VIA ELECTRONIC MAIL

April 30, 2018

Ms. Edith Brashares
Ms. Audrey Ellis
Mr. Stephen LaGarde
Mr. Krishna Vallabhaneni
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

RE: Section 199A of the Tax Cuts and Jobs Act (TCJA) and Treatment of S Corporation Banks

Dear Ms. Brashares, Ms. Ellis, Mr. LaGarde and Mr. Vallabhaneni:

On behalf of America's banks operating or considering operating under Subchapter S of the Internal Revenue Code (IRC), we thank you again for meeting with us on February 27th. Our organizations (the American Bankers Association[1], the Independent Community Bankers of America[2] and the Subchapter S Bank Association[3]) collectively represent most of the banks in the United States; including those banks that have elected Subchapter S (S Banks).

As discussed in greater detail herein, the application of the Section 199A deduction to S Banks should be consistent with the language of the statute and the overall intention of Congress to help pass-through businesses remain competitive in the context of a corporate rate reduction.[4] Moreover, S Banks are a critical source of capital for the small business community, and their eligibility for the pass-through deduction is consistent with the broader goal of Section 199A to help small businesses. Because S Banks are highly regulated and limited in their activities, a rule clarifying the availability of the Section 199A to S banks would be narrow and limited in application.

As you engage in the challenging process of providing guidance on the application of Section 199A, we urge you craft it with a view toward ensuring the success of the new law by providing tax relief that will stimulate new investment and economic and jobs growth while guarding against abuse. To achieve these objectives, we respectfully urge you to consider the following:

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[1] The American Bankers Association is the voice of the nation's $1 trillion banking industry, which is comprised of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.

[2] The Independent Community Bankers of America®, the nation's voice for nearly 5,700 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services. With approximately 52,000 locations nationwide, community banks employ 760,000 Americans, hold $4.9 trillion in assets, $3.9 trillion in deposits, and $3.3 trillion in loans to consumers, small businesses, and the agricultural community.

[3] Subchapter S Bank Association members share a common interest in their dedication to protecting and enhancing shareholder value through subchapter S treatment. Because of this unique link between its members, the Association is able to represent the interests of its members as a whole without regard to the size, location, charter type or market coverage of the individual members.

[4] Unless otherwise provided herein, all Section references are to the Internal Revenue Code of 1986, as amended.

- Congress clearly intended banks[5] to be excluded from the definition of "specified service trade or business" and as such, S Banks are eligible for the deduction created by Section 199A. Guidance should clarify that a "specified service trade or business" does not include banking.
- Read in context, "banking" is not a "specified service trade or business" and revenues derived from banking are "qualified business income." If Congress wanted banks to be excluded from the deduction, the statute would have been drafted differently.
- Banks are highly regulated and their permissible activities are clearly defined by statute and regulation. Thus, all of their permissible activities should be eligible for the deduction created by Section 199A.
- A "banking trade or business" could be appropriately defined as a trade or business conducted in an entity (i) that is engaged in activities that qualify it as a bank as defined in section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841) or (ii) that is engaged solely in activities permissible under section 4 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. §1843), and regulations issued thereunder, and is regulated by the Board of Governors of the Federal Reserve System.
- Certain references to ancillary activities in the statute (such as "dealing in securities") should be read narrowly, consistent with congressional intent, to capture only those entities that were intended to be excluded from the 199A benefits.

Background on Banks Operating as Pass-Through Entities and Serving Their Communities

There are 5,670 banks in the U.S as of December 31, 2017. Of that number, approximately 2,000 have elected Subchapter S and of the S banks, approximately 96% have total assets of $1B or less. Nearly two thirds of those banks have total assets less than $200M and over 200 have total assets less than $50M. These banks play a critical role in communities across the country. They operate as and in support of small businesses. Collectively, community banks, both in S and C status, are estimated to be responsible for over 50% of all small business loans and over 70% of all agriculture bank loans.

