



POWELL, GOLDSTEIN, FRAZER & MURPHY LLP

MEMORANDUM

To: 2001 Forum for Regional and Community Bank Examiners (Dallas, Texas)
Board of Governors of the Federal Reserve System

Re: S-Corporation Considerations

From: Financial Institutions Group
Powell, Goldstein, Frazer & Murphy LLP

Date: March 20, 2001

I. Why an S-Corporation?

- A. History.** About five years have passed since Congress authorized banks and bank holding companies to utilize the benefits of S-Corporation tax status. The first beneficiaries were small, family-owned banks with limited numbers of shareholders, particularly in the Midwest and Texas. As the potentially enormous tax savings have become evident, however, the number of existing shareholders is becoming less of an impediment to S-Corporation elections for many larger community banks and community bank holding companies.
- B. Primary Benefit.** The primary benefit of S-Corporation status is that there is no corporate level federal income tax (and, in many states, like Georgia, no state income tax) on the net income of an S-Corporation. The earnings are taxed to the shareholders, and the S-Corporation, in turn, makes a distribution to its shareholders in an amount equal to the taxes to be paid. The regular dividend paid by the S-Corporation to its shareholders thus becomes tax-free, and any undistributed earnings are added to each shareholder's basis in his or her stock. This reduces any taxes if the stock is ultimately sold.
- C. Sample Calculation.** We have attached a sample calculation of the pro forma annual tax savings that generally could be available as a result of converting to an S-Corporation. The savings (both actual dollars and as a percentage of earnings) are often dramatic. See Exhibit A.
- D. Enhancing Returns to Shareholders.** For community banks, an S-Corporation has the immediate benefit of significantly enhancing the returns to shareholders. In a time of tightening net interest margins and competitive pressures, this means that a shareholder's investment in S-Corporation community bank stock has been significantly enhanced and, as a corollary, the need to sell the bank for enhanced returns is significantly diminished. In addition, community banks that



have more than adequate, if not excessive, capital can pass through a much greater percentage of their earnings to their shareholders – in essence, tax-free – enhancing both their internal return on equity and long-term shareholder satisfaction.

II. Shareholder Qualifications

- A. Eligible Shareholders.** In general, S-Corporation requirements preclude corporations, partnerships, foreign shareholders and some trusts from qualifying as S-Corporation shareholders. Stock owned by an IRA, however, can be purchased by the beneficiary of the IRA in order to satisfy the eligible shareholder rules, but an exemption letter from the Department of Labor is required.
- B. 75 Shareholders.** The biggest technical issue precluding use of S-Corporations by many community banks is that S-Corporations can have a maximum of only 75 shareholders. (Legislation is pending in Congress to increase that number to 150.) However, there are readily available corporate techniques that permit the removal of excess shareholders at fair value.
- C. Eliminating Shareholders.** The first task is to determine the appropriate or desired number of shareholders, followed by a determination of the cost of eliminating excess shareholders, followed in turn by an analysis of the cultural impact of eliminating those shareholders.
- 1. Determining the appropriate number of shareholders.** While there are mechanical approaches that can be taken to reduce the number of shareholders in order to qualify for S-Corporation status (for example, a ranking by number of shares), a good argument can be made that the bank should instead deliberately determine which shareholders will be invited to participate in the new S-Corporation. Some banks have eliminated shareholders based on the small size of their holdings, their lack of support for the institution in the market, where they live, their involvement with other financial institutions, whether they do business with the bank, etc. Employee shareholders are usually allowed to remain, and optionholders usually have their options converted to options in the new S-Corporation. All of these are legitimate business factors to be considered.
 - 2. Cost.** The Board of Directors must approve any transaction that eliminates shareholders, keeping in mind that the Board has a fiduciary obligation to all shareholders. Accordingly, the price paid to those shareholders who are not invited to participate as S-Corporation shareholders, and thus are cashed out, has to be “fair value.”



