United States General Accounting Office

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Report to Congressional Committees

June 2000

BANKING TAXATION

Implications of Proposed Revisions Governing S-Corporations on Community Banks

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United States General Accounting Office
Washington, D.C. 20548

General Government Division

B-284651

June 23, 2000

Congressional Committees:

This report responds to a mandate in the Gramm-Leach-Bliley Act of 1999 to study certain rules that affect decisions by banks[1] to elect S-corporation status for federal tax purposes. Under the Small Business Job Protection Act of 1996, banks were permitted to elect S-corporation status for the first time beginning in 1997. Banking industry representatives have cited a number of obstacles that banks face when converting to S-corporation status. Possible revisions to the tax rules included in our mandate were proposed to address these obstacles and would generally expand the banking and, in some cases, other industries' eligibility to elect S-corporation status. Our objectives were to (1) analyze possible revisions to the rules governing S-corporations; and (2) determine the potential impact such revisions might have, primarily on community banks.[2]

As stated in the Gramm-Leach-Bliley Act, the specific revisions we studied were (1) increasing the permissible number of shareholders in S-corporations; (2) permitting shares of S-corporations to be held in individual retirement accounts (IRAs); (3) clarifying that interest on investments held for safety, soundness, and liquidity purposes should not be considered passive investment income;[3] (4) discontinuing the treatment of stock held by bank directors as a disqualifying second class of stock for such corporations; and (5) improving federal tax treatment of bad debt for banks converting to S-corporation tax status.

Corporations that elect Subchapter S status are not subject to federal corporate income tax. The S-corporation's income is "passed through" to S-corporation shareholders, who are taxed on their portion of the corporation's income, regardless of whether they receive a cash

[1] In this report, we refer to federally insured bank and thrift institutions as banks.

[2] Although no commonly accepted definition of a community bank exists, the term is often associated with smaller banks (e.g., under $500 million or under $1 billion in assets) that provide traditional "relationship" banking services to the local community, and have management and board members who reside in the local community.

[3] Section 1362 (c)(i) of the Internal Revenue Code defines passive investment income as gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. We discuss the restrictions on passive investment income for S-corporations in more detail in appendix V.

distribution. At the end of 1997, there were approximately 2.5 million S-corporations in the United States, according to Internal Revenue Service (IRS) data. S-corporations operate in every industrial sector and in every state. A corporation must meet a number of eligibility requirements to become an S-corporation, which we discuss more fully in appendix I. If any of the criteria are no longer met, a firm's tax status as an S-corporation would be terminated automatically, and it subsequently would be taxed as a C-corporation.

We conducted our work in Washington, D.C., and San Antonio, TX, between December 1999 and May 2000, in accordance with generally accepted government auditing standards. Appendix II describes our scope and methodology.

Results in Brief

We studied five possible revisions to the tax rules governing S-corporations. The proposed provisions were written to address perceived obstacles to becoming S-corporations cited by representatives of the banking industry. Two of the five proposed tax changes that we analyzed—increasing the number of shareholders and allowing IRAs as shareholders—would affect both nonbank and bank corporations. For example, the first proposed provision would increase the maximum number of shareholders in S-corporations from 75 to 150. Expanding the number of eligible shareholders would allow more firms to choose to become S-corporations. Increasing the shareholder limit, however, appears to be more important to the banking industry than to other industries because S-corporation banks have significantly more shareholders than S-corporations from other industries, according to IRS data.

The remaining three provisions—clarifying passive income rules, tax treatment of bank director shares, and tax accounting of bad debts—specifically affect individual banks' corporate strategies. Banks face certain obstacles in becoming S-corporations that are situational to an individual bank's history and business strategy. For example, because the current tax rules limit the amount of passive investment income that S-corporation banks can earn, some banks have found this rule to be a significant obstacle to becoming an S-corporation, but others have not. One provision we studied would clarify that a bank's income from investment securities usually held for liquidity purposes would not be considered passive investment income under IRS tax rules. The proposed change may be more consistent with bank regulatory objectives—safety and soundness—than with current tax treatment—taxing similar types of income across industries in a similar fashion. We discuss the specific proposed tax provisions in appendixes III through VII.

The proposed tax provisions would allow more and larger banks to benefit from not paying corporate tax by electing S-corporation status, and the overall impact on community banks would be determined by this expansion. It is difficult to project how many banks could be affected by the proposed tax changes. Estimates ranged from about 300 to 5,700 banks and thrifts. The proposed provisions could help community banks become more competitive relative to credit unions to the extent that converting banks provide the same services offered by credit unions. The benefits of these proposed provisions for community banks relative to larger banks would depend on the characteristics of the converting banks. Other potential impacts of the proposed provisions include

- tax revenue losses estimated by the Joint Committee on Taxation to be at least $748 million over a 5-year period; and
- behavioral changes—higher dividends and lower capital in S-corporation banks, relative to comparable banks, that might have regulatory implications.

The Departments of Labor and Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision provided comments on a draft of this report, which are included near the end of this letter.

Background

State banks are legally required to organize as corporations in order to obtain insurance from the Federal Deposit Insurance Corporation (FDIC).[4] Also the Internal Revenue Code defines the term “bank” to mean a bank or trust company that is incorporated and doing business under the laws of the United States.[5] A corporation is a legal business entity that generally raises money by selling shares of stock to shareholders. Corporations are generally subject to federal-level corporate income taxation on earnings that are either distributed to shareholders in the form of dividend payments or reinvested in the corporation in the form of retained earnings. Shareholders in corporations are in turn subject to the individual income tax on dividends received and capital gains realized. In contrast, corporations that elect Subchapter S status generally are not subject to federal corporate-level income tax. S-corporation tax status mainly allows small, closely-held corporations meeting certain requirements to elect to

[4] 12 U.S.C. 1813(a)(2). For purposes of determining eligibility for federal deposit insurance, the term “state bank” is defined as any bank, banking association, trust company, savings bank, industrial bank, or other banking institution that is (1) engaged in the business of receiving deposits and (2) incorporated under the laws of any state.

[5] 26 U.S.C. sec. 581.

eliminate corporate-level income taxation. S-corporation shareholders are taxed on their portion of the corporation’s taxable income, regardless of whether they receive a cash distribution.

The history of S-corporation legislation reflects congressional intent to provide a tax election to benefit small business corporations. Beginning in 1997, financial institutions that meet certain requirements were permitted to elect Subchapter S status. We discuss the history of S-corporations and the eligibility requirements for becoming S-corporations more fully in appendix I. Generally, to qualify for S-corporation status, a business must meet the following requirements:[6]

- The business must be a domestic corporation.
- The business must have only one class of stock.
- There must be no more than 75 shareholders.
- The shareholders must be only individuals; estates (including estates of individuals in bankruptcy); certain trusts; and for tax years beginning in 1997, certain tax-exempt organizations. [7] Nonresident aliens, partnerships, limited liability companies, and individual retirement accounts are not qualifying shareholders.
- The business cannot be a financial institution that uses the reserve method of accounting for bad debts for tax purposes. Certain other types of corporations[8] also do not qualify.
- All shareholders must agree to the business’ decision to be an S-corporation.

Banks meeting the eligibility requirements for S-corporations generally can avoid corporate income tax obligations. According to FDIC data, as of year-end 1999, slightly over 1,300 banks and thrifts were S-corporations (about 13 percent of total banks and thrifts) with average bank assets of about $100 million. Asset levels of S-corporation banks ranged from $4.7 million to $5.5 billion. However, most banks have continued their status as C-corporations. Reasons why banks may not choose to elect S-corporation status include (1) failure to meet the eligibility requirements, (2) conversion costs associated with meeting the requirements, and (3)

[6] Section 1361 of the Internal Revenue Code.

[7] An S-corporation may hold stock in a controlled subsidiary but may not be a subsidiary of another company unless it is wholly owned by a parent company that is also an S-corporation. The parent S-corporation must make an election to treat the subsidiary S-corporation as a Qualified Subchapter S Subsidiary (QSSS). The QSSS would essentially not be treated as a separate corporation.

[8] Insurance companies, domestic international sales corporations (DISCs), and corporations electing to take the possessions tax credit are also ineligible corporations.

expected rapid growth that requires a larger shareholder base to attract sufficient capital to support such growth.

Some S-corporation requirements, such as the shareholder and passive income restrictions, can affect bank management strategies related to a bank's capital structure. Capital provides banks long-term funding that cushions the banks against unexpected losses. Banks can raise capital by selling shares of stock to shareholders and by retaining earnings.

Under national banking law, directors of national banks that are regulated by the Office of the Comptroller of the Currency are required to hold shares of bank stock. Banks also are required to hold capital that is commensurate with the risks associated with their assets, liabilities, and ongoing banking activities. Credit risk faced by a community bank is closely tied to economic conditions in the specific community in which the bank provides banking services.

The Gramm-Leach-Bliley Act of 1999 expanded bank powers. It facilitated affiliation among banks, securities firms, and insurance companies. As a result, the competitive landscape faced by community banks could change, with or without changes to rules governing S-corporations. Likewise, the services provided by community banks could change.

Analysis

Our analysis addresses (1) the implications of individual proposed provisions; and (2) the overall impact of the provisions, if passed, primarily on community banks.

Two Provisions Affect S-Corporations in All Industries

The first two provisions we studied—increasing the number of shareholders and permitting individual retirement accounts (IRAs) as shareholders—affect S-corporations in all industries, not only the banking industry. The other three provisions we studied—clarifying passive income rules, tax treatment of bank director shares, and tax accounting of bad debts—were specific to the banking industry.

Increasing the Number of Eligible Shareholders Appears More Important to the Banking Industry than to Other Industries Wishing to Become S-Corporations

According to discussions with industry representatives and our analysis, the shareholder limit appears to be more of a constraint for banks wishing to elect Subchapter S tax status than for firms in most industries. Across all industries, roughly 2.5 million corporations have elected to be S-corporations as of the end of December 1997. Of these 2.5 million S-corporations from all industries, 91 percent had 3 or fewer shareholders, and less than 1 percent had more than 31 shareholders, according to IRS data. Since 1997, 1,318 banks, or about 13 percent of banks in the industry, have converted to S-corporation status, according to FDIC data as of the end December 1999. About 40 percent of these S-corporation banks had 3 or fewer shareholders, and about 11 percent had 31 or more shareholders, according to IRS data.

Bankers, banking industry representatives, and legal and accounting experts we interviewed cited the 75-shareholder limit as a major obstacle for banks wishing to elect Subchapter S tax status. Bankers told us that the current shareholder limit forced them to eliminate (i.e., "buy-out") minority shareholders and limited their ability to pass shares on to family generations for estate planning purposes.

Bank regulators did not express any safety and soundness concerns with increasing the number of eligible shareholders. If the shareholder limit were increased to 150, bank regulators noted that it would be easier for banks to raise additional capital, which could be important in the event of an economic downturn. On the other hand, some legal experts told us that the requirement to obtain 100 percent shareholder consent to elect Subchapter S status may become even harder if the shareholder limit were increased. Treasury officials expressed the concern that increasing the number of shareholders further distances S-corporations from the simplified business model—one of the main justifications for their corporation income tax exemption. We discuss this proposed provision more fully in app. III.

IRA Shareholders Must Be Eliminated During Conversion Process

Individual retirement accounts (IRAs) are ineligible shareholders for S-corporations. Although C-corporation banks are permitted to have IRA shareholders, if they wish to become S-corporations they must eliminate the IRA shareholders. Banks have found ways to eliminate their IRA shareholders. For example, some bankers and legal and accounting experts told us that banks repurchased stock held in IRAs, but this added to the cost of conversion. Others told us that individuals owning the IRA shares have applied to the Department of Labor for permission to buy back the bank shares,[9] which added to the time that it took to convert to an S-corporation. Department of Labor officials told us that processing the exemption takes a minimum of four months.

Bank regulators we met with did not identify any safety or soundness concerns with allowing S-corporation bank shares to be held in IRAs, because banks are permitted to do so as C-corporations. However, Treasury officials generally opposed this proposal because permitting IRAs to hold shares in S-corporation banks would create untaxed income for a

[9] We discuss this in more detail in appendix IV.

potentially long period of time. If this provision were passed, they supported an alternative proposal that would tax the IRAs under the Unrelated Business Income Tax, which parallels similar tax treatment of other pension funds. We discuss this proposed provision more fully in appendix IV.

Three Proposed Provisions Affect S-Corporation Banks' Operations

Three of the proposed provisions we studied—clarifying passive income rules, tax treatment of bank director shares, and tax accounting of bad debts—may affect banks' management strategies but do not directly affect S-corporations in other industries.

Clarifying Current Tax Treatment of Passive Investment Income Could Improve Converting Banks' Liquidity

If a bank's passive investment income[10] exceeds 25 percent of gross receipts for 3 years, it may lose its S-corporation eligibility. Bank accounting experts we interviewed stated that the present IRS rules for passive investment income relating to Subchapter S corporations and potential terminations of Subchapter S status are not clear. They said that at a minimum, IRS needs to provide clearer guidance on what constitutes passive investment income for banks. These experts proposed that a bank's income from investment securities not be considered passive income for tax purposes. IRS and Treasury officials stated that the current rules give tax examiners sufficient flexibility in dealing with different tax situations for banks and did not believe further clarification was needed.

IRS guidance lists banking assets that are not subject to passive investment income limitations.[11] The IRS guidance also includes a "catch-all" paragraph that excepts from passive investment income assets that are held by the bank to satisfy "reasonable liquidity needs." However, Treasury securities are not listed explicitly in IRS' current guidance. Some bankers are concerned that if the banks were audited, IRS examiners would consider their U.S. Treasury securities as "passive" investment income rather than actively held for "reasonable liquidity purposes." Bankers and legal and accounting experts emphasized that banks in rural and low-growth areas experiencing either cyclical or low loan demand may not be able to comply with current passive investment income rules. These banks typically hold large portfolios of Treasury securities to offset the cyclical cash flows and low loan demand in their communities.

[10] S-corporations with accumulated earnings and profits from years as C-corporations are subject to a corporate-level tax on net passive investment income exceeding 25 percent of gross receipts for any year.

[11] We cite this list in appendix V.

Some bankers and accounting experts whom we spoke with were concerned that IRS may treat banks' investment income as passive investment income in some situations, which may deter banks from holding prudentially adequate levels of liquidity. Federal Reserve officials told us that although they understood IRS' position on passive investment income, they were concerned that strict interpretation of tax rules could limit the liquidity a S-corporation bank would keep. They felt the limit would cause banks to change the types of assets they kept in their portfolios, lowering banks' overall liquidity.

We observed that accountants' interpretations of passive income rules varied, which could result in inconsistent treatment for tax purposes. Legal and accounting experts we interviewed told us that some banks are shifting investments to meet perceived passive investment income restrictions. For example, one banker told us that his bank had begun shifting the bank's Treasury securities into riskier investments to avoid losing its S-corporation tax status. Our analysis also suggested that S-corporation banks had slightly higher loan to asset ratios (had become slightly less liquid) relative to comparison groups of C-corporation banks (discussed below). We discuss the proposed provision on passive income more fully in appendix V.

Share Agreements of National Bank Directors May Need to be Rewritten to Qualify for S-Corporation Status

To become eligible to be an S-corporation, a firm is allowed to have only one class of stock. Under national banking law, bank directors are required to hold a minimum of $1,000 par value of stock in their bank.[12] The stock can be held in the form of common stock; but as a matter of practice, some bank directors hold preferred stock,[13] which constitutes another class of stock. Therefore, the way banks write their shareholder agreements for bank director shares can create a second class of stock (which would disqualify a bank from becoming an S-corporation), unless the agreements are rewritten during the conversion process so that the bank has only one class of stock.

Another requirement under national banking law that can affect an S-corporation bank is that national banks must have a minimum of five bank directors. These shareholder requirements for national bank directors increase the number of shareholders for banks electing S-corporation

[12] Par value is equal to the nominal or face value of a security. The par value could represent the original investment or the price paid for the share, which would not necessarily represent the market value of the share.

[13] Preferred stock is a class of capital stock that generally pays dividends at a specified rate and has preference over common stock in the payment of dividends and the liquidation of assets.

status. Some bankers have told us that these requirements limit their ability to manage the number of shareholders of the banks, and they cited them as an obstacle to the Subchapter S election.

The proposed provision would not consider bank director shares as a second class of stock or count bank director shares as shareholders for S-corporation purposes. IRS officials have not changed their regulations to address the bankers' concerns and stated that to do so would require legislative changes. We discuss this proposed provision more fully in appendix VI.

Technical Change in Banks' Tax Accounting for Bad Debts Lowers Cost for Converting to S-Corporation

Bank tax accounting experts we interviewed have cited the current tax treatment for banks' accounting for bad debt as an obstacle to the Subchapter S election. The proposed provision would change the tax deductions for certain losses embedded in the loan portfolio at conversion from a C-corporation bank to an S-corporation.

Current S-corporation eligibility restrictions require that for tax purposes, financial institutions must use the specific charge-off method for bad debt expense (i.e., firms can take a tax deduction against income or "write-off" an asset in the tax year that it is deemed worthless). Small C-corporation banks are permitted to use the reserve method of accounting for their bad debts for tax purposes (i.e., the bank can take a deduction against its income for additions to its bad debt reserves in an amount that will make the reserve balance large enough to absorb anticipated future bad debts). If a small bank that uses the reserve method wishes to become an S-corporation, it must change its accounting methods for bad debts from the reserve method to the specific charge-off method. Banks are then required to "recapture" their reserve (the value of estimated losses) as income, which is taxed at the corporate rate as "built-in" gain, income created by recapturing the reserve.[14] For some banks, this can be a costly part of conversion to an S-corporation. The built-in gain from the reserve is recaptured into taxable income over a 4-year period.[15] Currently, after conversion a bank can deduct its built-in losses only for the first year, and it can deduct these losses only up to the value of their built-in gains. Any remaining "built in" losses cannot be carried over or used against other income to lower taxes. The ability to deduct built-in losses from bad loans may become more important in the event of an economic downturn. When the economy is strong and a bank is experiencing relatively few loan

[14] Built-in gains (losses) generally refer to gains (losses) embedded in the asset portfolio at the S-corporation conversion date.

