



Credit Union National Association

# *CUNA Issue Summary*

## COMMUNITY BANK LEGISLATION

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**ISSUE:** Several bills were introduced in the 110<sup>th</sup> Congress to provide regulatory and tax relief to banks. The bill of prime importance to banks was the *Communities First Act* (H.R. 1869 and S. 1405), which was introduced in the House of Representatives on April 17, 2007 and in the Senate on May 16, 2007.

### **Key Bank Regulatory and Tax Breaks:**

- Reduces the quarterly regulatory paperwork requirement on certain banks.
- Exempts many banks from certain reporting requirements of the Sarbanes Oxley Act of 2002.
- Establishes a new requirement that bank and thrift regulators analyze the effects of any proposed regulations on the operations of any affected bank or savings association.
- Decreases the number of banks that must register with the Securities and Exchange Commission by requiring only banks with 1,000 shareholders to register.
- Creates new Bank Secrecy Act exemptions for banks filing currency transaction reports.
- Allows banks to forego the annual issuance of privacy statements if they don't share certain customer information.
- Increases to \$250,000 the individual non-exempt loan limit banks can provide to executives.
- Mandates the federal government reimburse banks when they produce records for any law enforcement investigations.
- Requires the Government Accountability Office to issue a report on the effect federal banking regulators commercial real estate guidance has had on bank profitability.
- Reduces bank lender fees imposed in certain Small Business Administration programs.
- Excludes from taxable income bank profits on certain agricultural loans.
- Allows banks to become [Limited Liability Companies \(LLCs\)](#), giving them preferential tax status along with fewer regulatory restrictions than other banks.
- Gives C-corporation banks a new 20% tax credit on taxable income up to \$250,000.
- Allows shareholders of tax-preferred [Subchapter S banks](#) to exclude from taxation 20% of distributable income up to \$1.25 million.
- Creates a 50% tax credit (up to \$500,000) for certain banks that operate in distressed communities.
- Allows S-corporation banks to exclude from taxes 50% of their distributable income (up to \$2.5 million) for serving distressed communities.
- Repeals the Alternative Minimum Tax for banks with assets under \$5 billion.
- Increases the number of shareholders a Subchapter S bank may have, from 100 to 150.
- Exempts the shares held by bank directors from the Subchapter S bank share limit.
- Allows Subchapter S banks to recapture their bad debt reserves in their first year.
- Expands the types of stock Subchapter S banks may issue.

**CUNA POSITION:** Community banks need regulatory relief, but so do credit unions. A decade has passed since major credit union legislation was passed by Congress. The bank trade associations vigorously supported the *Communities First Act* but continue to attack the tax status of credit unions and any regulatory modernization legislation designed to benefit them. In addition, there are over 2,500 banks that are organized as Subchapter S corporations, meaning they avoid corporate-level income taxes. Credit unions are not a threat to the profits of the banking industry, the most profitable sector of our nation's economy. That's because credit unions are not-for-profit financial cooperatives that have held a mere 6% of all deposits nationwide for 20 years. It's past time for the bankers to stop attacking America's member-owned credit unions.

**STATUS/OUTLOOK:** In the 110th Congress, Senator Max Baucus (D-MT) introduced S. 349, the *Small Business and Work Opportunity Act of 2007*. This legislation increases the federal minimum wage and includes a number of tax breaks intended to mitigate the increased burdens the bill places on small businesses. This legislation passed the Senate Finance Committee on January, 17, 2007 and most of the bill was incorporated into H.R. 2206, the *U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007*, which was signed into law on May 25, 2007.

There are six tax provisions in the new law benefiting Subchapter S corporations (including Subchapter S banks). Congress' Joint Committee on Taxation has estimated that all six Subchapter S provisions will cost the taxpayers \$892 million and that the two that apply only to banks will cost \$400 million. The following are the six provisions. The first two provisions listed below came directly from the *Communities First Act* (Sections 502 and 503 of the CFA).