- If a shareholder disagrees with the fair value assessment, the shareholder will be entitled to exercise dissenters' rights for a judicial determination of fair value.
 - While the price at which the shares have been trading in an arm's-length manner is evidence of fair value, it is not conclusive, and the Board of Directors would clearly want to obtain either an appraisal or a fairness opinion. Most appraisals come in at prices at or below the present price-to-book and price-to-earnings ratios at which bank shares usually trade.
3. **Impact on Cashed-Out Shareholders, Etc.** In all of the reverse stock split, going-private, or other S-Corporation reorganizations in which we have been involved, we are not aware of any shareholder who received cash ever having expressed pleasure at the price, at being cashed out, or otherwise. Even so, the shareholders being cashed out generally vote 2:1 in favor of the transaction, and seldom do the number of shares held by dissenters equal or exceed 10% of all outstanding shares. Thus, the "bark" is generally worse than the "bite."

Interestingly, most dissenters who did business with the institution before the transaction continue to do business with the institution after the transaction. In addition, some banks have utilized special promotions to try to preserve deposits, etc. Occasionally, the rhetoric is loud and hostile, but in the final analysis, generally the exercise of dissenters' rights is the only permissible remedy in the absence of fraud. For most small shareholders, the potential cost and hassle of going through a dissenter's proceeding does not justify the potential for a higher price.

III. Impact on Employees and Options

Because of the advantageous tax treatment accorded to dividends (or distributions) following an S-Corporation election, when dividends are being paid, employees tend to exercise options early. At the present time, the most outstanding tax benefit for employees is to own shares in an S-Corporation through an employee stock ownership plan or other eligible tax-qualified retirement plan. An S-Corporation routinely distributes a portion of its earnings to shareholders sufficient to pay their income tax. Currently, however, an employee stock ownership plan is not taxed on any portion of a distribution made to it by the S-Corporation. Accordingly, shares held in an employee stock ownership plan accrete value much faster than shares owned individually.



IV. Impact on Dividend Policy and Capital

Generally, banks increase the amount of cash distributions made to shareholders following an S-Corporation election, both to ensure the payment of taxes by the S-Corporation shareholders and, if applicable, to accelerate the distribution of excess earnings to shareholders. Earnings retained in the bank increase the shareholders' bases in their stock.

Most banks today are adequately capitalized, but their ability to remain adequately capitalized is a function of comparing their internal growth with their return on equity minus dividends. If a bank is expected to grow at a pace equal to or faster than its market, it will want to compare its need to retain earnings or to raise additional capital with its growth plans for the future. While a primary benefit of an S-Corporation election is the shareholders' receipt of excess cash in a tax-advantaged manner, there are significant benefits to shareholders in S-Corporations who receive no distributions other than the distributions necessary to pay taxes, since the excess retained earnings add to the shareholders' bases in their stock.

On the other hand, if the shareholders were by and large elderly and likely to receive a step-up in basis on death, then an S-Corporation structure might not be as advantageous. However, if the principals of the bank contemplate sale as a potential exit strategy within the foreseeable future (five to ten years), then there still may be benefits to an S-Corporation election even in the absence of current dividends (other than the tax distributions).

V. Bad Debt Reserve

Under the enabling legislation permitting banks and bank holding companies to qualify for an S-Corporation election, banks must recapture any excess bad debt reserve into the income statement, which means the excess bad debt reserve is taxed. Excess bad debt reserve is tax bad debt reserve minus book bad debt reserve. Under the applicable rules, the total recapture may be spread over five years.

VI. Built-in Gains Taxation

At the time of conversion, the bank will need to determine (by appraisal or otherwise) the fair market value of its assets. Despite the general rule that an S-Corporation is not subject to corporate-level federal income tax, in the future the bank could be subject to corporate-level federal income tax on the net appreciation, if any, of its assets determined as of the effective date of the Subchapter S election. Corporate-level federal income tax (at the highest corporate rate, currently 35%) arises if any of the bank's assets that have appreciated as of the date of the Subchapter S election are disposed of within ten calendar



years after the effective date of the election. The tax is imposed only on the net appreciation of the disposed assets.

