American Bankers Association
Building Success. Together.

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Senator Orrin G. Hatch
United States Senate
Chairman, Senate Committee on Finance
104 Hart Office Building
Washington, D.C. 20510

Dear Chairman Hatch,

On behalf of America's banking industry, the American Bankers Association[1] (ABA) thanks you and the Senate Finance Committee for your solicitation of input from the stakeholders in tax reform. Tax reform is badly needed to encourage economic growth. We applaud the Committee for taking on this difficult, but critically important task.

Overview

ABA strongly supports tax reform that boosts economic growth and creates jobs by lowering tax rates for everyone and broadening the tax base in a manner that avoids picking winners and losers. A stronger economy would be good for the country, our members, and their customers. ABA is eager to work with the Committee to craft a plan that meets these objectives.

Tax reform is a complex endeavor and getting the details right is critical to avoid unintentional harm. Our current Internal Revenue Code (Code) is extremely complex and difficult to administer for all taxpayers. Simplification must be part of the initiative. We commend the Committee for taking the time to get those details right.

From the banking industry's perspective, the most important details for Congress to focus on are:

- Significant reductions in tax rates for all businesses;
- Careful review of policies that provide incentives for saving and disincentives for borrowing;
- Avoiding industry-specific taxes;
- Ending the tax preferences for credit unions and the Farm Credit System; and
- Carefully crafting transition rules.

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend over $9 trillion in loans.

Significant Reductions in Tax Rates for All Businesses

It is well established that the United States has one of the highest rate structures for business taxation. This structure has important implications for the ability of businesses of all sizes to grow and compete. The structure also has significant international implications, including placement of capital and jobs and the potential for base erosion.

As the Committee considers tax reform, we urge that the lowest possible business tax rates be adopted on a permanent basis. While certainly not the sole indicator of successful tax reform, we believe that from a policy perspective, a low rate sends a clear pro-growth message that will encourage investment and job creation.

Lower rates should apply to all businesses, including C corporations and pass-throughs. As you know, there is a large portion of business income that is taxed directly at the ownership level. A significant number of our member banks operate in pass-through form as do many business customers of banks. This is a complex and critical area to be addressed.

Tradeoffs are necessary within tax reform. ABA will consider the impact of tax reform as an entire package and will encourage our membership to do the same. Nevertheless, without a significant reduction in rates, many benefits of a comprehensive plan will not be realized.

Review of Policies on Savings and Debt

ABA supports tax policies that encourage savings of all kinds. Lower rates for all taxpayers and all economic activity will result in additional after-tax income being available for savings and investment. More savings will increase investment in the economy, which will lead to more jobs and higher wages for American workers. More savings will increase the financial security of families.

An issue of critical importance to the banking industry is the tax treatment of debt and how it impacts investment in the economy. Interest expense deductibility, for example, is a key consideration in investment decisions and economic activity. We strongly urge the Committee to carefully consider the broader economic impact of any potential proposal that might alter interest expense deductibility.

Interest expenses are an ordinary and necessary cost of business that are incurred to finance operations, invest in new capacity or to fund new businesses. Economic theory suggests that when interest income is taxable to lenders, which it generally is, it is proper to allow a deduction for interest expense to borrowers. This way, taxes do not interfere in lending and borrowing decisions and the Code remains neutral toward debt-financed investment.

If tax reform reduces or eliminates the deduction, it will raise the cost of debt-financed investment, which, in the absence of other economic factors, will reduce investment. Even with lower tax rates, a broader base and other pro-growth policies, tax reform could end up reducing economic growth if investment declines enough because of the curtailing of interest deductibility.

For banks' customers, those that are highly leveraged will likely feel the largest impact from reducing the deductibility of interest. Small business, agriculture and commercial real estate are examples of industries that would likely be hardest hit. Many of these customers have limited access to capital markets or other alternatives to debt. Banks that service such businesses and their communities will be impacted. Examples of the potential impacts include unintended consequences on the value of collateral and the after tax cash flows of customers that gain limited benefits from expensing provisions or lower tax rates. This could severely impact economic growth and employment in such communities. Our members' may also be directly affected by potential decreases in loan demand.

For banks as taxpayers, interest paid is a cost for our inputs, just as steel is for the production of cars. This is why banks need to be allowed to continue to deduct interest under the Code. Under major proposals today, which would keep net interest expense deductible, banks will mostly continue paying taxes as they do under the current system. The larger concern for the banking industry is how changes in interest deductibility impact our customers and therefore, economic growth.

Avoid Industry Specific Taxes

Tax reform should level the playing field for all businesses. Industry-specific taxes are bad policy and would be contrary to this goal. They would be punitive and unfair to the industries targeted. Industry-specific taxes would also slow economic growth, which would hurt the central purpose of tax reform. Again, the tax Code should not pick winners and losers.

Eliminate the Special Tax Treatment of Credit Unions and the Farm Credit System

Tax reform should broaden the tax base to improve economic efficiency. For broadening to be effective, it should include a comprehensive review of our entire tax code. Tax reform should stop the Code from picking winners and losers, which means that businesses offering similar services should be treated equally under the Code. As such, the Committee should review and eliminate unnecessary tax preferences for credit unions and the Farm Credit System.

Credit unions have grown rapidly in recent years with the largest of them becoming virtually indistinguishable from local banks. The original statutory purpose of the credit union tax provision was predicated upon providing credit to "people of modest means" within a narrow common bond. Many credit unions now offer services to anyone, engage in complex commercial lending activities, and provide an array of financial services comparable to mainstream financial players. Often, these credit unions dwarf the size of local community banks while competing directly with banks for loans and deposits.

The Farm Credit System (FCS) also has an imbalanced tax advantage, affecting particularly banks that operate in the agricultural sector. Such banks are fully taxable. FCS institutions are exempt from income tax on profits from farm real estate lending, giving these institutions an unfair competitive advantage. In recent years, the FCS has expanded far beyond its charter boundaries of serving young, beginning and small famers in rural areas, and further exploited its tax-advantage to support the growth of its institutions.

Transition Rules

The transition from the current tax system to a new, improved system is a very important component of tax reform. Done properly, it will smooth the switch to the new system and growth will not be imperiled. If transition is done ineffectively, it could hurt economic growth and create harmful negative unintended consequences. This was the case in 1986, when the transition rules for tax reform were inadequate and a contributing factor in the Savings and Loan crisis.

We urge the Committee to provide adequate time in the transition rules for markets and taxpayers' balance sheets to adjust. It should pay particular attention to the impacts on any potential changes for certain tax credits and other investments that have historically received tax incentives for public policy reasons. Examples include the Low-income House Tax Credit, the New Markets Tax Credit, and municipal bonds. Banks have been significant supporters of communities through involvement in these programs.

International Taxation

For banks with international operations, changes to the tax treatment of foreign subsidiaries and branches will be a keen area of interest. The Committee should pay special attention to drafting policies pertaining to this difficult part of tax law, especially how those policies affect financial institutions and their products.

Conclusion

Tax reform would be tremendously beneficial to the economy, banks, and most importantly, the American people. ABA stands ready to work with the Committee to create a tax reform bill that frees the economy to grow stronger and create more jobs, while avoiding the potential pitfalls laid out above. We stand ready to assist in any way we can as you take on this vitally important initiative.

Sincerely,

Rob Nichols