Law

There is no provision under current law allowing the elective deferral of farm and ranch income.

Effect of Current Law

Factors beyond the control of farmers, such as weather or the effect of changes in supply and demand, can significantly influence the success of each year's crop. Earnings recognized in good years are generally subject to a higher tax rate than would apply in the less successful years. The ability of farmers to make payments on their loans is dependent on the success of each year's crop.

Many community banks make loans to farmers and ranchers to fund current operating costs and to fund the significant equipment costs necessary for efficient operations. Community banks also suffer from the cyclical nature of farming, as local farmers find it harder to make their loan payments in lean years, or to increase their savings.

Relief Being Sought

Allow farmers and ranchers to deduct contributions to a Farm and Ranch Risk Management (FARRM) account, to be held in an FDIC-insured financial institution, up to a maximum of 20 percent of taxable income related to their farming activity (as calculated prior to deducting the contribution to the FARRM account).

Tax the FARRM account as a grantor trust. Earnings would be required to be distributed currently, although amounts in the account could remain on deposit for five years. Distributions would first be made out of current year earnings; however, additional distributions of deposits would be considered as made from the oldest deposits.

The Secretary of Agriculture would provide a matching contribution on the amount deposited by the farmer or rancher in the account, based on a formula to be established by the Secretary.

Projected Benefit of Relief

The proposal will allow farmers and ranchers to more efficiently weather the economic storms that they face in connection with their business. FARRM accounts will provide an incentive for farmers and ranchers to save their earnings from good years so that they can be used during less successful periods.

FARRM accounts will provide farmers with an additional means of coping with the cyclical nature of their business. The FARRM accounts will increase the ability of farmers and ranchers to make loan payments more consistently during periods of economic hardship.

ICBA's COMMUNITY BANK TAX RELIEF AND SIMPLIFICATION OPTIONS

CHAPTER FIFTEEN

Increase Muni-Bond Bank Qualified Obligation Limits

Current Law

Under current law, banks are required to reduce their allowable deductions for interest expense allocable to tax-exempt obligations.⁶⁶ The Tax Equity and Responsibility Act of 1982 (TEFRA) disallowed 20 percent of the interest allocable to obligations acquired after December 31, 1982 but before August 8, 1986.⁶⁷ The Tax Reform Act of 1986 (TRA '86) added IRC § 265(b), which specifically targeted banks and increased the interest expense disallowance percentage to 100 percent for tax-exempt securities acquired after August 7, 1986.

TRA '86 created a special exception to the 100 percent disallowance rule, providing for treatment of certain qualified tax-exempt obligations (QTEO) acquired after August 7, 1986, as having been acquired on August 7, 1986 (thus still subject to the TEFRA 20 percent disallowance rule). Among other requirements, a tax-exempt obligation is qualified only if the issuer reasonably anticipates that it will not issue more than \$10 million of tax-exempt obligations during a calendar year.⁶⁸ In addition, an overall \$10 million limitation is imposed on the amount of tax-exempt obligations an issuer may designate as qualified.⁶⁹

Effect of Current Law

Inherent in the missions of all community banks is the commitment to serve their local communities. The reduced tax benefit of investing in tax-exempt securities has diminished the ability of community banks to invest in their local communities by holding local tax-exempt obligations. Tax-exempt obligations that fit into a community bank's business plan may or may not fit the special definitions needed to obtain the preferred QTEO status.

The limitations imposed on the issuance of qualified obligations have resulted in a limited supply of QTEOs. The limitation amount has not changed since it became part of the law in 1986. Fewer projects are eligible for the tax preferred treatment as a result of the effect inflation has had over the past 16 years.

Relief Being Sought

Increase the \$10 million expected annual issuance limitation to \$30 million for tax-exempt obligations and index future limitation levels for inflation.

⁶⁶ IRC § 291(e)(1)(B)

⁶⁷ Public Law 97-248

⁶⁸ IRC § 265(b)(3)(C)

⁶⁹ IRC § 265(b)(3)(D)

Projected Benefit of Relief

With a higher annual issuance limitation, more community organizations would qualify to issue “qualified” tax-exempt obligations that would be good investments for community banks and would further stimulate community bank investment in local tax-exempt, which in turn would significantly lower the cost of funds for the related projects. In some cases, larger projects could be undertaken by community organizations because lower interest rates could be offered while still attracting the interest of banks looking for investments. Community banks looking for bank-qualified investments would benefit from the increased pool of investments that would result.