For example, if the fair market value of the bank's assets were \$250 million and the bases of its assets were \$200 million, the potential built-in gain would be \$50 million. Assume that \$10 million of the gain is attributable to loans and other investments and the remaining \$40 million is attributable to goodwill and going concern value. If the loans and other investments were collected, sold, exchanged, or otherwise disposed of during the ten-year period, the bank would pay (based upon current rates) \$3.5 million in corporate-level federal income tax during those years in which the dispositions occur. The tax would reduce the amount of the bank's income that would be taxable to its shareholders. If the bank did not sell, exchange, or otherwise dispose of its assets (including its goodwill and going concern value) until after the ten-year period had passed, the appreciation with respect to the goodwill and going concern value would not be subject to corporate-level federal income tax.

On the other hand, if the bank were sold in a transaction where all of the bank's shareholders dispose of all of their stock in a taxable sale, rather than the bank selling its assets in a taxable sale, the built-in gains tax would not be triggered. Also, if the bank were acquired by means of a "tax-free" reorganization, the built-in gains tax would not be triggered.

Finally, if the acquiring company were another S-Corporation, the built-in gains and the ten-year holding period would carry over to the acquiring S-Corporation, and corporate level taxation would be triggered if the acquired S-Corporation's assets were disposed of by the acquiring S-Corporation within the original ten-year period.

VII. Net Operating Losses

A C-Corporation that possesses net operating loss carryforwards is not permitted to carry over and use the NOL carryforwards in a year in which the corporation is taxed as an S-Corporation. Instead, the NOL carryforwards become suspended and cannot be used until the corporation converts back to a C-Corporation. Upon conversion back to a C-Corporation, the NOL carryforwards will become available to shelter the taxable income of the C-Corporation. However, the years during which the corporation is "taxed" as an S-Corporation will count in determining whether the carryforward period for the NOLs has expired.

VIII. Passive Loss Limitation Rules

Taxable losses generated while the corporation is an S-Corporation will pass through and may be used by the S-Corporation's shareholders to offset their other personal taxable income, subject to the passive loss limitation rules and the rules regarding basis.



The passive loss limitation rules will limit the ability of an S-Corporation shareholder to offset other taxable income of the shareholder, unless the shareholder is considered to materially participate in the S-Corporation's trade or business. If the passive loss limitation rules apply, the S-Corporation shareholder generally can offset losses passing through from the S-Corporation only against other passive income taxable to the shareholder.

The basis rules provide that losses passing through to an S-Corporation shareholder may be used to offset other taxable income of the shareholder only to the extent of the shareholder's basis in his or her S-Corporation stock. Losses in excess of basis are suspended and generally may be carried forward indefinitely until such time as the shareholder has adequate basis in his or her S-Corporation stock. Generally, a shareholder's basis increases through additional investment in the S-Corporation or from the recognition of income passing through to the shareholder from the S-Corporation.

IX. Impact on Future Transactions

Since its shares are not publicly traded, as a practical matter, an S-Corporation may be restricted in its ability to acquire other institutions for stock. Cash acquisitions, however, are not affected.

X. Shareholders' Agreements/Liquidity

In connection with the S-Corporation election, each bank shareholder must sign an agreement to assure that subsequent stock transfers do not undermine the S-Corporation election. The agreement generally permits sales:

- Only following a right of first refusal by the bank;
- Only to a shareholder who is eligible;
- Only to a shareholder who signs a similar shareholders' agreement; and
- Only if the sale does not result in an increase in the number of shareholders.

Generally, the agreement will also provide that, upon death, shares owned by a shareholder may be distributed to one direct lineal descendant (i.e., the distribution will not result in an increase in the number of shareholders).

XI. Classes of Stock

S-Corporations may have only one class of stock, although they may issue both voting and non-voting common stock. The ability to utilize non-voting common stock should be considered as part of the new structure to facilitate estate planning.



XII. Potential Regulatory Issues

There remains some regulatory concern about a bank's ability to pay dividends if the bank has a bad year or generates regulatory criticism. While not entirely free from doubt, regulators have generally indicated that a dividend probably would be permitted in the amount that the bank would otherwise have paid in taxes.