[15] Other built-in gains generally are recaptured over a 10-year period.

losses, the ability to deduct the built-in losses is less important. Conversely, as loan losses increase, so does the importance of a bank's ability to deduct built-in losses.

The proposed change would allow built-in losses to be matched against built-in gains over the 4-year recapture period. Treasury officials indicated a willingness to address the issue, but they also said the change would complicate tax rules at a time when they are attempting to simplify these rules. We discuss this proposed provision more fully in appendix VII.

Obstacles that Banks Face in Electing Subchapter S Status Are Situational

Representatives from the banking industry cited a number of perceived obstacles in converting to Subchapter S status. However, the obstacles cited by bankers, industry representatives, and legal and accounting experts were situational and specific to a bank's history and business strategy. We found that obstacles cited by one bank were not necessarily important to another bank, depending on the nature of the bank's business. For example, some banks were very concerned about the IRS rules for passive investment income; other banks had little concern about their levels of passive investment income.

The American Bankers Association (ABA) and the Independent Community Bankers of America (ICBA), banking industry associations, surveyed their membership about obstacles in electing Subchapter S status. The major obstacles cited in these two studies included the 75-shareholder limit, the restriction on IRAs as shareholders, tax treatment of passive investment income as it relates to banks, inclusion of bank director shares in the 75-shareholder limit, and accounting problems with the way bad debts are treated for tax purposes. In our interviews with bankers and legal and accounting experts, bankers cited other obstacles, including the (1) requirement to have 100 percent shareholder consent to elect Subchapter S status and (2) inability to pass shares to family generations because of S-corporation shareholder rules that count each family member as a single shareholder.[16] The proposed provisions that we studied were written to address many of these obstacles.

Impact on Community Banks

The proposed tax provisions would allow more and larger banks to benefit from S-corporation tax status, and the overall impact on community banks would be determined by this expansion. To the extent that the proposed revisions would lead to Subchapter S conversions concentrated among smaller community banks, the major impact would be to improve the

[16] A husband and wife who each own shares in the S-corporation bank are counted as a single shareholder.

competitiveness of community banks in relation to credit unions. Alternatively, the proposed revisions could lead to Subchapter S conversions among larger banks not sharing the characteristics normally associated with community banks, which would increase competitive pressures for community banks. It is difficult to project how many banks would convert, and estimates varied on how many banks would likely convert due to these provisions. The impact of the proposed tax changes on community banks will ultimately depend on the characteristics of those banks that choose to convert to Subchapter S tax status.

In addition to the competitive impacts of the proposed provisions, banking regulators expressed a concern about the increased incentive for S-corporation banks to pay higher dividends relative to other banks in the event of an economic downturn. Our analysis supported this concern. Tax revenue losses could be associated with the proposed tax provisions, if passed.

Competitive Impact on Community Banks Depends on the Characteristics of Banks That Choose to Convert to S-Corporation Status

The impact of the proposed tax changes on community banks depends on the characteristics of those banks that choose to convert to Subchapter S tax status. By lowering the tax burdens on community banks that would convert to S-corporation status, the proposed provisions could help community banks become more competitive with credit unions, which are exempt from federal income taxes. In addition to an increase in the number of Subchapter S tax conversions, existing S-corporation community banks could become more competitive by virtue of the potential cost savings introduced by the proposed provisions, such as clarification of passive investment income rules.

Difficult to Project Potential Universe of Eligible Banks

We found it difficult to project a potential universe of those banks likely to be affected by expansion of the eligibility for becoming S-corporation banks. Three factors made it difficult to project the potential universe. First, there is no commonly accepted definition of community banks. Second, bank regulators do not track S-corporations differently from other banks. Third, shareholder data are not easily obtainable on nonpublicly traded firms.

Although we found no commonly accepted definition of a community bank, a number of characteristics are associated with community banks. Most often, a bank that limits itself to banking services in a local community, with board members and management who reside in the local community, is considered a community bank. In addition, banks can be classified as a community bank on the basis of asset size. For example, two commonly used asset size categories used to classify a community bank are assets of less than $500 million and assets of less than $1 billion. Other characteristics that have been used to classify a bank as a community bank include the provision of banking services that (1) use personal, relationship-based banking; (2) are limited to traditional banking services for individual and business customers, especially small business customers; and (3) are limited to rural communities.

Bank regulators do not track S-corporation banks differently from non-S-corporation banks, and they do not maintain data on the number of shareholders for banks. We asked regulators, tax experts, and banking industry representatives to provide their best estimates of the number of banks that would likely be affected by the provisions. Their estimates of how many banks would convert to S-corporation status varied and ranged from 300 to 5,662 banks and thrifts. We discuss these estimates more fully in appendix III.

S-Corporation Status Could Allow Community Banks To Be More Competitive With Credit Unions

S-corporation status could allow community banks to be more competitive with credit unions. However, credit unions may react by seeking additional relief from restrictions on their activities. As stated earlier, credit unions are financial institutions that are not subject to the federal corporate income tax. A credit union is owned by its members, which are the credit union’s customers, and does not issue stock. Credit unions generally have limited business powers in relation to banks. Officials from the American Bankers Association told us that their initiatives to expand S-corporation opportunities for banks were motivated by continued federal income tax exemption for credit unions. Officials from the National Credit Union Administration (NCUA) told us that if Subchapter S eligibility for banks were expanded, NCUA would ask for more leeway in membership. According to NCUA officials, because credit unions are structured as cooperatives,[17] they do not have the same profit motive as banks or the same incentive to pay out dividends to their membership. As tax-exempt institutions, credit unions can accumulate retained earnings tax-free, and such retention can be a major source of capital for credit unions. In addition, a credit union’s earnings are not passed through to its membership as taxable income in the same way that S-corporation bank shareholders must pay personal income tax on their portion of taxable income from the S-corporation bank. Therefore, the potential impacts of

[17] Credit union membership is limited to its members with a “common bond,” defined as “a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district.” The Credit Union Membership Access Act of 1998 (P.L. 105-219) expanded credit union powers and made the “common bond” requirement less restrictive. Credit unions can now serve multiple groups.

the proposed provisions on community banks could differ from the historical impacts of federal tax exemption on credit unions.

Competitive Pressures for Community Banks Could Increase if Larger Banks Become S-Corporations

The proposed provisions, especially the expansion in the maximum number of shareholders, could also affect the competitive playing field between community banks and large financial institutions.[18] Although the largest current S-corporation bank has about $5.5 billion in assets, most current S-corporation banks are relatively small community banks. The average asset size of S-corporation banks was almost $99 million as of year-end 1999, according to FDIC data. However, as stated earlier, the proposed expansion to a maximum of 150 shareholders has the potential to motivate larger banks to take actions to convert to Subchapter S status. In addition, due to insufficient data on the number of shareholders for privately held C-corporation banks with under 500 shareholders, it is difficult to project how many more banks would likely become S-corporations, as stated earlier.

To the extent that the proposed revisions would lead to Subchapter S conversions concentrated among smaller community banks, the major impact would be to improve the competitiveness of community banks in relation to credit unions. Alternatively, the proposed revisions could lead to Subchapter S conversions among larger banks not sharing the characteristics normally associated with community banks. With this scenario, the benefits associated with the proposed revision for community banks relative to credit unions would be offset by greater competitive pressures from larger banks that are able to convert to Subchapter S status.

Regulators Concerned About the Incentive for S-Corporation Banks to Pay Dividends in the Event of an Economic Downturn

Although the banking regulators expressed few specific concerns about individual proposed provisions, they were concerned about the supervisory implications of possible behavioral differences between S-corporation banks and other banks in the event of an economic downturn. They stated that the tax incentive for S-corporation banks to pay out dividends rather than retain earnings, compared to C-corporation banks, could mean that S-corporation banks build up less capital in good economic times. Moreover, in the event of an economic downturn, when other banks would likely lower dividends, the incentives for S-corporations to pay out dividends would likely continue so that individual

[18] The Gramm-Leach-Bliley Act of 1999 permits eligible bank holding companies to add affiliates that engage in securities and insurance activities within a “financial holding company.” The extent to which community and larger banks make use of the expanded powers will also affect the competitiveness of community banks relative to credit unions and larger banks. Of the 187 declared domestic financial holding companies, 145 or about 78 percent, had assets of less than $1 billion as of May 10, 2000.

shareholders could pay taxes. Potentially, this could precipitate bank capital falling below supervisory thresholds, thus increasing the risk of failure. This pressure to pay dividends, combined with the shareholder restrictions on S-corporation banks, could also affect the ability to raise capital compared to C-corporations that do not have the same shareholder restrictions.

The regulators noted that this concern could be mitigated because all banks are subject to the prompt corrective action statute and its implementing regulations.[19] As a result, an insured bank is prohibited from paying dividends if, after such a capital distribution, the bank would be undercapitalized as defined in section 38 of the Federal Deposit Insurance Act. The federal banking agencies also have noted that they have the authority to restrict, or in some cases entirely prohibit, payment of dividends in other situations, e.g., due to capital concerns arising from an institution's risk profile.

Key Performance Measures Differ between S-Corporation Banks and Other Banks

Our analysis of 520 S-corporation banks that converted to S-corporation status in the first quarter of 1997 showed differences in certain performance measures, relative to comparable banks. Our analysis of key performance indicators supports the regulators' views that S-corporation banks have an incentive to pay out dividends and that such behavior could raise supervisory concern in the event of an economic downturn.

To compare the financial performance of S-corporation banks that converted to S-corporation status in 1997 with comparable C-corporation banks,[20] we studied 1996-1999 quarterly data on the following indicators:

- dividend to net income (dividend payout) ratios,
- capital-to-asset (Tier-one leverage capital) ratios,
- return on asset ratios, and
- net loans and leases to total assets ratios (higher ratios represent lower liquidity).

[19] Section 38 of the Federal Deposit Insurance Act requires regulators to categorize depository institutions on the basis of their capital levels and to take increasingly severe supervisory actions as an institution's capital level deteriorates. For further discussion of the prompt corrective action provisions and their implementation by the supervisory agencies, see Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions (GAO/GGD-97-18, Nov. 21, 1996).

[20] The comparison group for this analysis was defined as the 1,284 banks that were active during the 4-year period, had never become S-corporations, had assets of less than $1 billion, and had made 25 percent or more of their loans for agricultural purposes in at least one quarter. Some of the findings in our report could change if a different comparison group were used.

We found statistically significant differences for the S-corporation banks in some of these indicators. Their median cash dividend payout ratios increased, but ratios for those C-corporation banks in the comparison group did not. The difference in the trends of cash dividend payouts between S-corporation banks and comparable banks were statistically significant. The higher dividend payouts in turn may have contributed to somewhat lower capital-to-asset ratios among S-corporation banks. Because of the importance of these indicators for maintaining bank solvency, regulators may need to pay special attention to the capital strength of S-corporation banks to avoid problems in these banks in the event of an economic downturn.

After conversion, the median cash dividend to net income ratio (the dividend pay-out ratio) for S-corporation banks increased relative to the C-corporation bank comparison group. This increase could be associated, in part, with the additional incentive for S-corporation banks to pay out dividends to shareholders (to cover their additional tax liability) relative to the incentive for C-corporation banks to retain earnings. In addition, the median capital-to-asset ratio[21] for S-corporation banks declined slightly relative to our comparison group of C-corporation banks. There were no significant post-conversion differences in liquidity between the trends of these two groups. The following indicators that we analyzed demonstrate some differences between S-corporation banks and the comparison group of banks.

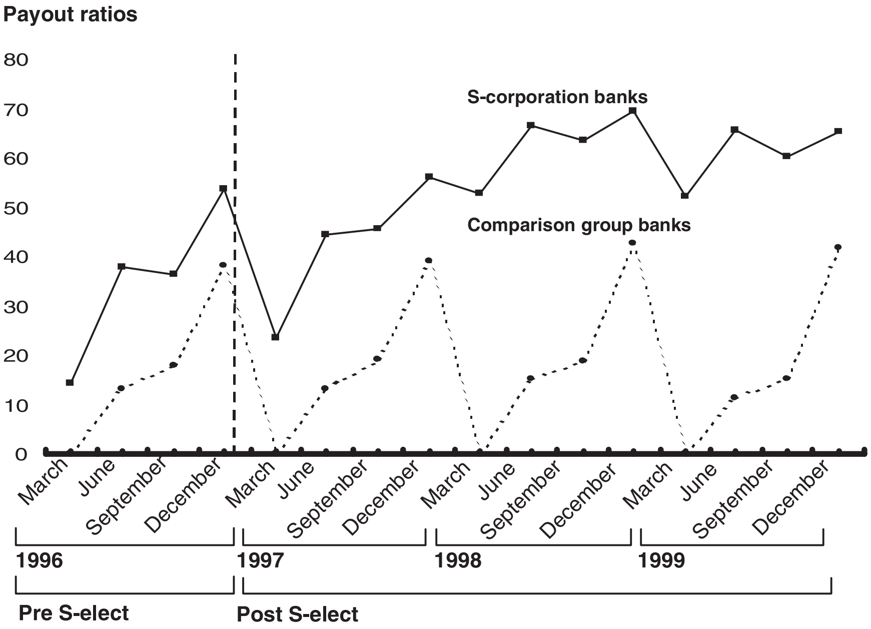
Dividends Increasing

The median cash dividend payout ratios[22] for S-corporation banks (which had been higher than for our comparison group, even before conversion) increased from 1996 through 1999; the comparison group did not change significantly during this time. Our analysis of the median cash dividend payout ratios showed an increasing gap between S-corporation and non-S-corporation ratios that was statistically significant. The increasing dividend payout ratios for S-corporation banks are not surprising because the shareholders now pay personal income tax on bank income, whether or not it is distributed as dividends (see fig. 1).

[21] The median ratio means that half the banks fell above and half fell below this ratio.

[22] The ratio is defined as the cash dividends declared divided by net income. The FDIC adjusts this ratio in the Uniform Bank Performance Report to reflect the Subchapter S tax status to facilitate comparative analysis with non-S banks. Although this adjustment improves comparability, it does not provide exact comparability between the two groups.

Figure 1: Median Cash Dividend to Net Income Ratios for S-Corporation Banks and Comparison Banks From 1996 to 1999



Source: GAO analysis of FDIC data.

Slight Decline in Capital-to-Asset Ratios

Bank capital performs several very important functions. It absorbs losses, promotes public confidence, restricts excessive asset growth, and provides protection to depositors. Bank regulators have traditionally placed a great deal of attention in their examination and supervisory programs on institutions' capital positions. Banks are subject to several capital-based regulations. One of these regulations establishes a minimum leverage capital standard. In general, the prompt corrective action statutes, which we referred to earlier, are triggered when the Tier 1 leverage ratio[23] is less than 4 percent, the Tier 1 risk-based capital ratio is less than 4 percent, or the total risk-based capital ratio falls below 8 percent.[24] Our analysis of the median Tier 1 leverage capital ratios showed that both groups of banks were well above the minimum regulatory requirement.

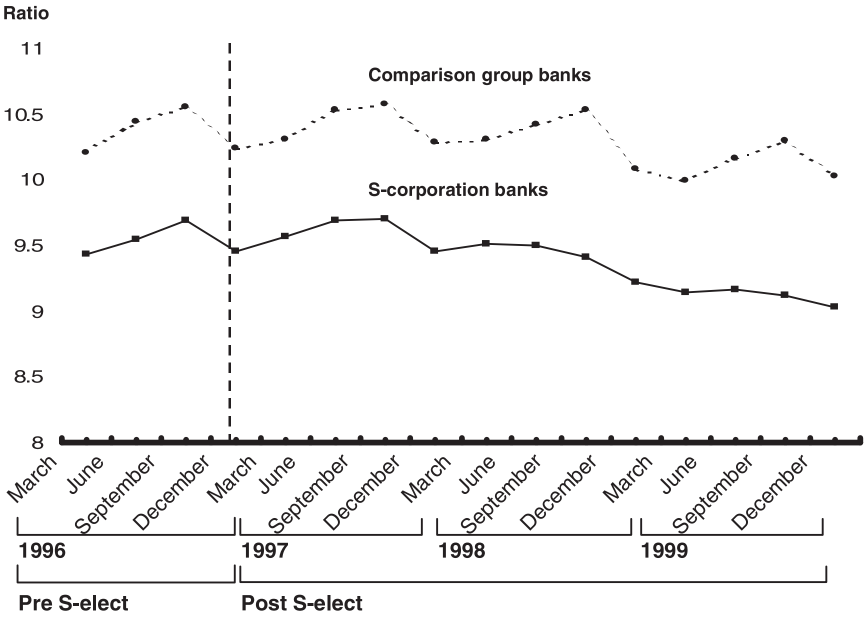
Consistent with the increasing cash dividend payout ratios, the median Tier 1 leverage capital ratios of S-corporation banks were lower than for the non-S-corporation comparison group in absolute terms and declined

[23] This ratio is Tier one capital divided by adjusted average assets as defined in the Uniform Bank Performance Report.

[24] 12 C.F.R. 325 establishes the criteria and standards FDIC will use in calculating the minimum leverage capital requirement and in determining capital adequacy. The other bank regulators have similar regulations. See Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk (GAO/GGD-98-153).

further from 1996 to 1999 than did non-S-corporation banks' Tier 1 leverage capital ratios across that same time period. From 1996 through 1999, in a comparison of the movement of the Tier 1 leverage capital ratios of S-corporation banks and the comparison group, the widening of the gap between the two groups was statistically significant—the S-corporation banks fell further below the comparison group (see fig. 2). Although the widening of this gap was statistically significant, the gap increased less than one half of a percentage point. Because our analysis spans only 4 years, these trends could change in either direction over a longer period of time and under different economic conditions.

