2000

S Banks: Should Banks Convert to S Corporations

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S Banks: Should Banks Convert to S Corporations?

I. INTRODUCTION

In 1996 Congress passed the Small Business and Job Protection Act which, among other things, for the first time allowed banks and other financial institutions to qualify for S corporation tax status.\(^1\) S corporation status has been available for other types of small businesses and has allowed for considerable reductions in income tax paid.\(^2\) One reason that banks were prohibited from filing as S corporations was that "they were already given a substantial tax break by being allowed to use methods of accounting for bad debts that were more generous than those permitted other taxpayers."\(^3\) These provisions were designed to provide banks with the ability to make loans to the public by protecting them from the potential for large losses.\(^4\) Eventually, however, Congress began to remove some of these provisions.\(^5\) Banks could not receive the benefits other corporations enjoyed, nor were they able to compete on an equal level with other financial institutions, like credit unions or thrifts, which are tax exempt institutions.\(^6\) The Small Business Act helped level the

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1. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1315 (1996). An S corporation is treated much like a partnership for purposes of taxation. See Peter M. Fass & Barbara S. Gerrard, The S Corporation Handbook, § 1.01 (1996). Earnings (or losses) are prorated to the shareholders on the basis of their equity share, and reported on their individual income tax returns. See id. This is referred to as "pass through" taxation. See id.
4. See Goldstein, supra note 3, at 649.
5. See id.
6. See id.
playing field for banks.

This article will explore the most important benefit, tax savings, for a bank that elects the S corporation tax status and decides to become an S bank. Then the article will set out the four main requirements to qualify for S corporation status: number of shareholders, types of shareholders, limits on classes of stock, and limits on the methods of accounting for bad debts. The article will next provide examples of banks which suited for S corporation status and benefits the S corporation status brings to these banks. Of course, there are potential drawbacks, and the article will explore concerns facing banks wishing to convert. Finally, the article will discuss potential changes in legislation that were proposed in 1999, the possibility of these changes occurring, and the potential ramifications of such changes on S corporation banks.

The most attractive benefit of converting to S corporation status is the tax savings that the corporation and its shareholders receive. The profits of a C corporation are taxed at the corporate level; then, if the corporation pays dividends to its shareholders, those dividends are subject to a shareholder level income tax. Thus, the profits of the corporation are subject to a double tax. In S corporations, however, the tax at the corporate level is removed, and only the shareholders pay a tax. Corporate income, loss, deductions and credits are "passed through" the corporation directly to the shareholders, who report a prorata share of income and losses on their personal income tax re-

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7. See infra notes 12-26 and accompanying text.
8. See infra notes 27-57 and accompanying text.
9. See infra notes 58-82 and accompanying text.
10. See infra notes 83-180 and accompanying text.
11. See infra notes 181-213 and accompanying text.
12. See Raymond J. Gustini, Here Come the S Banks, AMERICA'S COMMUNITY BANKER, June 1, 1999 at 33. Mr. Gustini is a partner with the law office of Peabody & Brown and represents banks and thrift institutions throughout the United States. See id.
13. See id.
14. See id.
15. See Goldstein, supra note 3, at 648.
If the bank makes a profit, the shareholders will have to pay taxes regardless of whether the bank distributes the earnings to the shareholders. The distributions themselves will normally not be taxed, although there are exceptions. Since the shareholders will be taxed regardless of whether dividends are paid, the corporations usually pay out over seventy percent of their earnings.

One bank CEO points out that by "eliminating one layer of taxation, we have increased our return on equity by 50 percent and increased stockholders' share of the earnings of the bank." The S bank provides "a win/win situation for the institution and shareholders." For example, the current highest marginal corporate tax is thirty-four percent. Therefore, assuming a bank is taxed at the highest level, for every $100,000 of corporate taxable income, $66,000 can be paid to the shareholders as individuals. The shareholders then pay a rate around forty percent on their retained earnings of an S corporation which has converted from a C corporation are divided into three different groups of earnings. See id. "Distributions generally are treated as coming out of the baskets in the following order: 1) Accumulated adjustments account (AAA), . . . 2) Accumulated earnings & profit (E&P), . . . 3) Other adjustments." Id. The first group, AAA, is the undistributed taxable income that is attributed to when the S Corporation period began. These dividends will not be taxed. See id. The second group, however, E&P, will be treated as taxable dividends because they are profits that were accumulated while the corporation was a C corporation. See id. The final group includes "items that affect the stock basis of S corporation shareholders but are not included in AAA." Id. These too are taxable dividends. See id.

See Gustini, supra note 12, at 34.


individual returns, which leaves them with $46,000. However, if the whole $100,000 passes through to the shareholders untaxed at the corporate level, the shareholders pay their forty percent tax on that amount, leaving them with $60,000—a substantial tax savings. Banks “can have higher dividends and still retain more cash because the net cost of taxation has been lowered.”

II. REQUIREMENTS FOR S CORPORATION STATUS

There are several requirements that a bank must achieve before it can elect to be an S corporation bank, either converting from a C corporation or electing as a de novo bank. The main four requirements include the following: the total number of shareholders cannot exceed seventy five, shareholders must be individuals or other certain trusts, the corporation can issue only one type of stock, and the bank may not use the reserve method of accounting for bad debts. All requirements, including number and type of shareholders, must be met before the beginning of the first S corporation tax year. Any lapse in these requirements, for example a sale resulting in seventy-six or more shareholders, will immediately terminate the S corporation status.