CHAPTER SIXTEEN

Simplify Accrual of Interest on Non-Performing Loans

Current Law

Differences in regulatory and tax accounting provisions for interest on loans create complexity and cost for community banks. Federal bank regulators require community banks to stop accruing interest on loans once payments have not been received for a significant number of days. For financial and regulatory accounting purposes, loans are generally placed in non-accrual status when payments have not been received after a predetermined number of days (e.g., 90 days). In some cases, a loan may also be placed on non-accrual status as a result of a specific event (such as notice that a debtor is in bankruptcy).

The Internal Revenue Service (IRS) requires significantly more documentation to justify the non-accrual of interest income. Banks are currently required to continue accruing interest on a non-performing loan either until it can demonstrate, using the principles set out in Revenue Ruling 80-361, that the interest is uncollectible or until the loan has been charged off. The IRS position in Revenue Ruling 80-361 is generally that interest income must be included in gross income when all of the events have occurred that fix the receiver's right to the income and the income amount can be determined with reasonable accuracy. If a payment is not reasonably expected to be received; a fixed right does not exist.

Effect of Current Law

Community banks find it extremely burdensome to substantiate the non-accrual of interest income on a loan-by-loan basis. Since the regulatory threshold is based primarily on the number of days the loan is delinquent, loan files may not contain appropriate information to provide the basis for non-accrual as required by the IRS. The inconsistent treatment by two federal agencies results in additional administrative costs for community banks.

Relief Being Sought

Bring into conformity tax and regulatory treatment of interest income related to non-accrual status loans by eliminating the accrual of interest income for federal income tax purposes when the bank regulators require non-accrual treatment for regulatory capital purposes.

Projected Benefit of Relief

Differences in accounting methods for tax and regulatory purposes are confusing to community banks and result in costly efforts at compliance, diverting funds from business applications to administrative expenses. Consistent accounting treatment by the IRS and the federal banking regulators of interest income generated on loans will help community banks better direct resources to the communities they are chartered to serve.

ICBA's COMMUNITY BANK TAX RELIEF AND SIMPLIFICATION OPTIONS

ICBA's COMMUNITY BANK TAX RELIEF AND SIMPLIFICATION OPTIONS

Appendix

**Update of Actions Taken on ICBA's Previous Tax Study Recommendations
(Released in 1999)**

<u>IBAA Tax Relief Recommendations</u>	<u>Description of Changes Made</u>	<u>Agent for making change</u>
Estate and Gift Tax Reform <ul style="list-style-type: none"> • Repeal estate and gift taxes. • Reduce estate tax rates. • Accelerate phase-in of the \$1 million estate exemption amount • Increase size of the estate exemption amount to \$2 million. 	Estate tax repealed for 2010; Tax rates reduced through 2009; exemption has phased-in increases to \$5 million through 2009. All provisions scheduled for reinstatement after 2010.	The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGRRTA)
S Corporation reform <ul style="list-style-type: none"> • Limit top tax rate applied to S Corporation income to C Corporation rate. • Allow IRAs as eligible S corporation shareholders. • Exempt sale of community bank stock by an IRA to the IRA owner from being treated as a prohibited transaction. • Allow community bank S Corporations to issue certain preferred stock. • Disregard certain director qualifying stock for purposes of the S Corporation and QSSS elections. • Increase maximum number of allowable S Corporation shareholders to 150. • Make bank income not subject to the passive investment income tax. 	Top individual rate lowered to equal top corporate rate phased in fully by 2005. Legislation Introduced	EGRRTA. Various 107 th Congress S. 936, HR 1263, S. 1201, HR 2576
Increase net operating loss carryback period from two to five years for community banks.	Change made for all C corps for 2001 and 2002 only.	The Job Creation and Worker Assistance Act of 2002
Reduce the tax rate on the first \$1 million of taxable income for "qualified community banks" to 15 percent.	Legislation Introduced	Various 107 th Congress S. 605 HR 1220
Expand use of the cash method of accounting by increasing the \$5 million average gross receipts threshold to \$20 million for community banks.	Procedure added to allow non-C corps to automatically change if gross receipts are \$10 million or less.	Rev. Procedure 2002-28
Apply U.S. Court of Appeals for the Eighth Circuit's decision regarding treatment of short-term loans (IRC §1281) to all community banks using the cash method.	Done.	IRS acquiesced
Reduce the individual maximum tax rate applicable to net long-term capital gains from the current 20 percent to 14 percent.	Legislation Introduced	Various
Remove "use it or lose it" requirements from flexible spending accounts.	Legislation Proposed	FY 2002, 2003 Federal Budgets
Clarify the deductibility of interest payments made in a trust-preferred security arrangement, which will allow community banks to raise the capital needed to serve their communities without sacrificing control of their local community bank.	IRS clarified position that interest should be deductible if structured in appropriate manner.	Technical Advice Memorandum (TAM 199910046)

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