Figure 2: Median Tier 1 Leverage Capital Ratio for S-corporation Banks and Comparison Banks From 1996 to 1999



Source: GAO analysis of FDIC data.

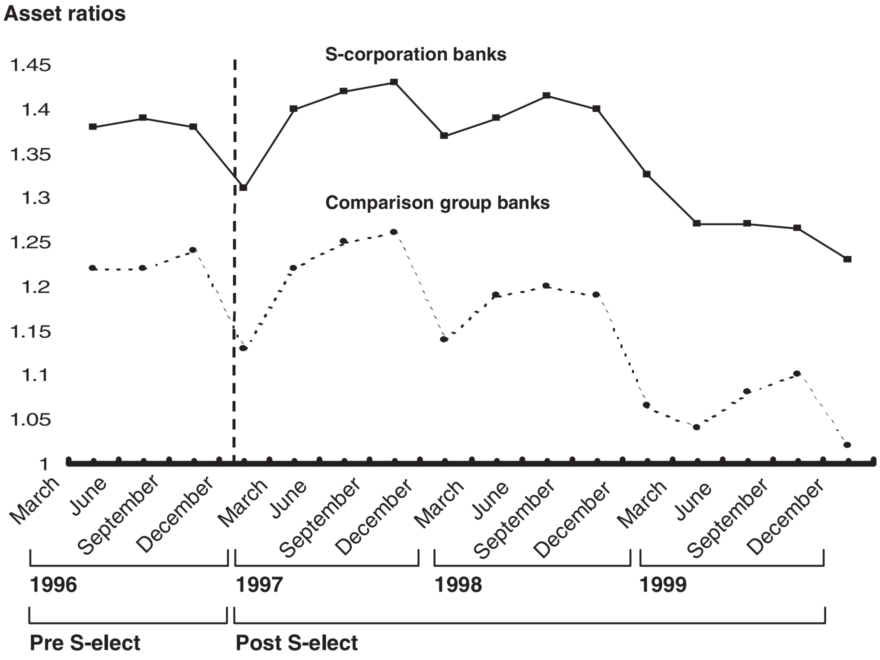
Higher Return on Assets

The continued viability of a bank depends on its ability to earn an appropriate return on its assets and capital. Good earnings performance enables a bank to fund its expansion, to remain competitive in the market, and/or replenish its capital funds. Probably one of the most widely used measures of bank earnings is the return on assets ratio. Our analysis of the return on assets ratios[25] showed that both groups of banks were considered profitable by industry standards.

[25] This ratio is defined in the Uniform Bank Performance Report as net income to average assets and equals net income after securities gains or losses and applicable taxes, divided by average assets. FDIC adjusted this ratio in the Uniform Bank Performance Report to reflect the Subchapter S tax status to

For the return on asset ratios (which were higher for S-corporation banks in every quarter), the median values for S-corporation banks declined somewhat less from 1996 to 1999 than the values for non-S-corporation banks across that same time period.[26] That is, both groups have seen a decline in this performance measure; but on average, the S-corporation ratio has fallen at a slower rate. The gap between S-corporation banks and the comparison group also widened slightly over this 4-year period (see fig. 3). This may indicate a number of things, including that the S-corporation banks (1) were more profitable; (2) had been more efficient in using their assets; or (3) became comparatively more risky relative to the comparison group, because higher returns on assets tend to be associated with higher risk. As stated before, this trend could change over a longer period of time and under different economic conditions.

Figure 3: Median Return on Assets Ratios for S-corporation Banks and Comparison Banks From 1996 to1999



Source: GAO analysis of FDIC data.

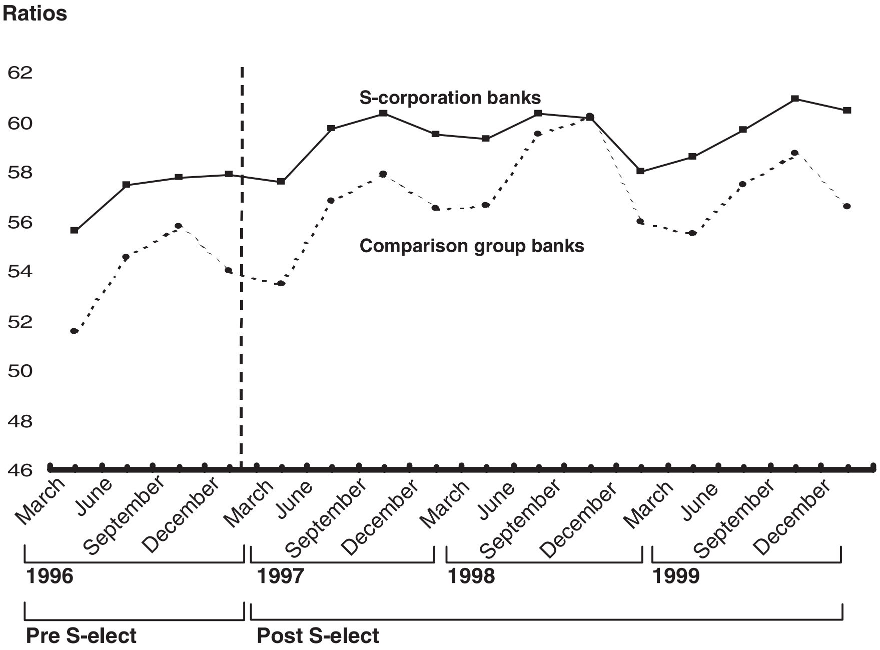
facilitate comparative analysis with non-S-corporation banks. Although this adjustment improves comparability, it does not provide exact comparability between the two groups.

[26] The Office of Thrift Supervision stated in a March 17, 1999, memo to thrift examiners that it is difficult to compare S-corporations to other thrifts because of tax differences and suggested that examiners compare S-corporations using the measure of reinvested earnings for better comparability. We also analyzed the measure of reinvested earnings for the two groups of banks. Our analysis was consistent with the trends on the return on assets ratios for these two groups of banks.

Slightly Lower Liquidity

S-corporation banks' median ratios of net loans and leases to total assets were higher (representing lower liquidity levels) than the comparison group for all quarters except one. In comparing the median net loans and leases to assets ratio of S-corporation banks to the same ratio in its peer group, we found that although both S-corporation and comparison group banks show a slight trend towards decreasing liquidity levels over the 1996 through 1999 period, there was no statistical difference between the trends of the two groups. The liquidity measure we analyzed—net loans and leases to asset ratio—increases as the bank becomes less liquid (i.e., as the bank's loans increase relative to its total assets).

Figure 4: Median Net Loans and Leases to Assets Ratio for S-Corporation Banks and Comparison Banks, 1996-1999



Source: GAO analysis of FDIC data.

Estimated Tax Revenue Loss for Proposed Provisions

Tax revenue losses would be likely if the five proposed provisions that we studied were passed. According to the proposals written for the 1999 tax reform act, the tax revenue losses were estimated to be at least $748 million over 5 years and about $1.9 billion over a 10-year period. If passed, the most costly provision—increasing the maximum number of shareholders to 150—would affect all industries. The revenue loss from the three provisions that would affect only the banking industry would not be as costly and was estimated to be $168 million over 5 years. The following table presents the revenue estimates for four of the proposed provisions that we studied.

Table 1: Tax Revenue Loss Estimates for 1999 Proposed Provisions

Provision	5-year estimate (2000-2004)	10-year estimate (2000-2009)
1. Affecting all industries		
(A) Increase shareholders to 150	$580 million revenue loss	$1,544 million revenue loss
(B) Include IRAs as eligible shareholders	No estimate[a]	No estimate[a]
Subtotal #1	$580 million revenue loss	$1,544 million revenue loss
2. Affecting only banking industry		
(C) Exclude investment securities income from passive income tax treatment	$10 million revenue loss	$23 million revenue loss
(D) Treatment of qualifying director shares	$26 million revenue loss	$100 million revenue loss
(E) Improve bad debt tax treatment	$132 million revenue loss	$201 million revenue loss
Subtotal #2	$168 million revenue loss	$324 million revenue loss
Total revenue impact	**$748 million revenue loss**	**$1,868 million revenue loss**

[a] At the time these estimates were prepared, several proposals were being considered that would affect the estimates. Therefore, the Joint Committee on Taxation did not prepare estimates for this provision.

Source: Estimates prepared by the Joint Committee on Taxation based on provisions presented for the 1999 tax reform bill.

Agency Comments and Our Evaluation

We requested comments from the Departments of Labor and the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Offices of the Comptroller of the Currency and Thrift Supervision. Treasury, FDIC, and the Federal Reserve provided written comments that are included in appendixes VIII, IX, and X respectively. The Director of Exemption Determinations, Pension and Welfare Benefits Administration, Department of Labor and the Director, Internal Review, Office of Thrift Supervision provided technical comments on a draft of this report, which we incorporated where appropriate. The Office of the Comptroller of the Currency did not have any comments on our report.

The Department of the Treasury stated that “the report presents an informative and balanced discussion of the issues involved and, in particular, the potential impact of the proposal on community banks.” In addition, Treasury had five general comments. First, Treasury stated that S-corporation status was originally intended for small, simple entities and that this form of corporate organization should not be available to large entities with complicated capital structures. Second, Treasury stated that most of the proposals address transition issues and are intended to address problems arising during conversion from C-corporation to S-corporation status. Third, Treasury stated that the impact of the proposals on community banks is not unambiguously favorable, because the proposed revisions might encourage large, noncommunity banks to convert to S-corporation status, thus subjecting community banks to greater competition. Fourth, Treasury stated that certain performance measures might not be comparable for S-corporations and C-corporations. For example, comparing pre-tax dividend-to-earnings ratios, (i.e., payout ratios) or return on assets ratios could indicate differences between C-corporations and S-corporations, even in cases where there is no difference in economic substance. Fifth, Treasury stated that S-corporations should not have greater difficulty retaining earnings.

The report states that the history of S-corporation legislation reflects congressional intent to provide a tax election to benefit small business corporations. The report states in relevant sections that most of the proposals are intended to address obstacles banks face in converting from C-corporation to S-corporation status. However, we do not think these obstacles represent transitory issues in the sense that they will dissipate or disappear over a short period of time. For example, C-corporations wishing to convert to S-corporation status in the distant future could face the obstacle created by the maximum number of allowable shareholders.

In response to Treasury's comment that certain performance measures may not be comparable for S-corporations and C-corporations, we added statements to clarify statistical adjustments that were made to improve comparability. The performance data we obtained from bank regulators contained statistical adjustments of dividend payout and return on asset variables for S-corporation banks to facilitate comparative analysis of the performance of S-corporation and comparison group C-corporation banks. The adjustments were made to after-tax measures of earnings and dividends. We note, however, that although these adjustments improve comparability, they do not provide exact comparisons. In response to Treasury's comment that S-corporations should not have greater difficulty retaining earnings, we note that discussion in the report focuses on incentives for S-corporation banks to make larger dividend payouts and reduce the use of retained earnings as a source of capital. The report does not contain a discussion of the difficulties S-corporation banks have in retaining earnings.

FDIC stated that there are four items in the report for which further clarification or comment may be needed. For the first two items, which are related, FDIC stated that the report is inconsistent in its discussion of proposed changes to the passive investment income rules; and the discussion in the findings section regarding passive investment income focuses exclusively on holding of U.S. Treasury securities. FDIC discussed distinctions between investment in Treasury securities; investments held for safety, soundness, and liquidity purposes, and investment securities.

FDIC addressed two additional items. First, FDIC stated that it is important to note that safety and soundness concerns associated with high dividend payout rates are mitigated by the fact that all dividend distributions to shareholders are subject to the prompt corrective action statute and its implementing regulations. In particular, FDIC cited the authority of federal banking agencies to restrict dividends if, after such a distribution, the bank would be undercapitalized. Second, FDIC stated that it is unclear what our basis is for the statement that S-corporation status can allow banks to be more competitive with credit unions. FDIC added that credit unions do not have the same incentive as S-corporation banks to pay dividends to their membership to satisfy personal income tax obligations.

The proposed revision in the passive investment income rules we studied was clarifying that interest on investments held for safety, soundness, and liquidity purposes should not be considered passive income. In discussing the revision, we make reference to investment securities that are usually held for liquidity purposes. We also discuss specific investment securities, such as Treasury securities, as an example of a major area where clarification may be warranted. Our discussion of securities in general or specific securities does not represent an inconsistency. In response to FDIC's comment, we added clarifying language in the report.

In response to FDIC's comment on dividend payout rates, we added statements indicating that federal bank regulators have prompt corrective action authority that can be used to restrict dividend payouts. FDIC's comment stating that it is unclear what our basis is for the conclusion that S-corporation status can allow community banks to be more competitive with credit unions appears to rely on differences between S-corporation banks and credit unions involving profit motive and tax treatment. Our conclusion is not that the playing field will be fully leveled. Rather, it is that the tax advantages community banks can obtain by converting from C-corporation to S-corporation status can improve the ability of community banks to compete with credit unions that are exempt from federal level income taxation.

We are sending copies of this report to the requesting congressional committees. We are also sending copies of this report to the Honorable Alexis Herman, Secretary of Labor; the Honorable Lawrence Summers, Secretary of the Treasury; the Honorable Donna Tanoue, Chairman, the Federal Deposit Insurance Corporation; the Honorable Alan Greenspan, Chairman, the Federal Reserve Board of Governors; the Honorable John D. Hawke, Jr., Comptroller of the Currency; the Honorable Ellen Seidman, Director, the Office of Thrift Supervision; and the Honorable Norman D'Amours, Chairman, the National Credit Union Administration. Copies will be made available to others upon request.

This report was prepared under the direction of William B. Shear, Assistant Director, Financial Institutions and Markets Issues. Please contact me or Mr. Shear at (202) 512-8678 if you or your staffs have any questions about this report. Other major contributors are acknowledged in appendix XI.

Thomas J McCool

Thomas J. McCool
Director, Financial Institutions and Markets Issues

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Abbreviations

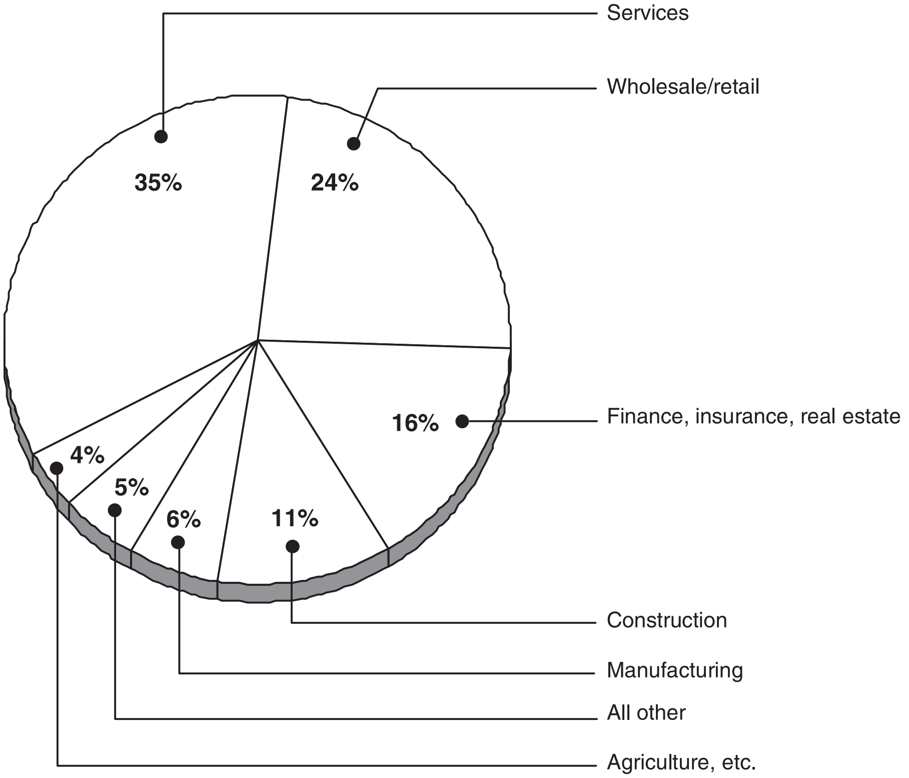
ABA	American Bankers Association
CRA	Community Reinvestment Act
ESOP	employee stock ownership plan
FDIC	Federal Deposit Insurance Corporation
ICBA	Independent Community Bankers of America
IRA	individual retirement account
IRS	Internal Revenue Service
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
REMIC	Real Estate Mortgage Investment Conduit
SEC	Securities and Exchange Commission
UBPR	Uniform Bank Performance Report
QSSS	Qualified Subchapter S Subsidiary

History and Background of S-Corporations

Banks Represent a Small Percentage of All S-Corporations

S-corporations are corporations that elect to pass through corporate income and losses to their shareholders for federal tax purposes. Shareholders of S-corporations report their pro rata shares of income or losses on their own tax returns and are assessed tax at their individual income tax rates. At the end of 1997, there were approximately 2.5 million S-corporations in the United States, according to Internal Revenue Service data. S-corporations operate in every industrial sector and in every state. However, banks account for less than 1 percent of the total S-corporation population.