24. See id.
25. See id.
26. S Corporation Election Sits Well, supra note 20. Security Federal had twenty shareholders when the S corporation election first came available in 1997. See id. The banks return on assets was 2.1% in 1997 after the conversion, compared to 1.4% it would have reported had it remained a C corporation. See id.
28. See id.
29. See 26 U.S.C.S. §§ 1362(b)(1)(A)-(B) (Law. Co-op. 1999). The Code provides that an election may be made by a “small business corporation” at any time during the preceding taxable year or “at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year.” Id. This article gives a quick checklist of tasks to be completed before the beginning of a banks first S corporation tax year: “1) Eliminate second classes of stock; 2) Eliminate ineligible shareholders; 3) Reduce the number of shareholders to 75 or less; 4) Obtain unanimous consent of shareholders; 5) File Form 2553, Election by a Small Business Corporation, before the fifteenth day of the third month of the year that a bank wishes election to be effective.” See Financial Institutions, supra note 18.
30. See 26 U.S.C.S. § 1362(d)(2)(A-B) (Law. Co-op. 1999). The code states that an “election under subsection (a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation)
A. Number of Shareholders

To qualify for S-corporation status a bank must have seventy-five shareholders or less.\(^{31}\) While meeting this requirement is easy for banks that currently have less than seventy-five shareholders, banks that are already established and have more than seventy-five shareholders do not find election as easy.\(^{32}\) Jim Montgomery had less than seventy-five shareholders when he started his bank in 1998.\(^{33}\) Since he was already under the required number of shareholders, his decision to take advantage of the significant tax breaks and electing to be an S corporation bank from the beginning was fairly simple.\(^{34}\) In contrast, a study by the Independent Bankers Association of America of its members indicated the most common problem facing community banks when exploring the Subchapter S corporation election is too many shareholders.\(^{35}\) Having more than seventy-five shareholder-
ers does not automatically mean a bank can never become an S-corporation; a bank may consider stock buybacks, reverse splits, or merger programs to reduce the number of shareholders over time in order to achieve the required number. A bank needs careful consideration and detailed planning before choosing this route, however, as potential problems and shareholder lawsuits may arise.

B. Types of Shareholders

A second requirement is that an S corporation’s shareholders are limited to individuals, estates, or certain trusts. A bank cannot elect S corporation status unless all shareholders fall into one of these categories. At present, corporations, partnerships, limited liability companies, and individual retirement accounts

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1, 1999. The report stated that 51 percent of the members of the Independent Bankers Association of America surveyed reported that too many shareholders was the biggest difficulty. See id. The results also showed that other difficulties were ineligible types of shareholders (40 percent); liability resulting from the built-in gains tax (9 percent); passive investment income, more than one class of stock, qualified subchapter S subsidiaries (all at 4 percent); and the need to raise additional capital (3 percent). See id.

36. See Gustini, supra note 12, at 34-5. In a reverse stock split, a large number of shares would become one share. See Joel E. Rappoport, Undervalued by the Market? Consider Ways to Go Private, AM. BANKER, July 9, 1999, at 10 (explaining several ways and reasons why a bank may decide to become a private institution). For example, every 500 shares would be reduced to one share. See id. Any stockholder who was left with fractional shares would receive cash for those shares. See id. In a merger program, the bank would merge with an entity that would be controlled by a smaller group of the bank’s shareholders (less than seventy-five if the bank is merging to become an S corporation). See id. Any stockholder who is then not part of the controlling group would be forced to sell his or her shares. See id.

37. See infra notes 83-133 and accompanying text.

38. See 26 U.S.C.S. §1361(b)(1)(B) (Law. Co-op. 1999). This provision provide that a bank must not have as a shareholder a person who is not an individual, other than estates, trusts, and organizations provided in 26 U.S.C.S. §§ 1361(c)(2), (6). See id. The following trusts may be shareholders: A trust all of which is owned by an individual who is a US citizen or resident, a trust provided in the previous clause which “continues in existence after the individual’s death,” but only for two years, “a trust with respect to stock transferred to it pursuant to terms of a will,” but only for a two year period, a “trust created primarily to exercise the voting power of stock transferred to it”, and an “electing small business trust.” 26 U.S.C.S. § 1361(c)(2)(A)(i)-(v)(Law. Co-op. 1999). Organizations described in 26 U.S.C.S. §401(a) or §501(c)(3) and exempt from taxation under § 501(a) may be shareholders in an S corporation. See 26 U.S.C.S. § 1361(c)(6)(A)-(B) (Law. Co-op. 1999).

CORPORATIONS may not be shareholders of an S corporation. There are, however, a few existing exceptions and others that are being considered. Another shareholder restriction is that shareholders must not be non-resident aliens. This requirement has been present throughout the history of S-corporations, and "is intended to ensure that S corporation income that is exempt from corporate-level tax is subject to a U.S. graduated tax rate."

John Burson, president and chief executive officer of Valley Bank of Commerce in Roswell, New Mexico, was ready to convert his bank to an S corporation; however, some of the stockholders were Investment Retirement Accounts and C corporations, both of which are prohibited as S corporation shareholders. Mr. Burson offered each of these shareholders the option of changing their ownership to a form that meets the requirements for an S corporation or allowing their shares to be bought out. Since employee stock option plans are permissible S-corporation shareholders, he converted his profit sharing plans into ESOPs. As a result, ESOPs are the largest shareholders of


41. See id. Some qualified plans are allowed to be shareholders, such as employee stock ownership plans and other tax-exempt entities. See id. Another interesting type of shareholder is the qualified subchapter S subsidiary, or QSSS. See id. If the QSSS is wholly owned by an S corporation, then the parent and the QSSS are treated as one entity. See id. See generally Favorable QSSS Regulations Proposed (last modified March, 1999) <http://www.gt.com/resources/finance/banktax/scorp/alerts/0399c.html> (discussing QSSS status and proposals that were considered in 1999).

42. See 26 U.S.C.S. § 1361(b)(1)(C) (Law. Co-op. 1999). An eligible corporation is one which does not "have a nonresident alien as a shareholder." See id.

43. Baran, supra note 40.

44. See Telephone Interview with John Burson, President and Chief Operations Officer of Valley Bank of Commerce, Roswell, New Mexico (Oct. 12, 1999)[hereinafter Telephone Interview: John Burson].

45. See id.

46. See id. One other piece of advice Mr. Burson added concerned the difference between profit sharing plans and employment stock option plans. See id. Profit sharing will be taxed on the dividends up-front, while the ESOPs are not touched. See id. In Burson's opinion, this is because the labor unions would create an uproar if the these plans were taxed up-front. See id. Burson's bank simply switched over any profit sharing plans to ESOPs and avoided being taxed up-front and also avoided being taxed at the personal level until these options are cashed
the bank. Burson is now able to take advantage of the fact that income attributed to the part of the bank owned by the ESOP is not subject to the unrelated business taxable income rules of the IRS. Neither the bank at the corporate level, nor the ESOP at the shareholder level, is subject to federal income tax.