- As mentioned previously, S-corporations are limited to 100 shareholders and may issue only one class of stock. This second requirement is met if all shares confer equal rights to their holders with regards to the distribution of profits and potential liquidation of assets. Since both federal and state banking laws require that S-Corporation bank directors hold stock in that bank, the bank may buy back that director's stock upon his departure at the original price paid. This new law clarifies that this type of arrangement does not constitute a second class of stock.
- Banks that use the reserve method of accounting for bad debts are not allowed to elect Subchapter S tax status. The *Tax Reform Act of 1986* abolished this accounting method for all businesses except banks and thrifts. Using this method, a bank makes a determination of the percentage of loans it predicts will eventually go uncollected. Then, it adds this figure to its bad debt reserve and the total is used as an offset to its accounts receivable amount. If a bank switches from this accounting method, there are additions and subtractions made to its taxable income to prevent any duplications or omissions. Additions to taxable income are usually spread over the first four tax years and subtractions to taxable income are usually taken in that tax year. Under current law, a bank that changes from the reserve method and elects to be an S-Corporation *THAT YEAR*, the adjustments are considered in the taxes for both the shareholder and the corporation. If this change in accounting is made for the last taxable year *PRIOR* to becoming an S-Corporation, the adjustments for that year are only considered in the taxation of the corporation. Under the new law, if this change in accounting is made for the S-Corporation's first tax year, the bank may choose to take all adjustments in the last taxable year it was a C-corporation. Therefore, the adjustments will only be subject to corporate taxation.

- Excludes capital gains from passive investment income restrictions
- Changes how parent Subchapter S corporations are treated when they sell their interest in one of their qualified Subchapter S subsidiaries
- Eliminates earnings and profits attributable to tax years prior to 1983
- Expands eligible beneficiaries of an electing small business trust

Also included in the war spending bill was Section 307 of the *Communities First Act* which extends Section 179 small business expensing.

On June 5, 2008, the Senate Finance Committee held a hearing on tax reform, focusing on the different forms of business organization that a company can choose, and the tax ramifications associated with this choice. In [information](#) provided to the Committee for the hearing, the Joint Committee on Taxation mentioned Subchapter S banks as benefiting from the tax code.

On February 17, 2009, the *American Recovery and Reinvestment Act* was signed into law. It contained a provision that reduces the built-in gains recognition period from 10 to 7 years for some S banks. Under previous law, when banks converted from a C-corporation to an S-Corporation, they often transferred assets that had appreciated in value. If the new S-Corporation sold such an asset within ten years, it became subject to a 35% corporate tax rate on the realized gains that occurred while the asset was owned by the C-corporation. The new law temporarily reduces the holding period from 10 years to 7 for taxable years that begin in 2009 and 2010. The new law provides additional benefits to banks. Under previous law, banks could not take a tax deduction for interest on tax-exempt municipal bonds. For purposes of calculating the interest expense banks owe on these investments, the new law excludes interest expense on municipal bonds issued during 2009 and 2010 as long as the bank's municipal bond portfolio is less than two percent of their assets. Also, under previous law, interest expense on municipal bonds issued by "qualified small issuers" was not counted in a bank's calculation of their tax liability. Previously, a "qualified small issuer" was an issuer that had outstanding tax-exempt bonds not exceeding \$10 million. The new law increases this amount to \$30 million.

Additional legislation has been introduced in Congress this year to provide tax relief to S Corporation banks. In the House of Representatives, Representative Ron Kind (D-WI) introduced H.R. 2910, the S Corporation Modernization Act of 2009. It would make permanent the provision in the *American Recovery and Reinvestment Act* that reduces the built-in gains recognition period from 10 to 7 years. It would also allow IRAs to become S Corporation shareholders. The bill also repeals the mandatory termination of an S corporation election for excessive passive investment income. It also allows these corporations to increase passive investment income from 25 to 60% without incurring additional tax. A companion bill has been introduced in the Senate by Senator Blanche Lincoln (D-AR). Also in the Senate, Senator Charles Grassley (R-IA) has introduced S. 1381, the *Small Business Tax Relief Act of 2009*. Among other provisions, this bill would make permanent the provision in the *American Recovery and Reinvestment Act* that reduces the built-in gains recognition period from 10 to 7 years.

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