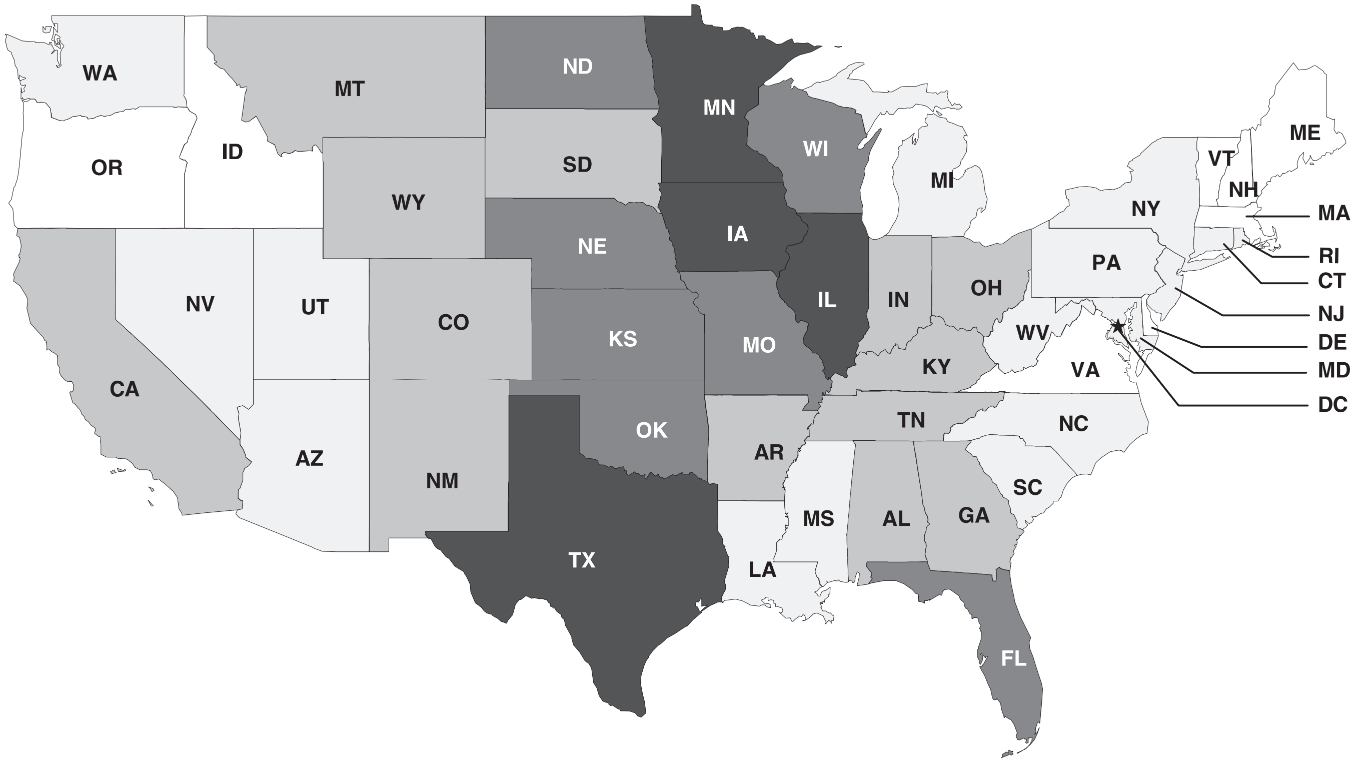
Figure I.1: Percentage of S-Corporations by Industrial Sectors



Source: GAO analysis of IRS Statistics of Income Data, 1997.

As of December 1999, there were 1,318 S-corporation banks, representing about 13 percent of the total banks and thrifts in the United States. Based on the share of total bank assets nationwide, S-corporation banks make up a small proportion, holding about 2 percent. We found that most S-corporation banks were geographically located in the central portion of the United States. The five states with the most S-corporation banks were Minnesota, Texas, Iowa, Illinois, and Kansas.

Figure I.2: Dispersion of S-corporation Banks by State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MO
KY
VA
MD
CA
DC
TN
OK
NC
AZ
AR
NM
SC
MS
AL
GA
TX
LA
FL

	Number of banks	Number of states in the specified range
■	120 to 182	(4)
▩	30 to 119	(7)
▨	10 to 29	(13)
░	1 to 9	(16)
□	None	(11)

Note: At the end of 1999, Hawaii had one S-corporation bank and Alaska did not have any S-corporation banks. The U.S. Virgin Islands had one S-corporation bank. Data were not available for the other U.S. territories.

Source: GAO analysis of FDIC data, year-end 1999.

Based on year-end 1999 data from the Federal Deposit Insurance Corporation (FDIC), FDIC is the primary federal regulator for about two-thirds of S-corporation banks. The Office of the Comptroller of the Currency (OCC) is the primary regulator for 23.1 percent of S-corporation banks and the Federal Reserve is the primary regulator for 8.3 percent of S-corporation banks. The Office of Thrift Supervision is the primary federal regulator for the remainder of the S-corporation thrift population—33 thrifts, or about 2.5 percent of the banking industry.

Current S-Corporation Requirements

To qualify for S-corporation status, a business must meet the following requirements:[1]

- The business must be a domestic corporation.
- The business must have only one class of stock.
- There must be no more than 75 shareholders.
- The shareholders must be only individuals; estates (including estates of individuals in bankruptcy); certain trusts; and, for tax years beginning in 1997, certain tax-exempt organizations. [2] Nonresident aliens, partnerships, limited liability companies, and individual retirement accounts are not qualifying shareholders.
- The business cannot be a financial institution that uses the reserve method of accounting for bad debts for tax purposes. Certain other types of corporations[3] also do not qualify.
- All shareholders must agree to the business' decision to be an S-corporation.

A firm's tax status as an S-corporation is automatically terminated if any of the criteria are no longer met. The business subsequently would be taxed as a C-corporation.

Subchapter S is a Hybrid of Other Business Structures

Congress added Subchapter S to the Internal Revenue Code (the Code) as part of the Technical Amendments Act in 1958. According to the legislative history, the provision was enacted for two reasons: (1) to diminish the effect of federal income tax considerations in the organizational choices of businesses and (2) to permit incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and the shareholder levels. The provision originally allowed a domestic corporation, which was not a member of an affiliated group, to make the Subchapter S election with the consent of 100 percent of its shareholders.

[1] Section 1361 of the Internal Revenue Code.

[2] An S-corporation may hold stock in a controlled subsidiary, but may not be a subsidiary of another company unless it is wholly owned by a parent company that is also an S-corporation. The parent S-corporation must make an election to treat the subsidiary S-corporation as a Qualified Subchapter S Subsidiary (QSSS). The QSSS essentially would not be treated as a separate corporation.

[3] Insurance companies, domestic international sales corporations (DISCs), and corporations electing to take the possessions tax credit also are ineligible corporations.

However, it also required the corporation to meet requirements that included limitations on the number and identity of its shareholders. As originally enacted, a Subchapter S election would be terminated if (1) 100 percent of the shareholders consented to a revocation; (2) the corporation ceased to be a “small business corporation;” (3) for any taxable year, the corporation derived more than 80 percent of its gross receipts from sources outside the United States; (4) for any taxable year, more than 20 percent of the corporation’s gross receipts were derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities; or (5) a new shareholder did not consent to the election within the time prescribed by regulations.

Subchapter S of the Code combines aspects of federal tax treatment under Subchapter C and Subchapter K. Under Subchapter C of the Code, businesses organized as corporations are generally treated as taxpaying entities separate and distinct from their shareholders. That is, a corporation must generally pay tax on its profits, although subsequent distributions from these profits (through dividends or at liquidation) will also be taxed to the individual shareholders as part of their own taxable income. Subchapter S tax status allows small businesses to function as corporations, thereby giving them the nontax benefits[4] of incorporation. These benefits include limited liability, unlimited life, or ease of ownership transfer, with no requirement to pay a corporate income tax on profits. Unlike C-corporations, S-corporations are not subject to the corporate alternative minimum tax or the accumulated earnings tax.

Businesses may wish to avoid the double level of taxation generally associated with the corporate structure. Businesses organized as partnerships and S-corporations generally are not separate taxpaying entities. As in partnerships under Subchapter K, corporate income and losses in S-corporations are passed through to shareholders[5], whether or not profits are distributed. S-corporation shareholders and partners then pay taxes on their requisite shares. However, unlike partnerships, the

[4] Businesses organized as C-corporations also have nontax benefits, such as limited liability, unlimited life, or ease of transfer of ownership. The liability of corporate shareholders is generally limited to the amount of their investment. Unlike partnership interests, corporate stock generally may be transferred without having any effect on the continuity of the business.

[5] The character of items of income did not originally pass through to the shareholders of S-corporations, as was the case with partnerships. Instead, the income that passed through to the S-corporation shareholders would be treated as ordinary income (except for long-term capital gains) without the retention of any special characteristics it might have in the hands of corporations. The Subchapter S Revision Act of 1982, P.L. 97-354, amended the Subchapter S provisions to allow the complete pass through of the tax characteristics of items of income and loss to the Subchapter S shareholders.

outstanding shares of an S-corporation must confer identical rights to profits and assets. An exception is made, however, to allow differences in voting rights.

Former C-corporations Face Corporate Taxes After Conversion to Subchapter S

Businesses that operated as C-corporations before making the Subchapter S election could face two corporate-level taxes after the election is made.[6] S-corporations are taxed on any built-in gain that must be recognized if they dispose of assets that appreciated during the years as a C-corporation within the first 10 years of S-corporation election. Consequently, double taxation is imposed on this appreciation of assets if the S-corporation does not hold the assets for a substantial period of time after making the election.[7]

S-corporations with accumulated earnings and profits from years as C-corporations are subject to a corporate-level tax on net passive investment income that exceeds 25 percent of gross receipts for any year. In addition, and perhaps more importantly, a company's S-corporation election will be terminated if passive investment income exceeds 25 percent for 3 consecutive years. According to the legislative history, to reduce the likelihood of terminations, Congress repealed the provision in the original act that automatically terminated a corporation's Subchapter S election if the corporation had excess passive investment income in any taxable year.

Besides having excess passive investment income for 3 consecutive years, there are two other ways a Subchapter S election can terminate. First, shareholders holding a majority (more than 50 percent) of the corporation's shares may voluntarily revoke the election. If S-corporation shareholders revoke the election on or before the 15th day of the 3rd month of the S-corporation's taxable year, the revocation will be retroactively effective as of the first day of that taxable year. If the election is revoked after that date, it will be effective on the first day of the next taxable year. Alternatively, the termination agreement may itself specify a prospective effective date. Second, a corporation's S-corporation election also terminates if it ceases to meet the initial requirements for eligibility. A termination resulting from the corporation no longer qualifying as a "small business corporation" is effective on the first date the corporation fails to meet the eligibility requirements, as discussed above.

[6] These two exceptions would not apply to start-up companies making the Subchapter S election.

[7] This same double taxation concept applies to C-corporations only to the extent that gains and earnings are paid out to the shareholders in dividends.

An invalid Subchapter S election or an inadvertent termination may be waived by IRS. The S-corporation must take steps to meet the eligibility requirements within a reasonable amount of time after the discovery of the invalid election or inadvertent termination. The S-corporation and its shareholders must also agree to make any adjustments prescribed by IRS that are consistent with treatment of S-corporations. According to the legislative history of the Subchapter S Revision Act, Congress intended IRS to be reasonable in granting waivers. This was intended to provide IRS flexibility in dealing with corporations whose Subchapter S eligibility requirements had been violated inadvertently. The waiver does not exempt small corporations from paying the tax consequences of a termination, if the firm would not avoid paying taxes resulting from the continued Subchapter S treatment.[8]

Subchapter S Has Been Revised Several Times

Several revisions have been made to the original Subchapter S provisions dealing with the allowed number and type of shareholders. According to the legislative history, the maximum number of shareholders in an S-corporation originally was set at 10 but was increased to 35 by the Subchapter S Revision Act of 1982[9] to correspond to the private placement exemption of federal securities law.[10] The Small Business Job Protection Act of 1996[11] set the current shareholder limit on S-corporations at 75. According to the legislative history of the 1996 act, the maximum number of shareholders was increased to 75 to facilitate corporate ownership by additional family members, employees, and capital investors.

The 1996 act also allowed tax-exempt charitable organizations and qualified retirement plans, including employee stock ownership plans (ESOPs), to be eligible shareholders. According to the legislative history of the act, the existing shareholder eligibility restrictions may have “inhibited employee ownership of closely-held businesses, frustrated estate planning, discouraged charitable giving, and restricted sources of capital for closely-held businesses.” Congress sought to lift these perceived barriers by allowing certain tax-exempt organizations to be shareholders in S-corporations. However, Congress also sought to preserve the concept that

[8] Section 1362(f) of the Internal Revenue Code.

[9] P.L. 97-354.

[10] There were several other increases to the allowed number of shareholders in S-corporations during the intervening years. The maximum number of shareholders was increased to 15 for certain corporations by the Tax Reform Act of 1976, P.L. 97-455. The Revenue Act of 1978, P.L. 95-600, increased the limit to 15 for all electing corporations. The limit was increased to 25 by the Economic Recovery Tax Act of 1981, P.L. 97-34, and then to 35 by the Subchapter S Revision Act.

[11] P.L. 104-188.

all income of the S-corporation would at least be subject to a shareholder-level income tax. Accordingly, the 1996 act provided that all income flowing through to a tax-exempt shareholder (including gains and losses from the disposition of stock) will be treated as unrelated business taxable income. The Taxpayer Relief Act of 1997[12] repealed the provision treating items of income or loss from an S-corporation as unrelated business taxable income with respect to employer securities held by an ESOP.

Law Expanded in 1996 to Allow Banks to Elect Subchapter S Tax Status

Until 1997, financial institutions were not allowed to elect Subchapter S status because of the special methods of accounting for bad debts that were available to them for tax purposes. The Small Business Job Protection Act of 1996 eliminated this total prohibition against banks electing Subchapter S status but limited it to banks that do not use the reserve method of accounting for tax purposes.[13] Thus, large banks that are ineligible to use the reserve method and small banks that choose to use the specific charge-off method for deducting bad debt expenses are now eligible to elect Subchapter S status. According to the legislative history of the 1996 act, Congress believed that any otherwise eligible corporation should be allowed to elect to be treated as an S corporation regardless of the type of trade or business conducted by the corporation, as long as special corporate tax benefits provided to such trades or businesses did not flow through to individual taxpayers.

[12] P.L. 105-34.

[13] This provision became effective January 1, 1997.

Scope and Methodology

Analysis of Proposed Tax Revisions and Potential Impacts

To respond to a mandate in the Gramm-Leach-Bliley Act of 1999, we analyzed proposed tax revisions and the potential impact of these proposed provisions primarily on community banks. Specifically, we focused on the proposed provisions that were contained in S. 875 and H.R. 1994 to (1) increase the permissible number of shareholders in S-corporations; (2) permit shares of S-corporations to be held in individual retirement accounts (IRAs); (3) clarify that interest on investments held for safety, soundness, and liquidity purposes should not be considered as passive investment income; (4) discontinue treatment of stock held by bank directors as a disqualifying second class of stock for S-corporations; and (5) improve federal tax treatment of bad debt. The scope of our review was on federal-level tax effects, and we did not address state-level tax impacts.

Analysis of Proposed Tax Revisions

To understand the proposed provisions and the effects of current and prior legislation on S-corporations, we reviewed legislative history and pertinent tax studies and literature. We also reviewed the U.S. Tax Code and relevant guidance from the IRS and banking regulators. We met with officials from IRS and the Department of the Treasury to discuss their perspectives on the tax policy implications regarding the proposed changes to Subchapter S of the tax code. We interviewed industry representatives from the S Corporation Association, the Subchapter S Bank Association, the American Bankers Association (ABA),[1] and the Independent Community Bankers of America (ICBA)[2] and obtained information on the proposed provisions. On the basis of discussions with industry representatives, we interviewed experts who specialize in the field of Subchapter S banking law and accounting. We also reviewed the ABA[3] and ICBA[4] industry surveys of their members on obstacles to

[1] ABA is a trade association that represents banks of all sizes on issues of national importance for financial institutions and their customers. Substantially all large banks are members of ABA, and most ABA members are banks with assets of under $70 million.

[2] ICBA (formerly the Independent Bankers Association of America) is a trade association for about 5,500 community banks nationwide. Approximately 54 percent of ICBA members serve rural communities, 29 percent are in suburban locations, and the remaining 17 percent are in urban communities.

[3] ABA conducted the Subchapter S Survey during the second and third quarter of 1999. The survey collected data on banks' Subchapter S status; the reasons why banks are not eligible; and, if eligible, why they choose not to make the conversion. ABA sent its survey to 5,872 banking institutions; a total of 817 institutions responded to the survey, for a response rate of 13.9 percent.

[4] ICBA conducts annual surveys of its membership on issues and concerns facing community banks. Grant Thornton, an international accounting and management consulting firm, conducted the survey and mailed questionnaires to 5,400 community banks in November 1998. Grant Thornton received 815 completed surveys, for a response rate of 15 percent. One part of the survey focused on S-corporation conversions and obstacles banks face during the conversion process.

Subchapter S election. To confirm the findings of these industry surveys, we spoke to some bankers who had already converted their banks to S-corporations or were interested in converting to S-corporations. We chose bankers on the basis of recommendations by legal and accounting experts. We also spoke to some bankers interested in electing Subchapter S status at ICBA's annual conference in San Antonio, TX.[5] We met with banking and thrift regulators from the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). We also met with representatives from the National Credit Union Administration. To further understand the treatment of IRAs and the Department of Labor's prohibited transaction exemption process for IRAs, we interviewed officials and reviewed documents from the Pension and Welfare Benefits Administration of the Department of Labor.