C. Types of Stock

The third major requirement for S corporation status is that an S corporation may have only one type of stock and cannot offer preferred stock. This rule "is intended to relieve any complications as a result of the apportionment of income and deductions among shareholders." This restriction may prevent the corporation from attracting even "qualifying shareholders who have varying investment requirements, such as those who would rather own preferred stock than common stock."

D. Accounting for Bad Debts

Finally, a bank will not be eligible for S-corporation status if it uses the reserve method of accounting for bad debts instead of the charge-off method of accounting for bad debts. Any bank which is not an S corporation and which has less than five hundred million dollars of assets is considered a small bank, and may use either method of accounting. The specific charge off method permits "a tax deduction only for actual charge-offs as
loans become worthless" while the reserve method uses "a six-year moving average of actual losses." 55

When a bank converts to S corporation status, the existing bad debt is considered a built-in gain and is subject to the built-in gains tax. 56 One plus is that the net charge-off of the loans that exist on the date of conversion to S corporation status may be used to reduce the amount of the tax reserve recognized as a built-in gain for the first year as an S corporation. 57

III. IDEAL CANDIDATES FOR S-CORPORATION CONVERSION

While most S corporation banks are small banks – both in terms of number of shareholders and assets – there is no requirement that a bank be small. 58 One of the largest S-corporation banks has $4.5 billion in assets, while the smallest has about $3 million. 59 Furthermore, while banks with fewer than seventy-five shareholders face fewer obstacles to claiming S corporation status, banks with more than seventy-five should not be deterred. 60 Amboy Bancorp in Old Bridge, New Jersey made

55. Baran, supra note 40. There are already restrictions on large banks, which are banks with over five hundred million dollars in assets, that require them to use the specific charge-off method. See Goldstein, supra note 3, at 650. In accounting for bad debts, a small bank may use the experience formula, which means it "may deduct the greater of (a) the amount of bad debt losses as a percentage of its loans outstanding in the current and preceding five years, or (b) the amount necessary to restore its reserve to its balance at the last taxable year beginning before 1988." Id. However, this option will not be available to banks that wish to qualify for S corporation status, as they must use the reverse method of accounting. See id. at 647. Mr. Goldstein points out that a large bank which cannot use the reserve method may elect to become an S corporation, while a small bank cannot do so unless it uses the specific charge-off method. See id. Goldstein feels this is "paradoxical, given the Code definition of an S corporation as 'a small business corporation.'" Id.

56. See infra notes 154–171 and accompanying text.


58. See The Supreme Court's February 25, 1998 Decision Regarding the Credit Union Common Bond Requirement: Hearing Before the Committee on Banking and Financial Services U.S. House of Representatives, 105th Cong. 348 (1998)(prepared statement of Don W. Lewis, President and CEO, Aberdeen Proving Ground Federal Credit Union, Aberdeen, MD; on behalf of the National Association of Federal Credit Unions). Mr. Lewis stated that the first Subchapter S bank had $1.2 billion in assets. See id.

59. See Gustini, supra note 12, at 33.

60. See supra notes 31-37 and accompanying text.
the switch to S corporation status after originally having over 400 shareholders.\textsuperscript{61} Granted, the switch may not have been easy, but it shows that the conversion is nonetheless possible.

S corporation banks are most commonly found in the midwest where small community banks and agricultural banks abound.\textsuperscript{62} Of course it is easier if the bank already has fewer than seventy-five stockholders and is well-capitalized; the limit on the types of stocks and the number of stockholders hinders a bank’s ability to raise capital.\textsuperscript{63} Also, the value of the stock in an S corporation will likely be lower than a C corporation bank because the restrictions on reselling it make it less attractive, and therefore, less marketable.\textsuperscript{64} Small family-owned banks that are already well capitalized are “a prime example of the type of institution that benefits most from S corporation status.”\textsuperscript{65} Farmers and Merchants Bank in Neola, Iowa is a good example of a small, family owned bank ($30 million in assets) with strong capital built up that decided to take advantage of S corporation status.\textsuperscript{66} Roger Hall, the bank’s fourth generation president, stated that the S corporation election looked like “a good deal to bring capital down and allow shareholders an opportunity to put some money to work elsewhere in the community.”\textsuperscript{67}

\footnotesize

\textsuperscript{61} See Gustini, supra note 12, at 34.
\textsuperscript{62} See Laura Pavlenko Lutton, A Tenth of All Banks Now Use Tax-Saving S Corp Structure, AM. BANKER, Aug. 4, 1998, at 9. In 1998 the heaviest concentration of S corporation banks were as follows: Minnesota, 148; Texas, 147; Illinois, 98; Iowa, 94; Nebraska, 79. See Gustini, supra note 12, at 34. There were no S corporation banks in the following states: Washington, Idaho, Virginia, New Hampshire, Rhode Island, Delaware, Alaska, and Hawaii. See id. It is somewhat interesting that Minnesota had the highest number of S corporation banks because Minnesota is one of the few states that do not give S corporation banks a tax break at the state level. See Laura Pavlenko Lutton, Minnesota S Corporation Banks Seeking Same Tax Break as Their Nonbank Peers, AM. BANKER, Oct. 22, 1998, at 7. The banks must continue to pay about 10 percent of their profits in state taxes. See id. There is a movement to have the legislature change these provisions. See id. Douglas H. Lewis, chairman of North Shore Bank of Commerce in Duluth, argues, “We’re a family business just like almost any other S corporation, and we shouldn’t be treated any differently.” Id.
\textsuperscript{63} See Gustini, supra note 12, at 34.
\textsuperscript{64} See id.
\textsuperscript{65} S-Corporation Election Sits Well, supra note 20.
\textsuperscript{66} See id.
\textsuperscript{67} Id.
Ideal candidates can be found throughout the country. One such ideal candidate was located in Florida.68 This bank had one dominant shareholder who, combined with his brother, owned over fifty percent of the stock.69 He negotiated individually with other shareholders and was able to reduce the number of shareholders below the limit.70 The bank was already well capitalized, and the conversion was relatively easy.71

One of the most important benefits the S corporation status provides is increased competitiveness for small community banks.72 The money saved by avoiding the double tax can be put back into the S bank, allowing them to deliver loans to small businesses.73 These savings are especially advantageous when the small community banks are competing with credit unions, which are tax-free institutions.74 Like "the small community banks that were chartered as America expanded west with pioneers, small community banks today remain a bulwark of institutional funding for local entrepreneurial ventures."75 A Peoria, Illinois bank president states the importance of S corporation status in the following way:

The Federal Reserve has delivered testimony stating that community banks deliver loans to small businesses that help feed the economic engine keeping rural communities going. . . . Reducing our tax burden results in more resources available to us for providing capital to community projects.