Banks are Highly Regulated Entities

All banks operate under either a state or a federal charter. State chartered banks are regulated at the state level and federally chartered banks are regulated by the Comptroller of the Currency. In addition, at the federal level, state chartered non-member (that is, not members of the Federal Reserve System) banks are regulated by the Federal Deposit Insurance Corporation (FDIC), and state member banks are regulated by the Federal Reserve. The FDIC, as provider of federal deposit insurance, has back-up regulatory authority with respect to all FDIC insured banks it does not regulate directly. All bank holding companies are regulated by the Federal Reserve. As discussed further below, the activities of banks and bank holding companies are carefully circumscribed: banks by their charters and by state and/or federal law; and bank holding companies by federal law. These limitations on the activities of banks and bank holding companies are enforced by their regulators, including through examinations on a regular basis.

Subchapter S banks are typically organized with a holding company that makes the S election. The subsidiary bank makes an election to be a Qualified Subchapter S Subsidiary (Q Sub). Generally, the holding company and the bank are treated as a single taxpayer, similar to the treatment of a single

[5] Wherever we refer to "banks" in this letter, we are also referring to federal and state savings associations and savings banks.

member limited liability corporation (also known as an "LLC"). Certain tax rules unique to banks also apply to S banks. A Q Sub bank or its holding company may have subsidiaries which engage in banking activities.

All of the activities of a bank or bank holding company are regulated activities; regardless of whether the activities are in a separate subsidiary or conducted directly by the bank or its holding company.

Eligibility of Banking Income for the Section 199A Deduction

Section 199A provides that an individual taxpayer generally can deduct 20 percent of qualified business income from a partnership, S corporation or sole proprietorship. Qualified business income is determined for each qualified trade or business of the taxpayer. A qualified trade or business generally means any trade or business other than a specified service trade or business and other than the trade or business of being an employee.

A specified service trade or business is defined in Sections 199A(d)(2)(A) and (B). Section 199A(d)(2)(A) cross references Section 1202(e)(3)(A) and generally provides the businesses enumerated in that section, including "financial services," as specified service trades or businesses. Financial services are, however, clearly something other than banking, which is a separate business activity listed in Section 1202(e)(3)(B). The list in Section 1202(e)(3)(B) refers to "any *banking*, insurance, financing, leasing, investing or similar business." Had Congress meant to treat banking as a specified service trade or business, drafters simply would have extended the cross reference to Section 1202(e)(3)(B).

While we believe this analysis alone should be conclusive, there have been questions about the application of the second part of the "specified service trade or business" definition in Section 199A(d)(2)(B). Section 199A(d)(2)(B) defines specified service trades or businesses to include a trade or business "which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2), partnership interests, or commodities (as defined in section 475(e)(2))…." "Investing and investment management as well as trading or dealing in securities" are traditional activities that banks are permitted to conduct.

Liquidity and diversification of the loan portfolio are critical to bank safety and soundness. Therefore, community banks routinely sell loans and participations in loans. For example, a community bank that makes a significant amount of mortgage loans will sell some of them to provide liquidity and to avoid an over-concentration in that business. While such activities, in certain cases, may technically involve dealing in securities within the meaning of Section 475(c)(1), we do not believe the definition in Section 199A(d)(2)(B) includes banks in such cases. The phrase "involves the performance of services," which appears in Section 1202(e)(3)(A) and also in Section 199A(d)(2)(B), is properly understood to mean rendering services to unrelated third parties. Otherwise, any business that employs a general counsel or maintains an accounting department, for example, would be a specified service trade or business within the meaning of Section 199A(d)(2)(A), because the business "involves the performance of services" in the fields of law or accounting. Properly understood, the definition in Section 199A(d)(2)(A) applies to law and accounting firms, the businesses of which involve the performance of legal and accounting services for third parties, but not to a widget maker that employs an in-house lawyer or accountant. Similarly, the definition in Section 199A(d)(2)(B) should not apply to a bank that sells its loans or participations in loans. Making loans and the sale of a bank's loans and participations in loans, just like taking deposits, is a long-standing, fundamental part of the business of banking and is significantly

regulated by governmental agencies as one business line, involving safe and sound lending practices; not multiple lines.