Impacts on Community Banks

To determine the impact of these proposed provisions on community banks, we first sought to define community banks and the potential universe that might be affected by these tax changes. The definition of community banks varied among those we interviewed. Common elements of their definitions for community banks included the types of activities and services, community locale, asset size of bank, and level of sophistication in banks' lines of business. To define the potential universe, we analyzed IRS' Statistics of Income data and banking data from FDIC and OTS. Bank and thrift regulators did not track S-corporations differently from other banks and thrifts. Bank and thrift regulators also did not routinely track the number of bank shareholders to determine which banks might be likely to elect Subchapter S status if the shareholder limit were increased to 150. The Securities and Exchange Commission (SEC) requires a firm to register only when it has 500 or more shareholders or publicly traded stock and $10 million or more in assets. To determine the potential universe of banks that may be affected by or would likely become eligible to elect Subchapter S status under the proposed tax changes, we requested estimates from FDIC, OTS, and industry representatives.

To further determine the impact of these proposed provisions on community banks, we interviewed and reviewed documents from bankers, legal and accounting experts, and banking regulators about their views on what the potential impacts might be. We also reviewed information on the history of banks related to corporate structure, individual retirement

[5] Over 2,000 community bankers attended the ICBA annual conference in March 2000.

accounts, bank director requirements, passive investment income, and accounting treatment of bad debt.

Also, to determine the potential impact of these proposed provisions on community banks, we analyzed the movements of several financial performance indicators for S-corporation banks, both before and after Subchapter S election, and compared them to non-S-corporation banks that had similar characteristics over the same period of time. Using quarterly reports of financial condition (Call Reports) submitted to regulators, we compiled performance data on the 520 commercial banks that (1) elected S-Corporation status in the first quarter of 1997, (2) did not revert to C-Corporation status at any time afterwards, and (3) were in business under the same charter for all 16 quarters from March of 1996 through December of 1999. That is, we compared the performance of non-S-corporation banks to S-corporation banks across 4 quarters before and 12 quarters after S-Corporation election. Our purpose was to determine if there were any significant changes in financial behavior and performance that could be associated directly with S-Corporation status and not solely with extraneous factors such as economic conditions. To measure financial performance, we analyzed certain statistics used in bank examinations, including measures of capital levels, asset strength, profitability, liquidity, and sensitivity to market risk. Specifically, the four ratios we analyzed from the Uniform Bank Performance Report (UBPR) were the (1) cash dividend to net income ratio, (2) Tier 1 leverage capital ratio, (3) return on assets ratio, and (4) net loans and leases to assets ratio.[6]

In this report, we (1) summarized the absolute differences in these financial performance measures between the S-corporation banks and comparison group banks over the study period, (2) determined the existence and direction of trends in any of these four performance measures for the two groups of banks, and (3) determined whether any of the trends for S-corporation banks diverge from the trends seen among the comparison group banks.

We used a variety of statistical tests to conduct these three analyses. To determine whether there was a difference in the absolute level of scores

[6] For banks that elect Subchapter S status for income taxes, the UBPR adjusts after tax earnings and dividends used in ratios. This adjustment is performed to improve the comparability of those items between banks that are taxed at the corporation level (non-S corporation banks) and those that have shifted income taxation to the shareholder level (S-corporation banks). In essence, an estimated tax is substituted for any reported taxes then deducted from income and a flat tax rate is applied to dividends. Although this adjustment improves comparability, it does not provide exact comparability between C-corporation and S-corporation banks.

on a performance measure between two groups, we calculated the probability that we would have observed a difference equal to or greater than the one we actually observed between the average value of the 16 (quarterly data over a 4-year period) S-corporation median scores and the average value of the 16 comparison group medians, had these two sets of scores been randomly selected from the same underlying population. The small probabilities we calculated indicate that the S-corporation banks and comparison group median scores were not drawn from the same population. These differences are statistically significant for all four performance measures.

To determine whether there have been trends over the study period among S-corporation banks and comparison group banks on a particular performance measure, we conducted linear regression tests on the 16 quarterly medians, cross-classified by S-corporation status or comparison group. We computed 95 percent confidence intervals around the slopes of the regression lines to see whether they contained the value zero, which would indicate that there was no trend, either positive or negative. We also conducted nonparametric trend tests on the medians of the four performance measures among the two groups of banks, testing a hypothesis of no statistically significant trend against the alternative hypothesis that capital-to-asset ratios decreased, dividend payout ratios increased, return on asset ratios decreased, and the (il)liquidity ratio increased, respectively.

To determine whether or not the observed trends on each of the performance measures were different for S-corporation banks, we conducted linear regression tests, as described above, on differences between the S-corporation bank medians and the comparison group medians for each of the performance measures. We also conducted nonparametric trend tests as described above on the differences between S-corporation bank and comparison group medians. That is, we determined whether the gap between the median value of S-corporation bank performance and comparison group performance was widening or narrowing over time.

We created comparison groups of banks that were as similar as possible to the group of S-corporation banks but had not elected S-corporation status at any time from 1996 through 1999. A number of possible comparison groups of non-S-corporation banks were defined using criteria such as asset size, agricultural lending activity, number of offices, and rural/urban location. The comparison group for this analysis was defined as the 1,284 banks that were active during the 4-year period, had never become S-corporations, had assets of less than $1 billion, and had made 25 percent or more of their loans for agricultural purposes in at least one quarter.[7] Some of the findings in our report could change if a different comparison group of banks were used or if data were available over a longer time period for banks that converted to S-corporations. We did not verify or otherwise assess the reliability of the Call Report data obtained from FDIC, because it is a well-known database that is widely used in official statistics and a wide range of studies of the banking industry.

Agency Comments

We requested comments on this report from the Departments of Labor and the Treasury, the Offices of the Comptroller of the Currency and Thrift Supervision, FDIC, and the Board of Governors of the Federal Reserve System. The Director, Internal Review, Office of Thrift Supervision and the Director of Exemption Determinations, Pension and Welfare Benefits Administration, Department of Labor provided technical comments that we incorporated in the report where appropriate. Treasury and FDIC provided written comments on our draft report; they are included in appendixes VIII and IX, respectively, and are discussed in the body of this report. The Board of Governors of the Federal Reserve System appreciated our consulting with them as well as considering their observations on our draft report. They provided us written comments on our draft report; they are included in appendix X, and are discussed in the body of this report. The Office of the Comptroller of the Currency did not have any comments on our report.

We conducted our work in Washington, D.C., and San Antonio, TX, between November 1999 to May 2000, in accordance with generally accepted government auditing standards.

[7] Of the 520 S-corporation banks we analyzed, 176 (34 percent) of the S-corporation banks had 25 percent or more of their loans for agricultural purposes in at least one quarter.

Proposed Tax Provision To Increase the Maximum Number Of Shareholders

Proposed Tax Provision

The proposed tax provision we studied would increase the number of eligible shareholders in S-corporations from 75 to 150.[1]

Present and Prior Law

Under current law, an electing "small business corporation" must have no more than 75 qualifying shareholders.[2] As originally enacted in 1958, Subchapter S status was elective for corporations which had no more than 10 individual shareholders. However, over the years, the number of permissible shareholders has been increased.[3]

Shareholder Limit Cited as an Obstacle for Becoming an S-Corporation Bank

ABA and ICBA cited the 75-maximum shareholder limit as a major obstacle for banks wishing to elect Subchapter S status. According to an ABA survey, of the 342 survey respondents that had considered becoming an S-corporation, 86.5 percent indicated that the reason their banks were ineligible to become S-corporations was because they had more than 75 shareholders. Twenty-nine percent of respondents to an ICBA survey of its community bank membership considered the maximum shareholder limit as an obstacle to conversion. Bankers and legal and accounting experts whom we interviewed told us that in order to meet the maximum shareholder limit, banks wishing to elect Subchapter S status often were forced to eliminate minority shareholders. Bankers felt that their banks lost goodwill in the community by eliminating community shareholders and also lost, in some cases, the ability to pass on family (generation) ownership in the banks.

About 13 Percent of Banks Have Become S-Corporations Since 1997

Recent growth trends in S-corporations illustrate, in part, the impact of current tax laws for S-corporations. As of year-end 1997, there were 2.5 million S-corporations, according to IRS' Statistics of Income data. In 1996, when the maximum number of shareholders was increased from 35 to 75, the number of S-corporation tax returns grew from 2.3 million to 2.5 million, or about 6 percent. Since being permitted to become S-corporations beginning in tax year 1997, 1,318 banks have become S-corporations. According to FDIC data, these banks represent about 13

[1] The proposed increase in shareholders is based on S. 875 and H.R. 1994.

[2] 26 U.S.C. sec. 1361(b)(1)(A). Qualifying shareholders include only individuals who are U.S. citizens or residents, estates, certain trusts, and certain tax-exempt organizations. An S-corporation may not have a shareholder that is a nonresident alien, a corporation (other than a tax-exempt charitable organization), partnership, or a limited liability company.

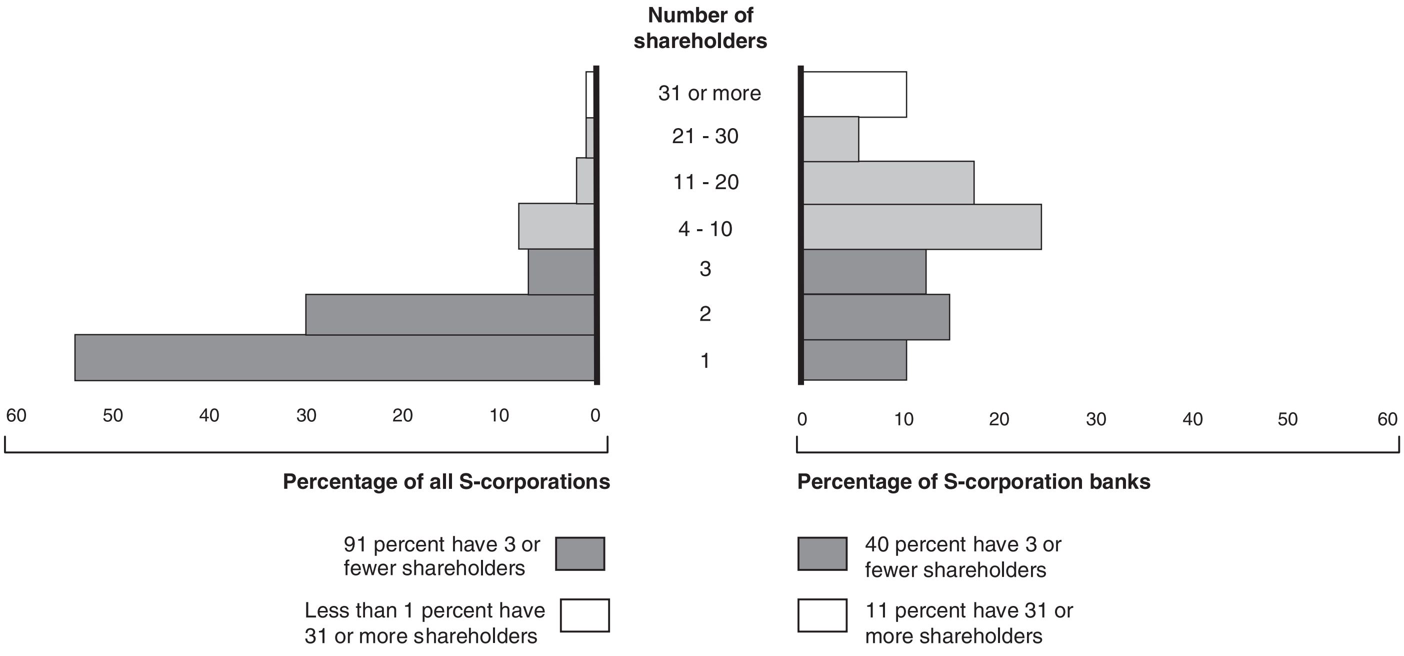
[3] The Tax Reform of 1976 increased the maximum number of shareholders to 15 for electing corporations in existence for more than 5 years. The Revenue Act of 1978 increased the limit to 15 for all electing corporations. The limit was increased to 25 by the Economic Recovery Tax Act of 1981 and then to 35 by the Subchapter S Revision Act of 1982. The maximum number was increased to 75 shareholders by the Small Business Job Protection Act of 1996.

percent of the U.S. banking industry, as of the end of 1999. S-corporation banks represent less than 1 percent of all S-corporations.

Increasing the Number of Shareholders Would Likely be More Important to Banks

As of year-end 1997, most S-corporations in all industries (about 91 percent) had three or fewer shareholders. A small percentage (less than 1 percent) of S-corporations in all industries had 31 or more shareholders. By comparison less than half (about 40 percent) of S-corporation banks had 3 or fewer shareholders, and about 11 percent had 31 or more shareholders as of year-end 1997. The S Corporation Association indicated that its membership (primarily nonbank S-corporations) did not view the maximum shareholder limit as a current obstacle because the majority of its members (1) have 3 or fewer shareholders; and (2) would prefer to limit the number of shareholders who have control over their businesses (i.e., maintain being a “closely-held” firm). The S Corporation Association generally did not oppose increasing the shareholder limit.

Figure III.1: Percentage Comparison of the Number of Shareholders between S-Corporations From all Industries and S-Corporation Banks



Source: Provided by IRS, Statistics of Income, 1997.

One effect of current law is that banks with more than 75 shareholders wishing to elect S-corporation tax status may be forced to eliminate minority shareholders even if they would prefer to be more widely held. Bankers and legal and accounting experts told us that in order to elect S-corporation tax status, banks often must eliminate shareholders through complex corporate reorganizations. Specifically, they have eliminated minority shareholders through reverse stock splits[4] or through the formation of new holding companies. Both are generally considered expensive strategies due to legal, accounting, and independent valuation costs. Legal experts told us that banks often have to pay a premium on the stocks they repurchase from these minority shareholders or face legal action from the minority shareholders, adding time and costs to the conversion process.

Bankers and legal experts we interviewed told us that some banks have rewritten shareholder agreements to restrict the sale of their shares and to give banks the first right to repurchase those shares, so that they maintain their current subchapter S status. We were also told, however, that changing banks' shareholder agreements limits estate planning by restricting the current shareholders' ability to pass their shares on to family members in the event of death. One legal expert told us that although he was in favor of increasing the number of shareholders, he was more in favor of treating family members as a single shareholder. He emphasized that minority shareholders often are forced out when a bank has more shareholders than allowed by S-corporation rules. He pointed out that in other tax contexts,[5] families (across generations) are treated as one shareholder. He proposed that if the law were changed to allow family members to be counted as one shareholder, it would be more conducive for maintaining family-owned banks and conducting estate planning. Currently, under Subchapter S, a husband and wife (and their estates) owning shares in an S-corporation are treated as a single shareholder.[6] A legal expert from the Office of Thrift Supervision pointed out that allowing family members to be treated as one shareholder could perpetuate insider preference and favoritism in the event of a reorganization to reduce the number of shareholders.

Likely Impacts of Proposed Change

Increasing the maximum number of shareholders would affect firms in all industries, not just banks. The tax revenue loss from increasing the maximum number of shareholders to 150 was estimated to be $580 million over a 5-year period and $1.5 billion over a 10-year period.[7] Overall,

[4] A reverse stock split is a procedure whereby a corporation reduces the number of shareholders.

[5] 26 U.S.C. 302(c)(1) and 318(a)(1). For example, the corporate tax redemption rules generally treat an individual as "constructively" owning the shares owned by the individual's spouse, children, grandchildren, and parents.

[6] 26 U.S.C. sec. 1361(c)(1).

[7] Based on estimates prepared by the Joint Committee on Taxation for the 1999 tax bill.

increasing the number of shareholders would permit more firms to become eligible to elect Subchapter S status. It is difficult to estimate the potential universe that might be affected by the proposed change because data are not readily available to determine the number of shareholders firms currently have, if the firms' stock is not publicly traded. (We discuss this limitation more fully in our Scope and Methodology, app.II.)

Increasing the Shareholder Limit Could Potentially Affect A Large Number of Banks

Officials and tax experts we spoke with estimated the potential universe of banks and thrifts that may be affected by the proposed tax changes to be between 300 and 5,662. Regulators estimate that 5,385 banks and 277 thrifts could potentially be eligible to elect subchapter S status if the maximum number of shareholders were increased to 150. ABA estimates that 4,665 banks would consider Subchapter S election if Congress removed obstacles for electing Subchapter S. Of the 4,665 banks, 2,892 would convert if the obstacles were eliminated; and 1,773 would consider Subchapter S status, but they may not convert for other reasons. ICBA estimated that more than 2,400 community banks plan to convert to Subchapter S status.

Bankers and legal and accounting experts whom we interviewed indicated that the proposed increase in shareholders would increase the continuity of family ownership and reduce the need for banks to undergo complex corporate reorganizations to eliminate minority shareholders. Industry representatives projected that the proposed increase would allow more community banks to become eligible to make the S-corporation election and, at the same time, allow community banks to continue to maintain wider ownership by their communities. Bank regulators told us that one advantage to increasing the number of shareholders would be that current S-corporations would find it easier to raise additional capital, which may become important during an economic downturn.

The unanimous shareholder consent rule could complicate the election process if the number of permissible shareholders were increased to 150. Current law requires that all eligible shareholders consent to the Subchapter S election. Some legal experts told us that obtaining the consent of all shareholders for banks wishing to elect Subchapter S tax status has been difficult at times. According to some legal experts we spoke with, the unanimous consent provision may have been more relevant to the election process when S-corporation rules limited the number of shareholders to 10.