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69. See id. This shareholder, perhaps with a good deal of foresight, had thoughts of converting the bank to an S corporation even before the laws permitted it for banks. See id.
70. See id.
71. See id. The bank has maintained its success, and the shareholders also enjoy nice dividends, especially in Florida where there is no state personal income tax. See id.
72. See Howard, supra note 23.
73. See id.
74. See id.
75. Id.
Our loans are awarded exclusively in the metro Peoria area. We don’t allocate money for any other community.76

The “role of these institutions in the vitality of small communities is dramatic. Sub S is intended to enhance that role, stimulate the economy and preserve an American institution.”77

John Burson believes the S corporation option enables small, family or otherwise closely held banks to prevent mergers or buyouts by larger banks.78 Previous to the Small Business and Job Protection Act, banks would just retain their earning for capital instead of paying them out as dividends and being taxed twice.79 If a shareholder wanted to do something with his money, however, he would be taxed when the dividend was paid out or if he sold the stock.80 Closely held banks would simply sell to a larger bank in order to get their money and would only be taxed around twenty percent (instead of the double taxation).81 Now, since the earnings are not taxed at the corporate level, the bank can pay out higher dividends without incurring such a high rate of tax. 82

IV. POTENTIAL DIFFICULTIES IN CONVERTING TO S CORPORATION STATUS

A. Litigation by Disgruntled Shareholders

Mass reduction in shareholders does give rise to one of the major problems that can face banks attempting to convert - lawsuits from those shareholders merged or frozen out.83 In fact, Amboy Bancorp is in the midst of litigation from disgruntled

76. Id. (quoting Dan Daly, president of First Capital Bank in Peoria, Illinois).
77. Id. (quoting Gerald Pfieffer, a CPA with Clifton Gunderson).
78. See Telephone interview: John Burson, supra note 44.
79. See id.
80. See id.
81. See id.
82. See id.
83. See Gustini, supra note 12, at 32
shareholders. Amboy decided to cash out approximately 350 shareholders, which Stan Koreyva states was clearly the "hardest part" of the conversion. There is a pending class action claim against the bank which is now at the appeal level. The issue of the claim is the fairness of the price given to the forced out shareholders. In the fall of 1997, Amboy went through the proper processes to make the cash out legal, and Mr. Koreyva remains confident that the conversion to S corporation status was the right decision. Unless the class action is successful in recovering substantial damages, the benefits of the S corporation will outweigh the unfortunate difficulties.

Banks wishing to cash out shareholders should "operate without conflict, with full information and treat minority buy-out in the same way that you would approach a tender offer from a third party, including getting a fairness opinion." Also, a bank should hire more than one outside expert to obtain more than one valuation for the bank. Evaluators of the bank's value should always be independent. Considering the delicate situations associated with buyouts, a bank should exercise extreme care and thorough planning when considering a reduction in the number of shareholders.

Mr. Burson reinforces the notion that being fair to shareholders who are being forced out is crucial to the transition operating smoothly. Mr. Burson started his bank in 1977, and he

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84. See id.
85. See Telephone Interview with Stan Koreyva, Chief Financial Officer, Amboy Bancorp, Old Bridge, New Jersey (Nov. 12, 1999)[hereinafter Telephone Interview: Stan Koreyva].
86. See id.
87. See id.
88. See id.
89. See id.
90. Gustini, supra note 12, at 32.
91. See id. See generally Todd Eveson, Note, Circling the Wagons: Has the Scope of the Duties of Bank Directors Faced with Acquisition Expanded?, 3 N.C. BANKING INST. 367 (1999).
92. See Telephone Interview: John Burson, supra note 44.
93. See id.
94. See id.
and his family owned a majority of the stock.\textsuperscript{95} Once he had an approval from at least two-thirds of the shareholders, he knew that by law he would be able to force out whomever he needed to – as long as he offered a fair price.\textsuperscript{96} In order to offer a fair price, Valley Bank had its stock appraised by an outside source to avoid any inside influence.\textsuperscript{97} Armed with a two-thirds vote and a fair price, it was fairly easy to peaceably accomplish a reverse stock split and freeze out the minority shareholders or those shareholders who would not comply with the requirements for S banks.\textsuperscript{98}

Mr. Burson contrasts his experience with another local bank, which did not seek an appraisal and merely offered a price to its other shareholders and “shot from the hip” in its attempted reverse stock split.\textsuperscript{99} There were many disgruntled shareholders, lawsuits ensued, and eventually the bank gave up its efforts to convert.\textsuperscript{100}

Two banks which considered a conversion to S corporation status are Sacramento Commercial Bank in Sacramento, California\textsuperscript{101} and First Capital Bank in Peoria, Illinois.\textsuperscript{102} Sacramento Commercial’s main problem is that the bank currently has 125 shareholders.\textsuperscript{103} Jim Sundquist, the bank’s chief operations officer, warns, “You have to be very careful not to force people out. The last thing we would want to do is to start something that would create litigation.”\textsuperscript{104} Mr. Sundquist concedes, however, that conversion “has to be a topic of consideration for any bank that pays its shareholders cash dividends” because of the double tax consequences of remaining a C corporation.\textsuperscript{105}