XIII. Fringe Benefit Issues

As a general rule, each 2% shareholder of an S-Corporation is treated as a partner for federal tax purposes. Because of this, the value of fringe benefits paid by the S-Corporation to the 2% shareholder is generally included in the shareholder's income. This results in the taxation of normally tax-free fringe benefits, such as employer-paid health insurance premiums, group term life insurance premiums, meals and lodging, and various cafeteria benefit plans. There are also usually ways to structure compensation packages to mitigate these issues.

XIV. Passive Investment Income Issues

An S-Corporation does have a corporate level tax on the amount of any "passive investment income" that exceeds 25% of the gross receipts of the S-Corporation. "Passive investment income" is defined as *gross receipts derived from royalties, rents, dividends, annuities, and sales or exchanges of stock and securities*. If an S-Corporation exceeds this 25% limitation for three consecutive years, the S-Corporation election will be terminated. Generally, this should not be an issue for most banks with adequate loan demand and adequate loan-to-deposit ratios. The IRS has specifically held that interest from real estate mortgage investment conduits (REMICS), Federal Reserve Bank stock, Federal Home Loan Bank stock, and various pledged assets or investment assets held by a bank to satisfy reasonable liquidity needs, will not be deemed passive investment income. As a result, investments held in the ordinary course of banking business should not be a problem.

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Comparison of Shareholder Tax Consequences

C-Corporation versus S-Corporation

EARNINGS BEFORE TAXES	\$4,000,000 ^{1/}	EARNINGS BEFORE TAXES (Fully Includable in Shareholders' Taxable Income)	\$4,000,000
Combined Effective Federal & State Corporate Income Tax Rate^{2/}	<u>38.00%</u>	Highest Combined Effective Federal & State Income Tax Rate for Individuals^{2/}	<u>43.22%</u>
FEDERAL & STATE INCOME TAXES PAYABLE	<u>\$1,520,000</u>	FEDERAL & STATE INCOME TAXES PAYABLE	<u>\$1,728,960</u>
Net Earnings Available for Distribution to Shareholders	<u>\$2,480,000</u>		
ACTUAL CURRENT DIVIDEND DISTRIBUTIONS	\$800,000	ACTUAL CURRENT DIVIDEND DISTRIBUTIONS	\$2,528,960
Highest Combined Effective Federal & State Income Tax Rate for Individuals	<u>43.22%</u>		
Federal & State Income Taxes Payable	<u>\$345,792</u>	Taxes Payable on S-Corporation Earnings	(1,728,960)
		Taxes Payable on Distributions	<u>0</u>
NET DIVIDEND TO SHAREHOLDERS AFTER TAXES	<u>\$454,208</u>	NET DIVIDEND TO SHAREHOLDERS AFTER TAXES	<u>\$800,000</u>
Retained Earnings for Future Distribution	\$1,680,000	Retained Earnings for Future Distribution	\$1,471,040
Deferred Federal & State Income Taxes Payable	<u>(726,163)</u>	Deferred Federal & State Income Taxes Payable	<u>0</u>
NET RETAINED EARNINGS AVAILABLE TO SHAREHOLDERS	<u>\$953,837</u>	NET RETAINED EARNINGS AVAILABLE TO SHAREHOLDERS	<u>\$1,471,040</u>
TOTAL EARNINGS AVAILABLE TO SHAREHOLDERS NET OF TAXES	<u>\$1,408,045</u>	TOTAL EARNINGS AVAILABLE TO SHAREHOLDERS NET OF TAXES	<u>\$2,271,040</u>
PERCENTAGE OF ORIGINAL EARNINGS AVAILABLE TO SHAREHOLDERS	<u>35.20%</u>	PERCENTAGE OF ORIGINAL EARNINGS AVAILABLE TO SHAREHOLDERS	<u>56.78%</u>
		Additional Earnings Available for S-Corporation Shareholders	<u>\$862,995</u>

^{1/} This example assumes that book and taxable income are approximately equal and does not reflect the tax cost of the loss reserve recapture.

^{2/} This example assumes that the state corporate income tax rate is 6%.



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