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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 Corporations

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In 1996 the Small Business Job Protection Act was signed into law making it permissible for small banks to become Subchapter S corporations beginning on January 1, 1997. Since its passage, many closely held banks have become Subchapter S corporations. According to the Federal Deposit Insurance Corporation ("FDIC") there are over 2,368 (33%) of all reporting financial institutions organized as Subchapter S corporations. A Subchapter S corporation is a corporation that has elected a special tax status with the Internal Revenue Service ("IRS") which permits the income to be passed through to the shareholders and avoids the double taxation of a "C" corporation.

In 2004, President Bush signed into law the American Jobs Creation Act (the "Jobs Act") which increased the maximum number of shareholders for Subchapter S corporations from 75 to 100 and allows up to six generations of a family to be counted as one shareholder. The Jobs Act also lifted the rule that prohibit banks from converting to a Subchapter S corporation if any of their shares were held in individual retirement accounts on October 22, 2004. Partnerships and C corporations are not eligible to hold stock of a Subchapter S corporation, and one Subchapter S corporation is not allowed to own another Subchapter S corporation. A husband and wife and all members of a family and their estates can be treated as on shareholder. All others are treated as separate shareholders. The number of shareholders may be a significant factor affecting whether a bank can make the election to be a Subchapter S corporation.

In those cases where the number of shareholders exceed 100, a bank may want to consider a tender offer for outstanding stock held by certain of its shareholders. In the event that the tender offer does not reduce the number of shareholders to less than 100, a bank may contemplate a reverse stock split to reduce the number of existing shareholders. Another alternative to reduce the number of shareholders would involve the merger of the corporation with a newly-formed interim corporation with those shareholders not agreeing to the Subchapter S election and/or those shareholders not owning a minimum number of shares being cashed out.

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. In the event that the bank is not a wholly owned subsidiary of a Subchapter S corporation, it would be treated as a C corporation.

Among the requirements that a corporation must meet in order to qualify as a

Subchapter S corporation is that it only have one class of stock. However, trust preferred securities issued by a bank holding company are not treated as a separate class of securities, since they are treated as debt and not capital for IRS purposes.

In 2003, the FDIC adopted a rule permitting banks to be organized as limited liability companies ("LLCs") and a number of states have passed laws permitting banks to be organized as LLCs. By becoming an LLC, the number of owners is not limited, as in the case of a Subchapter S corporation and LLCs are generally more flexible and liberal in terms of governance issues. However, the IRS does not currently permit a state bank chartered as a limited liability company to qualify for partnership tax treatment.

Any eligible small business corporation desiring to make the election to be a Subchapter S corporation must file IRS Form 2553, Election by a Small Business Corporation, (i) before the 16th day of the third month following the close of the "C" corporation's tax year if the election is to be effective for the current year, or (ii) at any time during the tax year preceding the tax year it is to take effect. A late election to be an S corporation generally is effective for the following tax year. However, relief for a late election may be available if the corporation can show that the failure to file on time was due to reasonable cause. The reasonable causes for the late election are contained in the instructions to Form 2553. All shareholders must consent to the Subchapter S election.

The tax treatment of a shareholder of a Subchapter S corporation is substantially different than that of a shareholder in a C corporation. Income is passed through by the Subchapter S corporation resulting in the tax basis of each shareholder being increased to the extent of its allocable income and being decreased by dividends or distributions. As a result, all taxable income not paid out in dividends, together with all permanently taxed income is added to the shareholder's tax basis. If the shares of the Subchapter S corporation are sold by the shareholder, his basis would generally be significantly higher than his original purchase price. The taxable capital gain will generally be lower than a comparable sale by a shareholder of a C corporation whose tax basis remains at the original cost.

The acquirer of a bank which is operated as a Subchapter S corporation may deduct for tax purposes over 15 years the premium paid above the actual value of the assets of the bank if an election is made by the parties under Section 338(h)(10) of the IRS Code. As a result, a Subchapter S corporation is generally worth more than a C corporation.

A Subchapter S corporation is subject to a built-in-gains tax whenever an asset which has had an unrealized gain at the election date (i.e, difference between the fair market value of an asset and its tax basis on the conversion from a C corporation to a Subchapter S) is sold during the ten year period following the conversion. As a result, when a C corporation decides to convert to an Subchapter S corporation, it will generally have a valuation of its assets performed as of the date of the Subchapter S election. The purpose of this valuation is to identify those assets that have built-in-gains. The tax, usually referred to as the *BIG tax* is paid by the Subchapter S corporation which passes a deduction for the tax through to its shareholders. De novo institutions that begin as Subchapter S corporations do not have a built-in tax gain. The built-in-gains tax is eliminated after a ten year period.

Because of the favorable tax consequences of a Subchapter S corporation which has been in existence for ten years, acquirers may be paying a higher price for a Subchapter S corporation than for a C corporation. A Subchapter S election requires careful legal and tax planning.

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