\textsuperscript{95} See id.
\textsuperscript{96} See id.
\textsuperscript{97} See id.
\textsuperscript{98} See id.
\textsuperscript{99} Id.
\textsuperscript{100} See id.
\textsuperscript{101} See Mark Anderson, Bank May Become S Corporation; Sacramento Commercial Bank, SACRAMENTO BUS. J., June 25, 1999, at 8.
\textsuperscript{102} See Howard, supra note 23.
\textsuperscript{103} See Anderson, supra note 101.
\textsuperscript{104} Id.
\textsuperscript{105} Id.
Mr. Sundquist's concerns for litigation are certainly warranted. Another local, independent bank, Stockman's Bank, in nearby Elk Grove, decided to convert to S corporation status. Some shareholders were forced out, and now have litigation pending against the bank. In the end, Sundquist's bank decided not to convert unless Congress approves an increase in the number of shareholders from seventy-five to one hundred and fifty, an item supporters have repeatedly lobbied for. The possibility of shareholder dispute was too costly to make the conversion. While there are legal measures the company could follow and effectively reduce the number of shareholders, Mr. Sundquist and the other members find these measures "unpalatable." He offers that sometimes in a small community bank the role and the purpose of the bank would be compromised by forcing out shareholders who play important roles in the community or have connections throughout the community. Disgruntled former shareholders would create public relations problems for the bank, which depends on a favorable image in the community. Even though he is relatively confident that, in the legal arena, the bank would be victorious, the legal battles and the public relations battles make the conversion costly for a small, community bank and create too much risk. As he understands it, most banks that convert already have below seventy-five shareholders. Assuming that a legislative increase in shareholders occur, Mr. Sundquist believes the topic will again surface, and the bank will reconsider conversion.

106. See id.
107. See id.
108. See Telephone Interview with Jim Sundquist, Chief Operations Officer, Sacramento National Bank (Nov. 8, 1999)[hereinafter Telephone Interview: Jim Sundquist]. See also supra notes 181–213 and accompanying text (discussing proposed legislation concerning S banks).
109. See Telephone Interview: Jim Sundquist.
110. Id.
111. See id.
112. See id.
113. See id.
114. See id.
115. See id.
Michael Mckenzie, Vice President and Controller of First National Bank in Peoria, Illinois, related a similar story to Mr. Sundquist's. Mckenzie's bank also seriously considered converting to S corporation status but in the end decided against it, at least for the present. Like Sundquist, Mr. Mckenzie pointed to the seventy-five shareholder restriction as the main reason First National decided not to convert. Future capital issues were also a concern; the bank knew there would be difficulties if they ever had to do another stock offering.

Mr. McKenzie also pointed to the restriction that shareholders could not own stock through IRA's. Many shareholders, including him, owned stock in this manner. If these stockholders wished to retain their stock ownership, they would effectively have to sell themselves the stock they already owned through the IRAs, but the stockholders would have to come up with other funds in order to purchase it. This process would be difficult if not impossible for many of these shareholders, leaving a buyout or freeze out as the only alternative.

Since the only solution available to both of these major stumbling blocks was to complete a freeze-out, the bank decided not to elect the S corporation status. Even though the bank has $103 million in assets, it still functions as a small community bank with an important role in the community. Since a good amount of its business results from referrals that are due to relationships various shareholders have, it would not be good for business to have disgruntled ex-shareholders.

116. See Telephone Interview with Michael McKenzie, Vice President and Controller of First National Bank, Peoria, Ill. (Nov. 12, 1999) [hereinafter Telephone Interview: Michael McKenzie].
117. See id.
118. See id.
119. See id.
120. See id.
121. See id.
122. See id.
123. See id.
124. See id.
125. See id.
126. See id.
The decision to convert is an individual decision. Amboy faced the same concerns that First National and Sacramento Commercial faced – litigation and public relations issues – nonetheless Amboy decided to convert. The opportunity to eliminate the double tax was the primary motive to convert. Also, Amboy wanted to go private and assure itself independence as a community bank. The bank was concerned about shareholders, many of whom were customers of the bank, becoming upset because of a force out, and the bank tried to assure them that S corporation status was in the best interests of the bank. Obviously many were still upset, and the litigation ensued. Nonetheless, even with the litigation and public relations issues, Mr. Koreyva is convinced that the conversion was “the best thing the bank has done.” The tax breaks, the independence, and the ability to better manage capital all outweigh the difficulties the bank has experienced since the conversion.

Another problem of conversion to and maintenance of S corporation status concerns the types of shareholders a bank may have. In addition to his concerns over the number of shareholders Sacramento Bank has, Mr. Sundquist also faces the problem that many of his stockholders hold stock through investment retirements accounts. Again, either new legislation will have to remove this restriction or the shareholders will have to change the entity that owns the shares. Although some shareholders may actually benefit by discontinuing ownership within the IRA’s and converting to S Corporation status, each shareholder’s situation must be addressed on an individual basis.

127. See Telephone Interview: Stan Koreyva, supra note 85.
128. See id.
129. See id.
130. See id.
131. See id.
132. Id.
133. See id.
134. See supra notes 38-49 and accompanying text (discussing restrictions on types of shareholders an S corporation may have).
135. See Telephone Interview: Jim Sundquist, supra note 108.
136. See id.
be beneficial to some, and Sacramento Bank would again be faced with the difficult problem of forcing these shareholders out or not converting.

Also, even if a bank has seventy-five or less shareholders, or is relatively confident that it can reduce its existing number of shareholder to the required number, the bank still must consider how to ensure that its number of shareholders remains below seventy-five. This problem led First National not to convert. The bank was concerned that even if they could get the existing shareholder limit under seventy-five, it would be difficult to monitor future shareholder transactions or the passing of stocks through probate to multiple or ineligible shareholders. Usually the solution to this problem involves shareholder agreements drawn up restricting to whom an existing shareholder may sell his or her stock. A shareholder has to be careful that the transferee meets the requirement as a qualifying S corporation shareholder so as not to terminate the S corporation status. This requirement can create complications for shareholders who are contemplating or who are already engaged in complicated estate planning.