The proposed increase in shareholders would lead to a large, but nonquantifiable, increase in the number of S-corporation banks. Many banks that currently have between 75 and 150 shareholders, such as community banks with a long legacy of family ownership, would be likely to convert. However, although 99.6 percent of existing S-corporation banks have total assets of less than $1 billion, predicting the size distribution of banks that would convert with the proposed increase in shareholders is difficult. For example, some larger banks that currently have over 150 shareholders may choose to undergo complex corporate reorganizations to eliminate minority shareholders. In such an event, some of the larger converting bank holding companies may be ones that provide a wide array of financial services that would be facilitated by the Gramm-Leach-Bliley Act of 1999. Therefore, banks that may convert could include some banks that have characteristics not commonly associated with the classification of a bank as a community bank. However, of the 187 bank holding companies that have become domestic financial holding companies under this act, 145 (78 percent) had less than $1 billion in assets as of May 10, 2000.

The proposed increase in shareholders could help community banks become more competitive in relation to credit unions to the extent that converting banks provide the same banking services offered by credit unions. The benefits of the proposed increase in shareholders for community banks in relation to larger banks would depend on the characteristics of the converting banks.

Proposed Tax Provision To Allow Individual Retirement Accounts As Shareholders

Proposed Tax Provision

The proposed tax provision would permit S-corporation shares to be held by individual retirement accounts[1] (IRA).

Present and Prior Law

IRAs are not eligible to be S-corporation shareholders under present law. S-corporation shareholders are restricted to individuals who are U.S. citizens or residents, estates (including estates of individuals in bankruptcy), certain trusts, and certain tax-exempt organizations. An S-corporation may not have a shareholder that is a nonresident alien, a corporation[2] (other than a tax-exempt charitable organization), partnership, or a limited liability company. Beginning January 1, 1998, the S-corporation rules were changed to allow qualified pension plans, including employee stock ownership plans (ESOPs), to be shareholders in S-corporations.

Reasons Cited for Proposed Change

Legal and accounting experts we interviewed indicated that eliminating IRA shareholders increases the cost and length of the Subchapter S conversion process for banks and their shareholders. They told us that banks and their shareholders incur high costs when obtaining the necessary stock appraisals and repurchasing the stock held in IRAs. They also told us that when C-corporation banks offer stock to their employees, it is not uncommon for an employee to choose to hold the stock in an IRA. An ABA survey of its membership showed that of the 273 respondents, 42 percent of the ineligible shareholders that S-corporation banks removed were IRAs. However, the S Corporation Association, primarily representing nonbank S-corporations, indicated that its membership generally does not consider the IRA restriction a significant obstacle to electing Subchapter S status.

Impacts of Current Law

Eliminating IRA shareholders complicates the Subchapter S conversion process. Legal and accounting experts told us that stock appraisals required in the transactions used to remove bank stock from IRAs increase the overall costs and time associated with the conversion process. An independent and qualified appraiser must determine the fair market value

[1] An IRA is a trust or custodial account set up in the United States for the exclusive benefit of the account holder or his or her beneficiaries. The IRA must meet certain requirements generally established under Section 408 of the Internal Revenue Code, and it generally permits an individual to save on a tax-favored basis.

[2] An S-corporation may hold stock in a controlled subsidiary but may not be a subsidiary of another company unless it is wholly owned by a parent company that is an S-corporation. The parent S-corporation must make an election to treat the subsidiary S-corporation as a Qualified Subchapter S subsidiary (QSSS). The QSSS essentially would not be treated as a separate corporation.

of the stock because the stock of banks with fewer than 500 shareholders is not publicly traded.

Bank shareholders generally use three lengthy and costly methods to remove their bank stock held in IRAs. Bankers and legal and accounting experts told us that some bank shareholders holding their stock in IRAs chose to sell their stock to qualified shareholders, typically majority shareholders. However, upon selling the stock, the individual could cease to be a shareholder in the bank if he or she owns no other stock in the bank. By selling the stock, the individual loses future dividends, loses the potential for capital gains, and could terminate the IRA. At the bank holding company level, shareholders often have the holding company redeem the stock held in their IRAs. However, depending upon the fair market value of the stock and the amount held in the IRA, redeeming the stock could pose a significant reduction in the holding company's capital. In this case, the bank also incurs the cost of the appraisal, and the individual shareholder would lose future dividends, lose potential capital gains, and could terminate the IRA.

Legal and accounting experts told us that to a lesser extent, bank shareholders have applied for exemptions from sanctions generally associated with repurchasing stock from their own IRAs. They indicated that such persons faced high costs and a lengthy application and exemption determination process. Current law treats IRA account holders as disqualified persons[3] in a transaction wherein stock is repurchased from their own IRAs. Such a transaction generally results in sanctions stipulated in the Internal Revenue Code.[4] Thus, the IRA account holder must apply to the Department of Labor[5] for an administrative exemption from these sanctions, which partly, involves obtaining an independent appraisal of the stock. Moreover, depending upon the complexity of the individual exemption application, the resulting administrative fees could be significant. Department of Labor (Labor) officials told us that the time needed to make a determination on an application similarly depends upon the complexity and completeness of the application.

[3] Internal Revenue Code Section 4975(a)(b).

[4] The prohibited transaction would generally result in sanctions under Section 4975(a),(b), and (c)(3) of the Internal Revenue Code.

[5] By virtue of Reorganization Plan No.4 of 1978, the authority of the Treasury Department to grant exemptions for prohibited transaction under the Internal Revenue Code was largely transferred to the Department of Labor.

Labor officials told us that they have processed four exemption applications from IRA account holders for the purpose of facilitating a bank conversion to Subchapter S status. They said IRA account holders were granted exemptions from the sanctions associated with the prohibited transaction, provided that the sales of the stock met certain conditions.[6]

Impacts of Proposed Provision

Allowing IRAs to be eligible shareholders in S-corporations would affect S-corporations in all industries. Among banks choosing to elect Subchapter S status, the change would reduce the overall costs associated with making the conversion. Specifically, allowing IRAs to be shareholders would eliminate the need for banks and shareholders to obtain stock appraisals needed in the transactions to remove the stock. However, an appraisal of the stock may still be required for other aspects of the conversion process, such as eliminating minority shareholders.

The Federal Reserve, FDIC, OCC, and OTS indicated that they view the proposed provision as a tax policy issue. They expressed no safety and soundness concerns with allowing IRAs as eligible shareholders in S-corporation banks. However, Treasury generally opposed the proposal. Treasury indicated that if IRAs were allowed to be S-corporation shareholders, from a policy standpoint, the Unrelated Business Income Tax should be imposed, which parallels similar tax treatment of other pension funds.

Labor officials stated that from their perspective, allowing IRAs as S-corporation shareholders introduces no policy or procedural concerns. They indicated that the IRA shareholders that have applied thus far were granted exemptions from the sanctions associated with the prohibited transaction.

[6] The conditions stipulate that (a) the terms and conditions of the sale of stock would be at least as favorable to each IRA as those obtainable in arm's-length transactions with an unrelated party; (b) sale of the stock would be one-time transactions for cash; (c) the IRAs would receive the fair market value of the stock as established by a qualified, independent appraiser; and (d) the IRAs would pay no commissions, costs, or other expenses with respect to the sale of the stock. 63 FR 241 December 16, 1998.

Proposed Tax Provision to Clarify Passive Investment Income Rules

Proposed Tax Provision

The proposed tax provision seeks to clarify that interest and dividends on investments maintained by a bank for liquidity and safety and soundness purposes would not be treated as "passive" income for tax purposes.

Present and Prior Law

Under present law, S-corporations must restrict the amount and type of passive investment income. Passive investment income refers to income derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (but only to the extent of gains).[1] Although income and loss derived from the active trade or business of S-corporations pass through to the shareholder and thus are taxed at the individual rate, excess net passive investment income is taxed at the highest corporate rate. Currently, S-corporations with accumulated C-corporation earnings and profits are subject to 35-percent tax on passive investment income exceeding 25 percent of gross receipts in a tax year.[2] Moreover, the Subchapter S election is terminated if (1) the corporation has previously accumulated earnings and profits as a C-corporation at the close of each of 3 consecutive taxable years following the election, and (2) during each of the 3 years more than 25 percent of the corporation's gross receipts are passive investment income.[3] The Subchapter S Revision Act of 1982,[4] among other things, provided the current termination rules that are applied when an S-corporation has excessive passive investment income. Until 1982, the Subchapter S election terminated if more than 20 percent of the corporation's gross receipts derived from passive investments for any taxable year.

Passive Income Regulations Predate Banks' Eligibility to Become S-Corporations

Before banks were permitted to become S-corporations, IRS issued regulations interpreting the definition of passive investment income to exclude income earned in the active conduct of a trade or business. Subsequently, the Small Business Job Protection Act of 1996[5] permitted banks to become S-corporations beginning in tax years after December 31, 1996. IRS issued regulations in Notice 97-5 interpreting active and passive investment income, with special rules for lending, financing, and other similar businesses. IRS regulations generally state that income (gross receipts) from the business of lending or finance includes gains and interest income from loans. However, the interest earned from investments

[1] Section 1362 of the Internal Revenue Code.

[2] Section 11(b) of the Internal Revenue Code generally provides a graduated tax on corporate income, ranging from 15 to 35 percent, based on the amount of taxable income for a tax year.

[3] Section 1362 (d)(3)(C)(iii) of the Internal Revenue Code.

[4] P.L. 97-354.

[5] P.L. 104-188.

in short-term securities does not constitute gross receipts directly derived in the ordinary course of business (i.e., is not considered active income).[6] Consequently, such interest could be classified as passive investment income. IRS Notice 97-5 does not consider income and gain from the following banking assets subject to the passive investment limitation for S-corporations:

- all loans and mortgage-backed securities, such as Real Estate Mortgage Investment Conduits (REMIC),[7] regular interests owned, or considered to be owned, by the bank regardless of whether the loan originated in the bank's business (for these purposes, securities described in Section 165(g)(s)(C) are not considered loans).
- assets required to be held to conduct banking businesses (such as Federal Reserve Bank, Federal Home Loan Bank, or Federal Agricultural Mortgage Bank stock, or participation certificates issued by a Federal Intermediate Credit Bank that represents nonvoting stock in the bank).
- assets pledged to a third party to secure deposits or business for the bank (such as assets pledged to qualify as a depository for federal taxes or state funds); and
- investment assets other than assets specified in the preceding paragraphs that are held by the bank to satisfy reasonable liquidity needs, including funds needed to meet anticipated loan demands.

Banking Industry Wants Passive Income Rules Clarified

Bankers and legal and accounting experts we interviewed want the current tax rules clarified so that bank investment income is treated as active income (and not as passive investment income) because it is part of the ordinary business of banking. Some bankers view the current rules on passive investment income for S-corporation banks as an obstacle to electing Subchapter S status. For example, ABA cited the passive investment income restriction as an obstacle for banks wishing to elect Subchapter S status. According to an ABA survey, of the 125 survey respondents that considered converting to Subchapter S status, 34.4 percent indicated that passive investment income was the reason their banks were not planning to elect Subchapter S status within the next 2 years.

Specifically, bankers are concerned that if audited, IRS examiners would consider income from their U.S. Treasury securities as "passive" because current IRS guidance does not explicitly list U.S. Treasuries among

[6] Section 1.1362-2(c)(5)(iii)(B)(2) of the Internal Revenue Code.

[7] Real estate mortgage investment conduits, called REMICs, are multiclass mortgage securities that assign cash flows to different classes of investors.

banking assets considered part of the active business of banking. Bankers and legal and accounting experts we interviewed emphasized that banks in rural and low-growth areas that experience cyclical or low loan demand may not be able to comply with current passive investment income rules. These banks typically hold large portfolios of Treasury securities to offset the cyclical cash flows and low loan demand in their communities.

Impacts of Current Law

We observed several impacts of the current law on passive investment income for S-corporation banks. The first impact that we observed is that treatment of passive investment income varies among banks. Some accountants of S-corporation banks have interpreted current guidance broadly and have treated all investment income as active. Other accountants have interpreted the guidance conservatively and have treated only some investments as active. However, legal and accounting experts told us that banks have strong justification for treating investments as "reasonable for liquidity purposes" and think that their view would prevail in a potential IRS audit. They submit that investment income gained from banking assets, including U.S. Treasury securities, is part of the ordinary course of the banking business.

The second impact we observed is that S-corporation banks face competing regulatory treatment of investments held for liquidity purposes. Treasury indicated that the current guidance is sufficiently flexible to provide for the cyclical nature of business that some banks experience. Treasury opposes an expansion of the current passive investment rules, out of concern that income accumulated while a C-corporation could avoid corporate taxation without the passive investment income rules. Conversely, bank regulators do not share this concern. Bank regulators want to ensure that banks have sufficient liquidity for safety and soundness reasons. They stated that applicable bank laws, including the Community Reinvestment Act (CRA), limit the ability of individuals to use banks as individual investment vehicles. In particular, bank regulators are concerned that banks, in reaction to the uncertainty of IRS interpretation, may shift their investments for liquidity purposes from the safety of U.S. Treasury securities to riskier investments such as real estate mortgage investment conduits.

We also observed an unintended consequence of this difference between regulatory and current tax treatment of passive investment income in the investment behavior in some banks. According to legal and accounting experts, some banks are making riskier investments because IRS guidance considers the investments active income for tax purposes. For example, some accounting experts and bankers we interviewed told us that banks were shifting investments out of less risky instruments, such as U.S. Treasury securities, that would generate income that IRS could consider passive. The banks then shifted those assets into riskier instruments, such as collateralized, mortgage-backed securities—considered to generate active income under IRS rules—to avoid terminating their Subchapter S election.

Impacts of Proposed Provisions

Bankers and legal and accounting experts stated that the proposed provision would eliminate the uncertainty of how IRS examiners would treat the investment income of S-corporation banks.

Although bank regulators expressed few specific safety and soundness concerns with the proposed provision, Treasury and IRS stated that the current guidance is sufficient on passive investment income for banks and provides them with flexibility in applying the law. Treasury officials were not in favor of the proposed provision, stating that expanding the current law could allow income accumulating during an S-corporation's years as a C-corporation to avoid the corporate level tax.

Revenue losses associated with excluding securities income from passive investment income tax treatment are estimated to be $10 million over 5 years and $23 million over 10 years, from 2000 to 2009.

Proposed Tax Provision to Redefine Treatment of Bank Director Shares

Proposed Tax Provision

The proposed provision would provide that any stock that bank directors must hold under banking regulations would (1) not be a disqualifying second class of stock and (2) not count towards the total number of shareholders.

Present S-Corporation Law and National Banking Law

To be eligible for Subchapter S status, the current law requires that corporations have only one class of outstanding stock.[1] Unlike with partnerships, the outstanding shares of an S-corporation must confer identical rights to profits and assets. An exception is made, however, to allow differences in voting rights (i.e., includes voting and nonvoting stock).

National banking law requires that a director of a national bank own stock in the bank. According to OCC's interpretative ruling, this requirement is to ensure that the bank director has a sufficient financial interest in the bank to be vigilant in protecting the bank's interests. A number of states have similar requirements for state-chartered banks. Bank directors' qualifying stock must be at least $1,000 par value, or an equivalent interest as defined by the OCC.[2] In addition, a national bank is required to have at least five directors.[3]

Under OCC regulations,[4] bank directors can meet the requirement for bank director shares by holding common or preferred stock in the bank or its holding company with an aggregate par or fair market value of at least $1,000.[5] A director may hold qualifying shares in a profit-sharing plan, IRA,[6] retirement plan, or similar arrangement while retaining beneficial ownership and legal control over the shares.[7] In addition, a director may hold qualifying shares subject to an agreement that another shareholder will repurchase the shares if the director ceases to serve in that capacity.[8] A director may assign the right to receive dividends or distributions on

[1] Internal Revenue Code, Title 26, Sec. 1361(b)(1)(D).

[2] See 12 U.S.C. Section 72.

[3] See 12 U.S.C. Section 71.

[4] See 12 C.F.R. sec. 7.2005(b)(1).

[5] OCC interprets national banking law as requiring national banks to have one class of common stock. See 12 U.S.C. Section 61.

[6] Banks wishing to become S-corporations cited an obstacle in converting because an IRA is considered an ineligible shareholder in an S-corporation. We discussed this in appendix IV.

[7] See 12 C.F.R. sec. 7.2005(b)(4)(i.).

[8] See 12 C.F.R. sec. 7.2005(b)(4)(ii).

qualifying shares and may execute a revocable or irrevocable proxy authorizing another person to vote the director's qualifying shares.[9]

Reasons Cited for Proposed Change

Two major reasons were cited for the proposed change in tax law. First, legal and accounting experts told us that some agreements for bank directors' shares were written in such a way that they fulfill the national banking requirement but this creates a second class of stock. Creating a second class of stock makes the bank ineligible to elect Subchapter S status. For business reasons, some community banks or their holding companies chose to issue shares to bank directors that may not convey the same economic interests given to the other shareholders. For example, the bank may have an agreement to buy back the bank director's stock at par value rather than at market value when the director leaves his position. Another example could be that the director's shares have preference rights over common stock in the payments of dividends and the liquidation of assets. In both situations, the qualifying director's shares create a second class of stock because there are economic differences between shareholders.

The second reason cited for the proposed change is that the national banking law requirement to maintain five bank directors counts toward the total number of shareholders in an S-corporation.[10] Some bankers and legal and accounting experts told us that counting bank director shares towards the maximum number of shareholders limits the bank's ability to manage its number of shareholders below the allowable limit.

Impacts of Current Law

The combined effects of both Subchapter S law and national banking law could create an obstacle to Subchapter S bank conversion. National banking law permits a bank to issue the same stock to its directors as it issues to other shareholders, but the law also gives banks latitude in giving directors different options on their shares. IRS' stated perspective is that the way some banks have treated their bank director shares creates a second class of stock, which makes those banks ineligible to elect Subchapter S tax status.

This proposed change was considered to be less important when ranked against other obstacles for Subchapter S conversion by ABA survey

[9] See 12 C.F.R. sec. 7.2005(b)(4)(iii) and (iv).