There have been some suggestions, for tax purposes, that a bank may have to split its business into qualified and non-qualified activities. We believe that the core business of banking includes well understood and integrated activities regulated as banking activities. These activities should not be split up. Any such effort would not be consistent with our understanding of the intent of policy makers. Moreover, any artificial separation of these activities would impose a significant and unnecessary administrative burden on banks, complicate tax administration, and ultimately raise costs for borrowers, including small businesses, undermining the objective of the tax law changes.

To address any potential ambiguity in the interpretation of Section 199A, we suggest that future Treasury guidance should clarify that income from a "banking trade or business" is qualified income for purpose of the Section 199A deduction. Properly defined, a "banking trade or business" will include only the limited set of activities in which regulated banks and bank holding companies are permitted to engage, and the clarification does not run the risk of becoming an unintended loophole.

Banking Regulations Provide a Natural Governor on the Activities of Banks

Banks and bank holding companies are regulated entities with significant capital, employees, technology, premises, processes, etc. that represent an integrated business. The regulation of banks and bank holding companies is significant and includes reviews of compensation practices. While it is certainly true that manager-shareholders of banks may have an important role in leading the success of an individual bank, those individuals are only part of the business activities of the organization.

Banks and bank holding companies may only engage in activities that are considered permissible under banking law. Examples of such activities include trust and fiduciary services, insurance brokerage, originating and selling mortgages, assisting customers in retirement planning, safe deposit and safe-keeping of customer assets, and other related financial service activities. These activities may be performed in a bank holding company, a bank or in one of more subsidiaries.

It is also important to note that Congress has long recognized that banks may perform certain brokerage activities without being considered to be a broker under federal securities law, because those activities are part of traditional banking activities.

In recent surveys conducted by ICBA and the S Bank association, S banks indicated that they provide a variety of services in addition to accepting deposits and lending. The level of revenue and income generated by these activities is dependent on the individual bank. For the vast majority of banks, these activities represent a relatively small portion of the activities of the bank.

All of these permissible activities are part of an integrated business activity: banking. In fact, the services in question are vital aspects that are often required to support the safety and soundness of a banking institution.

Congressional Intent

During the development and drafting of the TCJA legislation, we had extensive discussions with Congressional staff and various members in both the House and Senate. In the course of these discussions, we were assured repeatedly that S Banks would qualify for the lower tax rate for pass-through businesses provided by Section 199A. Since the passage of the TCJA, we have met with staff of the tax-writing committees and various Members who have confirmed the intent of policy makers with respect to S banks.

Potential Definitional Guidance in Regulations and Next Steps

It is clear from the statute that banking is a qualified trade or business. It is our position that the definition of banking should include activities that fall within the scope of well understood permissible, regulated banking activities. The definition should include activities that are conducted either inside a bank legal entity, its holding company, or their regulated subsidiaries. As noted elsewhere, a regulated banking organization operates under very specific rules as to what is permissible.

As you consider providing guidance in this area for banks, we have been evaluating definitions that may be helpful. One approach, which we have proposed above, would be to reference banking laws that list and define specific activities, as follows:

> A qualified trade or business includes those conducted in an entity (i) that is engaged in activities that qualify it as a bank as defined in section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841) or (ii) that is engaged solely in activities permissible under section 4 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. §1843), and regulations issued thereunder, and is regulated by the Board of Governors of the Federal Reserve System.

While this definition references “an entity,” it in fact ties to the activities of a trade or business; that is, banking. There are other possibilities as to definitions of banking activities found elsewhere in the Internal Revenue Code that we continue to explore and can discuss with you as we continue to engage on these matters.

We will schedule a follow up meeting with you in the near future to review these matters and discuss potential approaches to guidance.

We look forward to continuing to work with you and would be glad to assist to any way that would be helpful. As you continue your work in this area, please do not hesitate to contact us. Our contact information is included below.

Sincerely,

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