Mr. Burson’s firm, yet fair approach towards his fellow shareholders in meeting the requirements for S corporation status also extended past the actual conversion. His primary caution to those converting to S Corporation status is to draft a tight shareholder’s agreement as to the future sale and transfer of the stock to prevent inadvertent – or intentional – termination of the

137. See Telephone Interview: Michael McKenzie, supra note 116.
138. See id.
139. See id.
140. See id.
141. See Baran, supra note 40. Termination of an S corporation occurs immediately upon a violation. See id. The corporation ceases to be treated as such for tax purposes for the year the termination occurred in. See id. S corporation status may be terminated voluntarily, statutorily, or inadvertently. See id. Once the termination occurs, the corporation must wait five years before making another election, unless approval is received from the U.S. Department of Treasury. See id.
142. See Goldstein, supra note 3, at 653.
143. See Telephone Interview: John Burson, supra note 44.
S corporation. Mr. Burson had the shareholders all enter into an agreement that no one will put the stock in a trust or sell to multiple people. Burson points out that of course there has to be some latitude – he himself has four children, two of whom are already shareholders - and he understands the desire one may have to pass on the stock to more than one person. Though the agreement gives some latitude, it provides that if anyone transfers, sells, or does anything with the stock that will in any manner cause the S corporation to terminate they will be liable to all the other shareholders. Any decision must be approved by the other shareholders, and they have the right of first refusal where a shareholder desires to sell his shares. The agreement has worked well; there have been a few occasions where people have tried to make transfers that may not have been in the best interests of the bank, and the other shareholders refused. The agreement also stipulates that the party wishing to transfer must pay the attorney fees for a review.

B. Problems Resulting From New Tax and Accounting Methods

Other problems that may confront banks converting to S corporation status are the different tax and accounting issues. Many of these issues result from carry over profits extending from the days the bank may have spent as a C corporation. An S corporation election “can do a mind spin on shareholders who are forced to deal with a host of hefty accounting and tax issues” that they never had to deal with as a C corporation. Proper “tax planning before the effective date of the S election can usually minimize the effect of most of the issues”; however, these

144. See id.
145. See id.
146. See id.
147. See id.
148. See id.
149. See id.
150. See id.
151. See S Corporation Election Sits Well, supra note 20.
152. Id.
issues can still be troublesome and costly.\textsuperscript{153}

The built-in gains tax\textsuperscript{154} is an important consideration for banks that were C corporations before electing S corporation status.\textsuperscript{155} Any gain that is attributed to assets or activity while the bank was a C corporation will be taxed as if the bank was a C corporation.\textsuperscript{156} The built-in gains tax was designed to prevent C corporations from electing S-corporation status in order to avoid corporate level tax on a subsequent sale of its assets and avoiding corporate level tax.\textsuperscript{157} Under current law, if an S-corporation sells assets with a built-in gain, a tax will be imposed at both the corporate and the shareholder level.\textsuperscript{158}

The built-in gains subject to this tax are the net unrealized built in gains on the date of conversion to S corporation status.\textsuperscript{159}

\begin{itemize}
  \item \textsuperscript{153} Id. (quoting Tim Wilson, tax manager, Grant Thorton).
  \item \textsuperscript{154} See 26 U.S.C.S. § 1374(a) (Law. Co-op. 1999). The general rule is "for any taxable year beginning in the recognition period an S corporation has a net recognized built in gain, there is hereby imposed a tax \ldots on the income of such corporation for such taxable year." Id.
  \item \textsuperscript{155} See 26 U.S.C.S. § 1374 (Law. Co-op. 1999). The tax will not apply to corporations that were always S corporations. See id. The tax will also not apply to assets acquired when the bank is presently an S corporation. See Goldstein, supra note 3, at 652. This is another advantage of being an S corporation instead of a C corporation. See id. If the asset appreciates in value, the corporation will not be taxed on any gain it might receive from a sale of that asset, as long as it was acquired while the bank was an S corporation. See id.
  \item \textsuperscript{156} See Baran, supra note 40. Built-in gains for banks may include "(a) Gains attributable to assets held on the first day of S corporation election, (b) Negative adjustments made under Internal Revenue Code Section 481 resulting from a change in the overall accounting method from accrual to cash method, (c) Intangibles such core deposits and excess servicing rights (d) Unrealized gains in the securities portfolio, (e) the recapture of the bad debt reserve upon the change from the reserve method of accounting for bad debts to the specific charge-off method." Id.
  \item \textsuperscript{157} See Telephone Interview with Cindy Marcelles, Tax Advisor at Dixon Odom, Sanford, North Carolina (Nov. 8, 1999). Before 1986, a corporation could simply liquidate its assets and pay dividends from the profits. See id. They would only be taxed at one level. See id. This changed in 1986, when Congress repealed the General Utility Doctrine. See id. As a result, when the company paid any dividend it would be taxed at the corporate and the shareholder level. See id. Eventually, companies realized that if they had assets they wished to sell and pass on dividends, they would simply elect S corporation status, liquidate and sell the assets, and only be taxed at the shareholder level. See id.
  \item \textsuperscript{158} See id. If a corporation wishes to elect S corporation status, it cannot sell the C corporation assets for ten years, or the assets will be taxed at both the corporate and the shareholder level. See id.
  \item \textsuperscript{159} See Applying the Built-In Gains Tax to Bank S Corporations (visited Feb. 3, 2000) <http://www.gt.com/resources/finance/banktax/scorp/alerts/052897>.}


If the aggregate fair market value of a bank’s assets exceed the aggregate tax base of the assets on the date of conversion, the bank will have a net unrealized built-in gain.\textsuperscript{160} If any of these assets which were held on the conversion date is sold for a gain, the gain will be taxed at the corporate level.\textsuperscript{161} The entire gain will be taxed unless the bank can prove that the gain or a portion of the gain relates to appreciation of the asset since the date of conversion.\textsuperscript{162} One piece of good news is that this tax is only applicable during the bank’s recognition period, or 120 months from the date of conversion.\textsuperscript{163} Any assets sold after this date will not be subject the built-in gains tax.\textsuperscript{164}