[10] Current law limits the maximum number of shareholders to 75. We discussed the shareholder limit in more detail in appendix III.

respondents.[11] About 17 percent of ABA's survey respondents that had already converted to S-corporation banks eliminated a second class of stock. The second class of stock in this case could have included preferred stock or bank director shares that created a second class of stock.

Banks' Attorneys Have Developed Methods to Address Bank Director Shares

To become eligible to make the conversion, some banks have rewritten their shareholder agreements so that there are no longer differences between bank directors and other shareholders. In other words, the share agreement is rewritten so the bank directors receive dividends and pay taxes proportionately to their share of the bank's income, the same as other shareholders. Bankers indicated that involving their attorneys in rewriting their shareholder agreements or eliminating shareholders to accommodate the number of bank director shares has lengthened and added cost to their conversion process.

Bankers and legal and accounting experts also told us that some banks became S-corporations despite differences between their director qualifying shares and other shares that created a second class of stock and are not in compliance with S-corporation rules. One banker told us that "his bank is operating in limbo" because his S-corporation bank had not issued stock to a few of its directors and was waiting for an approval from OCC examiners.

Some banks chose not to elect Subchapter S status because they would be forced to eliminate minority shareholders to accommodate the additional requirement for bank director shares to become eligible to be an S-corporation.

Impacts of Proposed Changes

We studied two legislative changes concerning bank director shares. The first change would not treat qualifying director shares as a second class of stock. This proposed change would eliminate the bank's need, in some cases, to rewrite shareholder agreements for bank directors. The second proposed change would not consider the bank director shares as shareholders in the bank for purposes of the Subchapter S conversion. This change would help banks to maintain their current shareholders and possibly reduce the need to increase the allowable number of shareholders for S-corporations. If the proposed provision were passed, the Joint Tax Committee on Taxation estimated tax revenue losses from this proposed

[11] On ABA's survey, respondents were asked to rank the relative importance of proposed changes. On a ranking of 1 to 5 with 1 equal to a low priority and 5 equal to a high priority, the change to allow qualified director stock was ranked as 2.62.

provision, if passed, at $26 million over 5 years and $100 million over 10 years.

Bank regulators did not express any safety and soundness concerns with the proposed provision. IRS officials discussed the proposed changes with bank regulators and met with OCC officials to clarify what qualifies as bank director stock. IRS officials have not changed current tax regulations to address bankers' concern about creating a second class of stock because they believed that the law needed to be changed first. The proposed provision would permit IRS to address the bankers' concern but would change the underlying simplicity of the one class of stock rule for S-corporations.

Proposed Tax Provisions to Improve Bad Debt Treatment

Proposed Tax Provision

The proposed provision would change the tax deductions for certain losses embedded in the loan portfolio at conversion from a C-corporation bank to an S-corporation. The proposed tax change would allow "built-in" losses to be matched with certain "built-in" gains. The proposed tax provision would treat the charge-off of bad debts[1] that were embedded in the bank's loan portfolio at conversion as items of built-in loss[2] over the same number of years that the accumulated bad debt reserve must be recaptured as built-in gains[3] for tax purposes.

Definition of "Built-in" Gain or Loss

For tax purposes, a built-in gain or loss is defined as the difference between the fair market value and the adjusted tax bases of the assets (value of the assets for tax purposes) of the S-corporation at the beginning of the tax year that it elected Subchapter S status. As an S-corporation, realized built-in gains are taxed at the corporate tax rate.

Present and Prior Law

Under current law, to become eligible for Subchapter S tax status, S-corporations (including small banks) use the specific charge-off method of accounting for bad debts for tax purposes.[4] Under the specific charge-off method for bad debt expense, firms take a deduction against income or "write-off" an asset in the tax year in which the debt is deemed worthless. In contrast, small banks that use the reserve method for accounting for bad debts (for tax purposes) are ineligible to elect Subchapter-S status, unless they change the way they account for their bad debts. The reserve method of accounting for bad debts permits small banks to deduct from taxable income additions to the bad debt reserve such that the reserve balance is large enough to absorb anticipated future losses on the small banks' loan portfolios.

Currently, small C-corporation banks under asset size of $500 million can use the reserve method of accounting for bad debts for tax purposes.[5] Larger C-corporation banks with assets greater than $500 million must use the specific charge-off method for tax purposes. Therefore, small banks wishing to convert to S-corporation status that have used the reserve method of accounting must change their method of accounting for bad debts for tax purposes. Because of this change in tax accounting, the

[1] Section 166 of the Internal Revenue Code.

[2] Section 1374(d)(4) of the Internal Revenue Code.

[3] Section 1374(d) of the Internal Revenue Code.

[4] Section 1361(b)(2)(A) of the Internal Revenue Code.

[5] Section 585 of the Internal Revenue Code.

banks must "recapture" the bad debt reserve as taxable income,[6] because the previous additions to the reserve had been allowed as tax deductions. The recaptured bad debt reserve is taxed at the corporate rate as a built-in gain.

Prior to 1996, financial institutions were not allowed to elect Subchapter S status because of the special reserve method of tax accounting for bad debts used by financial institutions. The reasoning for this was that banks were given a substantial tax break in their ability to use methods of tax accounting for bad debts that were more generous than those permitted other industries. Over time, Congress disallowed some of the special methods of tax accounting for bad debts for financial institutions. However, the difference in tax accounting for bad debts still exists for small C-corporation banks that use the reserve method.[7]

Bad Debt Recapture Cited as Obstacle to Subchapter S Election

Banking industry representatives cited the cost incurred from changing the tax accounting methods for bad debts as an obstacle to electing Subchapter S status. In an ABA survey of its membership, the respondents ranked "bad debt charge-offs to offset reserve recapture" as second in the relative importance of pending legislation for S-corporation banks. Under present law, a bank is permitted to "charge-off" its built-in losses against its recaptured income in the first S-corporation year. For banks that are recapturing large bad debt reserves, the increased tax liability from recapturing this reserve into income can add to the costs for conversion to Subchapter S status. The bad debt reserve is a more significant issue for small banks converting to Subchapter S status than for other industries because of their special tax treatment of bad debt reserves. In addition, nonbank firms typically do not have bad debt reserves to the magnitude that banks do because of the basic loan business of banking.

Tax Accounting Costs Associated with Subchapter S Conversion

Industry representatives said the cost of changing to the specific charge-off method for tax purposes is significant for many community banks and their shareholders. Shareholders must recapture the bad debt reserve into income as an S-corporation, but the bank often ends up paying a corporate-level tax (i.e., built-in gains tax) on the recapture of this income. Industry representatives and accounting experts assert that the net federal tax paid as a result can exceed 60 percent of the recaptured amount. Because the built-in losses, held as of the S-corporation conversion date, may not be recognized over the same period that the bad debt reserve

[6] Section 481 of the Internal Revenue Code.

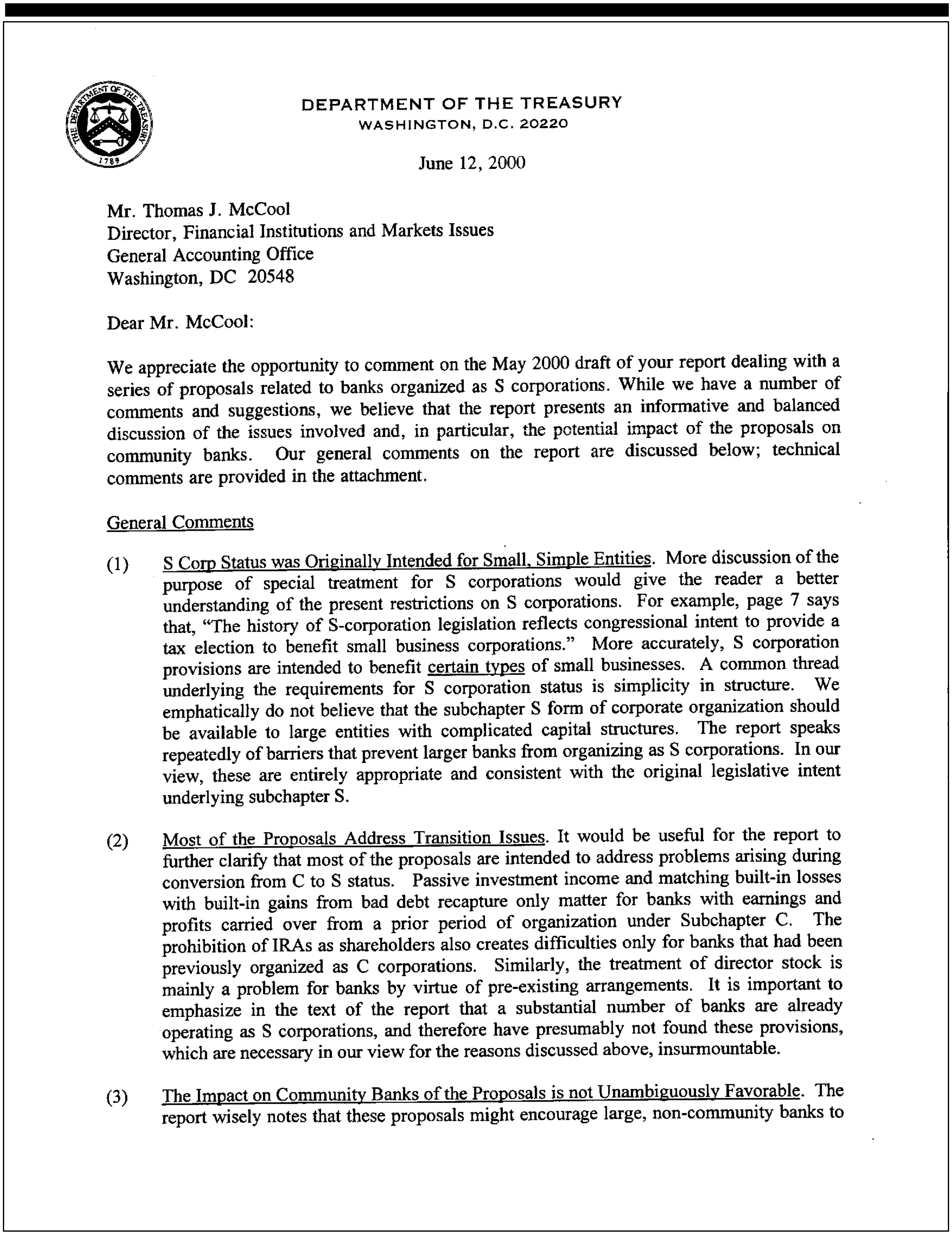
[7] "Banks as S Corporations: The Small Business Job Protection Act of 1996," The Banking Law Journal, Richard Goldstein, New York, Jul./Aug. 1997.

must be recaptured, paying tax on the recapture of the bad debt reserve is an added cost for converting to Subchapter S status. Accounting experts told us that they have advised their banking clients to change accounting methods prior to electing Subchapter S status so that the recaptured amounts would be taxed while in the C-corporation status to reduce the built-in gains tax passed through to the shareholders of the S-corporation bank.

Proposed Change Would Likely Lower Banks' Tax Costs During Conversion to Subchapter S Status

The proposed change would potentially lower the cost of conversion for banks. Bank tax experts stated this proposed change would permit banks to better match their built-in losses against built-in gains for tax purposes during the recapture period. The Joint Committee on Taxation estimated tax revenue losses from this proposed provision, if passed, at $132 million over a 5-year period and $201 million over a 10-year period. Bank regulators did not express safety and soundness concerns with the proposed change. Treasury officials indicated a willingness to accept the change but stated that they believe such a change further complicates the tax code at a time when they are trying to simplify it.

Comments from the Department of the Treasury



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 12, 2000

Mr. Thomas J. McCool
Director, Financial Institutions and Markets Issues
General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

We appreciate the opportunity to comment on the May 2000 draft of your report dealing with a series of proposals related to banks organized as S corporations. While we have a number of comments and suggestions, we believe that the report presents an informative and balanced discussion of the issues involved and, in particular, the potential impact of the proposals on community banks. Our general comments on the report are discussed below; technical comments are provided in the attachment.

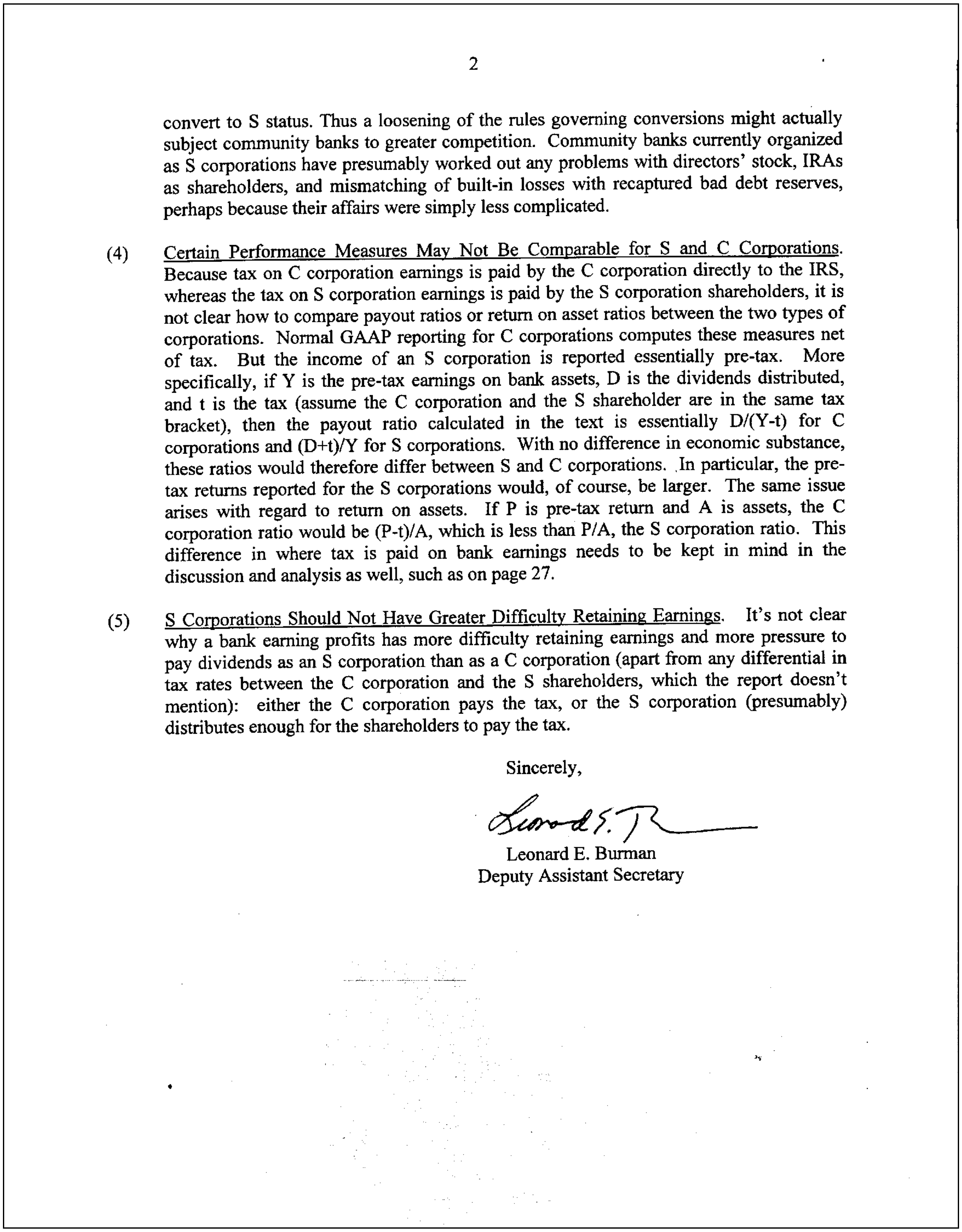
General Comments

Now on p. 4.

(1) S Corp Status was Originally Intended for Small, Simple Entities. More discussion of the purpose of special treatment for S corporations would give the reader a better understanding of the present restrictions on S corporations. For example, page 7 says that, "The history of S-corporation legislation reflects congressional intent to provide a tax election to benefit small business corporations." More accurately, S corporation provisions are intended to benefit certain types of small businesses. A common thread underlying the requirements for S corporation status is simplicity in structure. We emphatically do not believe that the subchapter S form of corporate organization should be available to large entities with complicated capital structures. The report speaks repeatedly of barriers that prevent larger banks from organizing as S corporations. In our view, these are entirely appropriate and consistent with the original legislative intent underlying subchapter S.

(2) Most of the Proposals Address Transition Issues. It would be useful for the report to further clarify that most of the proposals are intended to address problems arising during conversion from C to S status. Passive investment income and matching built-in losses with built-in gains from bad debt recapture only matter for banks with earnings and profits carried over from a prior period of organization under Subchapter C. The prohibition of IRAs as shareholders also creates difficulties only for banks that had been previously organized as C corporations. Similarly, the treatment of director stock is mainly a problem for banks by virtue of pre-existing arrangements. It is important to emphasize in the text of the report that a substantial number of banks are already operating as S corporations, and therefore have presumably not found these provisions, which are necessary in our view for the reasons discussed above, insurmountable.

(3) The Impact on Community Banks of the Proposals is not Unambiguously Favorable. The report wisely notes that these proposals might encourage large, non-community banks to



convert to S status. Thus a loosening of the rules governing conversions might actually subject community banks to greater competition. Community banks currently organized as S corporations have presumably worked out any problems with directors' stock, IRAs as shareholders, and mismatching of built-in losses with recaptured bad debt reserves, perhaps because their affairs were simply less complicated.

