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# U P D A T E

## News of Developments in the Financial Sector and Related Areas

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### *Subchapter S Corporation Legislation*

A Subchapter S corporation is a corporation which has elected a special tax status with the Internal Revenue Service ("IRS") which permits the income tax liability to be passed through to the shareholders and avoids the double taxation of a "C" corporation.

The *Small Business Job Protection Act* was signed into law in 1996 making it permissible for small banks to become Subchapter S corporations beginning on January 1, 1997. Since its passage, in excess of 27% of all reporting financial institutions are organized as Subchapter S corporations.

Earlier this year President Bush signed Public Law 110-28 (the "New Legislation") containing revisions effecting Subchapter S corporations.

The New Legislation eases the passive income test for Subchapter S corporations. Prior to the New Legislation, banks organized as Subchapter S corporations were subject to a corporate level tax at the highest corporate tax rate on excess net passive income if it had (i) accumulated earnings and profits in that taxable year and (ii) gross receipts of more than 25% of which are passive investment income. If a bank organized as a Subchapter S corporation met or exceeded these limits for three consecutive taxable years, the Subchapter S election was automatically terminated. Under the New Legislation, capital gains from the sale of stocks and securities will no longer be treated as passive income.

A Subchapter S corporation may only have one class of stock. As a condition of being a director of a national bank, a person much own a qualifying equity interest of either the national bank or its holding company. In order to limit the total number of shareholders, the qualifying shares held by a director are sometimes subject to buy/sell agreements that require directors to sell back his shares on specified terms upon ceasing to be a director. A Subchapter S corporation is treated as having one class of stock outstanding if all the shares confer identical rights to distribution and liquidation proceeds. In IRS Private Letter Ruling 2002-17-048, the IRS stated that buy/sell agreements that provide for a purchase or redemption of stock at book value or a price between fair market value and book value may not be considered to establish a purchase price based on fair market value, thereby creating a separate class of stock and disqualifying the corporation from Subchapter S treatment. The New Legislation eliminates this problem by providing that shares held by bank directors are not considered a second class of stock. Directors holding only qualifying shares will not be counted as shareholders

for determining the maximum number of shareholders of a Subchapter S corporation, which are currently limited to not more than 100. Directors' qualifying shares will also be disregarded in allocating items of income and loss among shareholders of the Subchapter S corporation and distributions paid to directors holding qualified shares will now be tax deductible.

The New Legislation provides more flexibility in accounting for bad-debt reserves banks. Banks that use the reserve method of accounting for bad debt expense, which is available only to those institutions with less than $500 million of assets, are required to switch to the chargeoff method when the institution becomes a Subchapter S corporation. This change in accounting method often sets off a large one-time tax burden in the year that the institution converted to a Subchapter S corporation. The New Legislation gives institutions the option to recapture all the reserves in the last year the institution pays corporate taxes, which is a substantial advantage to most institutions.

In those cases where a bank holding company is organized as a Subchapter S corporation and owns 100% of a subsidiary bank, the bank holding company would treat the bank subsidiary as a Qualified Subchapter S Subsidiary ("QSub"). All of the assets and liabilities of the QSub are treated as the bank holding company's, rather than a separate corporation for income tax purposes. The New Legislation clarifies the tax treatment of the sale of a QSub. Under the old law, there was an issue as to whether the Subchapter S corporation had a 100% tax liability if only a portion of the QSub was sold. The New Legislation specifically specifies that Subchapter S corporations are taxed only on that portion equal to the percentage of the interest sold. As a result, if only 25% of the assets of the QSub are sold, the Subchapter S corporation recognizes a gain or loss of 25% as opposed to 100%.

Prior to the New Legislation, institutions making Subchapter S Elections were forced to transfer all of their accumulated earnings and profits when converting to Subchapter S corporation. Under the New Legislation, institutions making Subchapter S elections will be permitted to reduce their accumulated earnings and profits by the amount that was accumulated in any taxable year beginning before January 1, 1983.

Prior to the New Legislation, the interest on debt paid by an electing small business trust to purchase stock in a Subchapter S corporation was not a deductible administrative expense for purposes of determining the taxable income of the Subchapter S portion of the small business trust. The New Legislation permits the deductibility of interest expense on debt when computing taxable income of the Subchapter S portion of the small business trust.

The New Legislation did not change the limitation that a Subchapter S corporation have no more than 100 shareholders which prevents a significant number of institutions from becoming Subchapter S corporations.

### *Overdraft Fees*

In connection with litigation pending in the state of California regarding state law prohibiting banks from exercising the right of setoff, i.e., charging an overdraft fee, on customer accounts that contain social security funds or other government payments, the Office of the Comptroller of the Currency has issued Interpretive Letter No. 1082 which holds that when a national bank processes an overdraft item and receives a fee for doing so, it is merely providing a service to customers and is not exercising its right to collect a debt.

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