Careful tax planning by someone who understands the complexity of the built-in gains tax is needed for a bank to weigh the advantages of converting to S corporation status and also to avoid some of the potential problems and expenses resulting from the built-in gains tax.\textsuperscript{165} A bank needs to keep records regarding the value of its assets.\textsuperscript{166} It may also be advisable to have an independent appraisal of this value.\textsuperscript{167} The appraisal should also be performed near the S corporation election date in order to accurately contrast the value as a C corporation and any appreciation that might occur while the asset is under S corporation status.\textsuperscript{168} The built-in gains tax can be avoided simply by not selling any appreciated asset during the ten year recognition period.\textsuperscript{169} However, if this alternative is not feasible and an asset must be sold, it is important to note that any built-in gain realized during the ten year recognition period can be offset by any built-in loss that is realized during the same year.\textsuperscript{170} Therefore, it

\begin{itemize}
  \item \textsuperscript{160} See id.
  \item \textsuperscript{161} See 26 U.S.C.S. § 1374 (Law. Co-op. 1999).
  \item \textsuperscript{162} See Applying the Built-In Gains Tax, supra note 159.
  \item \textsuperscript{163} See id.
  \item \textsuperscript{164} See id.
  \item \textsuperscript{165} See id.
  \item \textsuperscript{167} See Baran, supra note 40.
  \item \textsuperscript{168} See Taxable Sales, supra note 166.
  \item \textsuperscript{169} See Applying the Built-In Gains Tax, supra note 159.
  \item \textsuperscript{170} See id.
\end{itemize}
is important to analyze both potential gains and losses and try to match both so that they are recognized in the same year.\textsuperscript{171}

Passive investment income limits also may pose problems to banks trying to qualify as an S corporation.\textsuperscript{172} Passive investment income includes income received from royalties, rents, dividends, interest, annuities, and gains on the sales of stocks and securities.\textsuperscript{173} Any passive investment income that exceeds twenty-five percent of a bank’s gross receipts will be subject to the highest marginal tax rate – the same amount as for C corporations.\textsuperscript{174} In addition, any bank that exceeds this twenty-five percent limit for more than three consecutive years will automatically have its S corporation status terminated.\textsuperscript{175}

A bank must also be concerned with the fringe benefits that it gives to its shareholders.\textsuperscript{176} Any shareholder who owns at least two percent of the stock is treated the same as a partner in a partnership for federal tax purposes – meaning fringe benefits are included in that shareholder’s income.\textsuperscript{177} These fringe benefits include employer paid health insurance premiums, group-term-life insurance premiums, meals and lodging, and other benefit plans.\textsuperscript{178} In a C corporation the shareholder is allowed to exclude certain fringe benefits such as insurance premiums paid by the corporation.\textsuperscript{179} A shareholder in an S corporation needs to be aware of these rules and classifications before filing his or her

\textsuperscript{171}See id.

\textsuperscript{172}See Richard Z. Soukup and John R. Ziegelbauer, Grant Thorton Analysis of Banks Making the S Corporation Election (visited Feb. 3, 2000) <http://www.gt.com/resources/finance/banktax/ scorpscorp/analysis.html>. Income from the following assets is considered part of the ordinary course of business and is therefore not a subject of the passive investment income limit: loan, participations, or REMIC regular interests, equity investments needed to conduct business, assets pledged to a third party to secure deposits or business, or investment assets needed for liquidity or loan demand. See id.


\textsuperscript{177}See id.


\textsuperscript{179}See Goldstein, supra note 3, at 654.
V. LEGISLATIVE PROPOSALS TO EASE THE RESTRICTIONS ON S CORPORATIONS

Although the changes in the S corporation status have provided significant advantages to small banks, not everyone is completely satisfied. Senator Wayne Allard of Colorado has pushed for legislation that would make it easier for banks to convert. In 1997, when banks first could apply for S corporation status, the existing S corporation rules were simply applied to banks. Banks, however, have certain quirks that make them different from other small businesses, and the rules have presented complications. In addition to attempting to alleviate these problems, Senator Allard has attempted to ease the restrictions for all S corporations, including banks, in trying to convert. In his remarks before introducing S. 875, Senator Allard stated that Subchapter S provisions:

reflect the desire of Congress to eliminate the double tax burden on small business corporations. . . This legislation contains several provisions that will make Subchapter S election more widely available to small businesses in all sectors. It also contains several provisions of particular benefit to community banks that may be contemplating a conversion to Subchapter S. . . . This legislation builds on and clarifies the

180. See id.
181. See Telephone Interview with Sean Conway, Press Secretary for Senator Wayne Alland (Feb. 23, 2000) [hereinafter Telephone Interview: Sean Conway].
182. See id. Senator Allard (R), who serves on the Senate Banking Committee, began his career as a small business owner as a veterinarian. See id. He understands the value small businesses have in the community and also the difficulties they face. See id. Much of his work in Congress, as well as his motivation for entering a political career, has been to ease these difficulties. See id.
183. See id.
184. See id.
185. See id.
186. See id.
Subchapter S provisions applicable to financial institutions.187

One economist states that unfortunately "many community banks are having trouble qualifying under the current complicated rules and cannot benefit from Congress's intended tax relief. We are confident that lawmakers will expand Sen. Allard's efforts when a final tax relief bill becomes law."188 The measures would provide "needed relief from punitive taxation. Community banks are being squeezed by mega-mergers, rural agricultural difficulties, and encroachment by tax-free rivals."189

In a general sense, these proposed amendments would not change decisions by banks to convert; they would simply make it easier for a few banks on the fence or which cannot quite reduce the number of shareholders.190 Although it looks as if there will be no legislation passed this year,191 it is useful to review the provisions supporters of S corporations are attempting to get en-

188. See ICBA Lauds Senator Allard's Efforts for Community Banks, PR Newswire, Aug 2, 1999. (quoting Paul Merski, the International Community Bankers of America chief economist and director of federal tax policy). The ICBA is a major voice for community banks. See id. It represents nearly 5400 institutions nationwide. See id.
189. Dean Anason, Capital Briefs: Bill Would Ease Rules For S Corporations, AM. BANKER, Apr. 27, 1999, at 2. (quoting Richard N. Barsness, president of the ICBA.) Of course, these new recommendations are not without opposition from people, especially the "tax free rivals." Banks Lobbying for Expanded "Sub-S" Tax Loophole, PR Newswire, March 31, 1999. Ron Halvorsen, president of the Wisconsin Credit Union League, stated that bankers "have been saying for years that credit unions have an unfair competitive advantage due to the income tax exemption credit unions receive for being not-for-profit. This drive to expand S Corp status to even more banks just exposes the duplicity and hypocrisy behind the bankers attacks on credit unions." Id.
190. See Telephone Interview: Sean Conway, supra note 181. See also supra notes 101-126 and accompanying text (discussing two specific banks that ultimately decided not to convert, but would reconsider their decision if legislative changes occur).
191. See Telephone Interview: Sean Conway, supra note 181. The Small Business and Financial Institution Tax Relief Act of 1999 was part of a much larger tax plan that was vetoed by President Clinton. See id. Tax changes are packaged together, and the whole is either approved or rejected. See id. There are no individual tax bills. See id. Many of these provisions will probably find their way onto the large tax package of 2000. See id.
acted.