(4) Certain Performance Measures May Not Be Comparable for S and C Corporations. Because tax on C corporation earnings is paid by the C corporation directly to the IRS, whereas the tax on S corporation earnings is paid by the S corporation shareholders, it is not clear how to compare payout ratios or return on asset ratios between the two types of corporations. Normal GAAP reporting for C corporations computes these measures net of tax. But the income of an S corporation is reported essentially pre-tax. More specifically, if Y is the pre-tax earnings on bank assets, D is the dividends distributed, and t is the tax (assume the C corporation and the S shareholder are in the same tax bracket), then the payout ratio calculated in the text is essentially D/(Y-t) for C corporations and (D+t)/Y for S corporations. With no difference in economic substance, these ratios would therefore differ between S and C corporations. In particular, the pre-tax returns reported for the S corporations would, of course, be larger. The same issue arises with regard to return on assets. If P is pre-tax return and A is assets, the C corporation ratio would be (P-t)/A, which is less than P/A, the S corporation ratio. This difference in where tax is paid on bank earnings needs to be kept in mind in the discussion and analysis as well, such as on page 27.

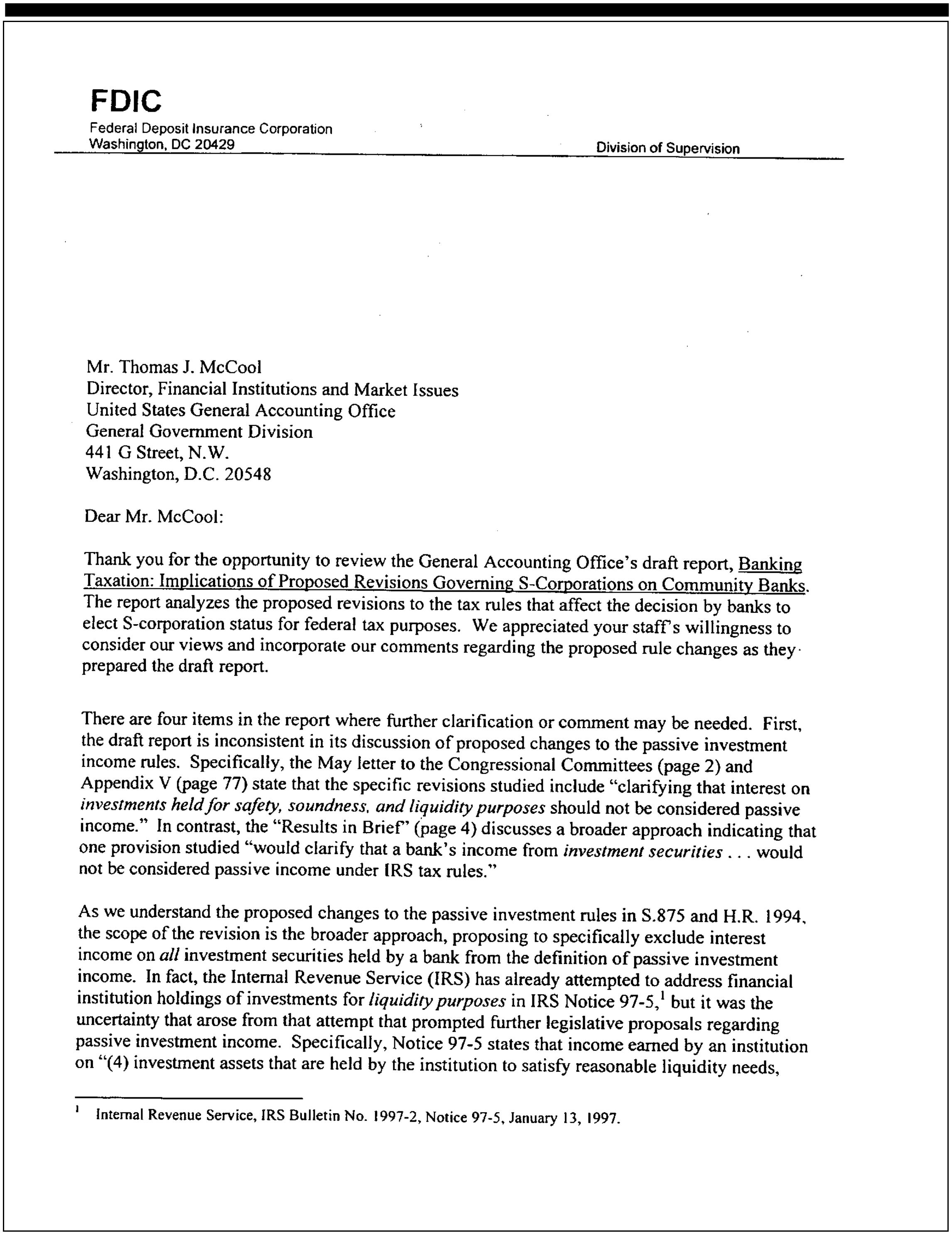
Now on p. 15.

(5) S Corporations Should Not Have Greater Difficulty Retaining Earnings. It's not clear why a bank earning profits has more difficulty retaining earnings and more pressure to pay dividends as an S corporation than as a C corporation (apart from any differential in tax rates between the C corporation and the S shareholders, which the report doesn't mention): either the C corporation pays the tax, or the S corporation (presumably) distributes enough for the shareholders to pay the tax.

Sincerely,

Leonard E. Burman
Deputy Assistant Secretary

Comments from the Federal Deposit Insurance Corporation



FDIC

Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Supervision

Mr. Thomas J. McCool
Director, Financial Institutions and Market Issues
United States General Accounting Office
General Government Division
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. McCool:

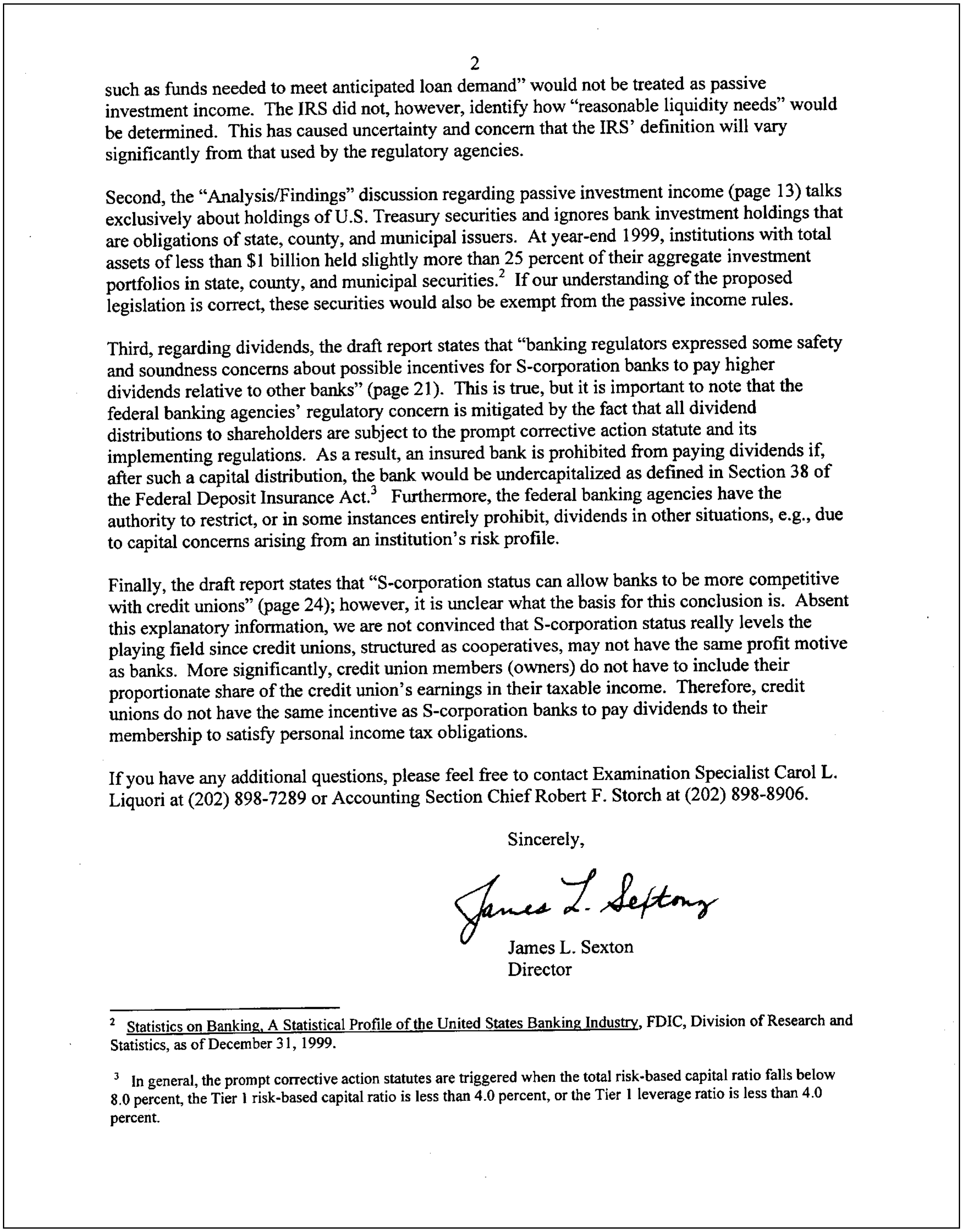
Thank you for the opportunity to review the General Accounting Office's draft report, Banking Taxation: Implications of Proposed Revisions Governing S-Corporations on Community Banks. The report analyzes the proposed revisions to the tax rules that affect the decision by banks to elect S-corporation status for federal tax purposes. We appreciated your staff's willingness to consider our views and incorporate our comments regarding the proposed rule changes as they prepared the draft report.

No on pp. 1, 50, and 2.

There are four items in the report where further clarification or comment may be needed. First, the draft report is inconsistent in its discussion of proposed changes to the passive investment income rules. Specifically, the May letter to the Congressional Committees (page 2) and Appendix V (page 77) state that the specific revisions studied include "clarifying that interest on *investments held for safety, soundness, and liquidity purposes* should not be considered passive income." In contrast, the "Results in Brief" (page 4) discusses a broader approach indicating that one provision studied "would clarify that a bank's income from *investment securities* . . . would not be considered passive income under IRS tax rules."

As we understand the proposed changes to the passive investment rules in S.875 and H.R. 1994, the scope of the revision is the broader approach, proposing to specifically exclude interest income on *all* investment securities held by a bank from the definition of passive investment income. In fact, the Internal Revenue Service (IRS) has already attempted to address financial institution holdings of investments for *liquidity purposes* in IRS Notice 97-5,[1] but it was the uncertainty that arose from that attempt that prompted further legislative proposals regarding passive investment income. Specifically, Notice 97-5 states that income earned by an institution on "(4) investment assets that are held by the institution to satisfy reasonable liquidity needs,

[1] Internal Revenue Service, IRS Bulletin No. 1997-2, Notice 97-5, January 13, 1997.



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such as funds needed to meet anticipated loan demand" would not be treated as passive investment income. The IRS did not, however, identify how "reasonable liquidity needs" would be determined. This has caused uncertainty and concern that the IRS' definition will vary significantly from that used by the regulatory agencies.

Now on p. 7.

Second, the "Analysis/Findings" discussion regarding passive investment income (page 13) talks exclusively about holdings of U.S. Treasury securities and ignores bank investment holdings that are obligations of state, county, and municipal issuers. At year-end 1999, institutions with total assets of less than $1 billion held slightly more than 25 percent of their aggregate investment portfolios in state, county, and municipal securities.[2] If our understanding of the proposed legislation is correct, these securities would also be exempt from the passive income rules.

Now on pp. 13-14.

Third, regarding dividends, the draft report states that "banking regulators expressed some safety and soundness concerns about possible incentives for S-corporation banks to pay higher dividends relative to other banks" (page 21). This is true, but it is important to note that the federal banking agencies' regulatory concern is mitigated by the fact that all dividend distributions to shareholders are subject to the prompt corrective action statute and its implementing regulations. As a result, an insured bank is prohibited from paying dividends if, after such a capital distribution, the bank would be undercapitalized as defined in Section 38 of the Federal Deposit Insurance Act.[3] Furthermore, the federal banking agencies have the authority to restrict, or in some instances entirely prohibit, dividends in other situations, e.g., due to capital concerns arising from an institution's risk profile.

Now on p. 12.

Finally, the draft report states that "S-corporation status can allow banks to be more competitive with credit unions" (page 24); however, it is unclear what the basis for this conclusion is. Absent this explanatory information, we are not convinced that S-corporation status really levels the playing field since credit unions, structured as cooperatives, may not have the same profit motive as banks. More significantly, credit union members (owners) do not have to include their proportionate share of the credit union's earnings in their taxable income. Therefore, credit unions do not have the same incentive as S-corporation banks to pay dividends to their membership to satisfy personal income tax obligations.

If you have any additional questions, please feel free to contact Examination Specialist Carol L. Liquori at (202) 898-7289 or Accounting Section Chief Robert F. Storch at (202) 898-8906.

Sincerely,

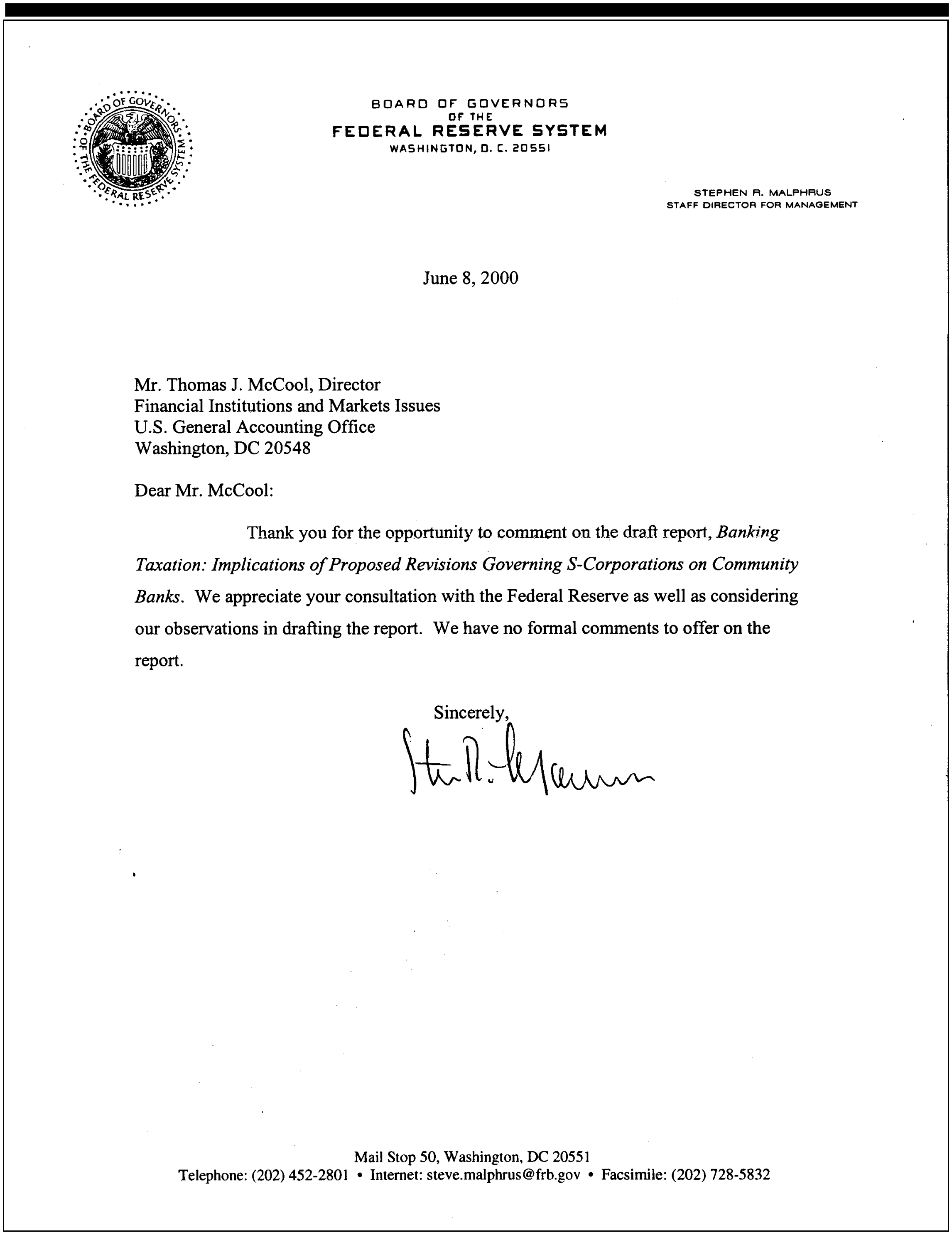
James L. Sexton

James L. Sexton
Director

[2] Statistics on Banking, A Statistical Profile of the United States Banking Industry, FDIC, Division of Research and Statistics, as of December 31, 1999.

[3] In general, the prompt corrective action statutes are triggered when the total risk-based capital ratio falls below 8.0 percent, the Tier 1 risk-based capital ratio is less than 4.0 percent, or the Tier 1 leverage ratio is less than 4.0 percent.

Comments From the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS
OF THE
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WASHINGTON, D. C. 20551

STEPHEN R. MALPHRUS
STAFF DIRECTOR FOR MANAGEMENT

June 8, 2000

Mr. Thomas J. McCool, Director
Financial Institutions and Markets Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

Thank you for the opportunity to comment on the draft report, *Banking Taxation: Implications of Proposed Revisions Governing S-Corporations on Community Banks*. We appreciate your consultation with the Federal Reserve as well as considering our observations in drafting the report. We have no formal comments to offer on the report.

Sincerely,

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Acknowledgments

William B. Bates, Jeanette M. Franzel, Tonita W. Gillich, Debra R. Johnson, Shirley A. Jones, Mitchell B. Rachlis, Carl M. Ramirez, Anne O. Stevens, and John H. Treanor.

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