S. 875 is the most recent bill that has been introduced.192 It contained several provisions that would help relieve restrictions on banks wishing to convert.193 In addition to increasing the number of shareholders an S corporation may have from seventy-five to one hundred-fifty, the bill would also allow IRA's to be shareholders.194 Easing these restrictions would enable certain businesses and banks, like First National Bank and Sacramento Commercial Bank, to avoid the public relations problems and potential litigation resulting from shareholder freeze-outs.195

Also, some states require their banks to issue special shares for directors, which is a violation of the requirement that a bank only issue one class of stock.196 One provision of the bill would clarify that qualifying bank director stock does not represent a second class of stock.197 Generally, a director is required to own stock in the bank to help ensure the director will be vigilant in protecting the bank’s interest.198 If the director owns a sufficient financial interest in the bank, the director will more than likely have a significant interest in the bank’s success.199 Director’s shares would be defined as stock “held by an individual solely by reason of status as a director of such bank or company or its controlled subsidiary” and must be disposed of when the holder’s status as a director is terminated.200 The new provision

193. See id.
194. See id.
195. See supra notes 101-126 and accompanying text (discussing First National Bank’s and Sacramento Commercial Bank’s consideration of S corporation status).
198. See Levy, supra note 3, at 86. This problem sometimes arises in small family owned banks, where the family shareholders do not want the director to have a measure of control over the bank. See id. Therefore, the family may elect to give director’s stock with limited economic rights. See id. Sometimes director’s stock may also be in the form of IRA’s, or may be stock of the bank instead of the holding company. See id.
199. See id.
200. Id. The stock must be sold at the same price as the individual acquired such shares of the stock. See id.
would allow banks to continue with the practice of issuing limited director's stock while also preserving their S corporation status.

Another provision would reduce the percentage of shareholder approval needed for conversion to S corporation status from one hundred percent to ninety percent. The remaining non-consenting shares shall not be treated as a second class of stock, but will be treated like C corporation stock. The pro rata share of distributions for non-consenting stock will be subject to a tax that will be paid by the S corporation as well as a tax paid by the shareholder. The Act would also allow for the issuance of preferred stock.

Other provisions in the Act would have excluded investment securities from passive investment income, excluded non-healthcare benefits from wages for two percent shareholders, allowed family limited partnerships to be shareholders, and allowed bad debt charge-offs to be treated as built-in loss.

These provisions would not revolutionize S corporation status, but they would make converting easier and also relieve some tax burden for the bank. One lobbyist argues: "Nonbank competitors, such as farm credit lending institutions and credit unions, continue to enjoy significant tax advantages that make it difficult for banks to compete in their local communities. These important provisions would help level the playing field."

Two provisions made it into the final tax provision package that was approved by both the House and the Senate in late 1999.

202. See id.
203. See id.
204. See id.
206. See supra notes 101-126 and accompanying text (discussing two specific banks that ultimately decided not to convert, but would reconsider their decision if legislative changes occur).
July and August: the clarification that director's stock should not be counted as a second class of stock and the exclusion of investment portfolios from passive investment income.\textsuperscript{208} Unfortunately, President Clinton vetoed this tax package in September.\textsuperscript{209} Most, if not all, of the provisions will likely be renewed in 2000, with the hopes of including as many as possible in the 2000 tax package.\textsuperscript{210}

One measure finally approved at the end of 1999 is legislation that mandates a study into the effects of revising the rules and easing the restrictions governing S Banks.\textsuperscript{211} The revisions in this study include: increasing the number of shareholders, allowing IRA as shareholders, clarifying that interest held for safety and liquidity purposes will not be counted as passive investment income, and improving the treatment for bad debt and interest deductions.\textsuperscript{212} The Comptroller General of the United States must submit a report within six months of the enactment of the bill detailing the results of their study.\textsuperscript{213} Hopefully, for those wishing to convert, the study will help these changes occur in the year 2000.

VI. CONCLUSION

The benefits of S corporation status, on its face, to a community bank are obvious. The tax breaks greatly enhance the ability of a qualified community banks to be successful and compete in a competitive market – often times competing with credit unions that already enjoy significant benefits and tax breaks that banks do not enjoy. The difficulty and questions in deciding to convert or not to convert arise in the cost of a bank putting itself

\textsuperscript{208} See Legislative Updates, supra note 196, at 6.
\textsuperscript{209} See Legislative Updates, AM. BANKER, Oct. 14, 1999, at 5.
\textsuperscript{210} See supra notes 181-191 and accompanying text. (discussing Senator Allard's efforts to pass S corporation legislation and his opinion of that legislation in 2000).
\textsuperscript{212} See id.
\textsuperscript{213} See id.
in a position to realize these benefits. A bank that can meet the requirements of S corporation status in terms of number and types of shareholders should find the decision of whether to convert or not an easy one. The only problems a bank in this category would face are obstacles to substantial growth and the cost of abandoning the reserve method of accounting.

Of course, a bank that foresees difficulty in converting, both because of the threat of litigation, and also because of the potential public relations problems, has an additional layer of issues to confront. Here, the bank must carefully assess its role in the community and its long-term goals. It also must evaluate the importance of the shareholders it inevitably will have to force out, and what the effect of that action could be, in terms of its customer base and reputation in the community.

In order to make these decisions, a bank certainly needs careful planning, both from a legal standpoint and an accounting standpoint. This planning needs to be done prior to making an election, but the S corporation status will also need careful supervision if a bank actually decides to elect. Maintaining the S corporation status can prove to be costly as well, but if a bank can comfortably position itself before election, the maintenance cost should prove to be worthwhile considering the substantial tax benefits the bank would receive.

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