



Credit Union National Association

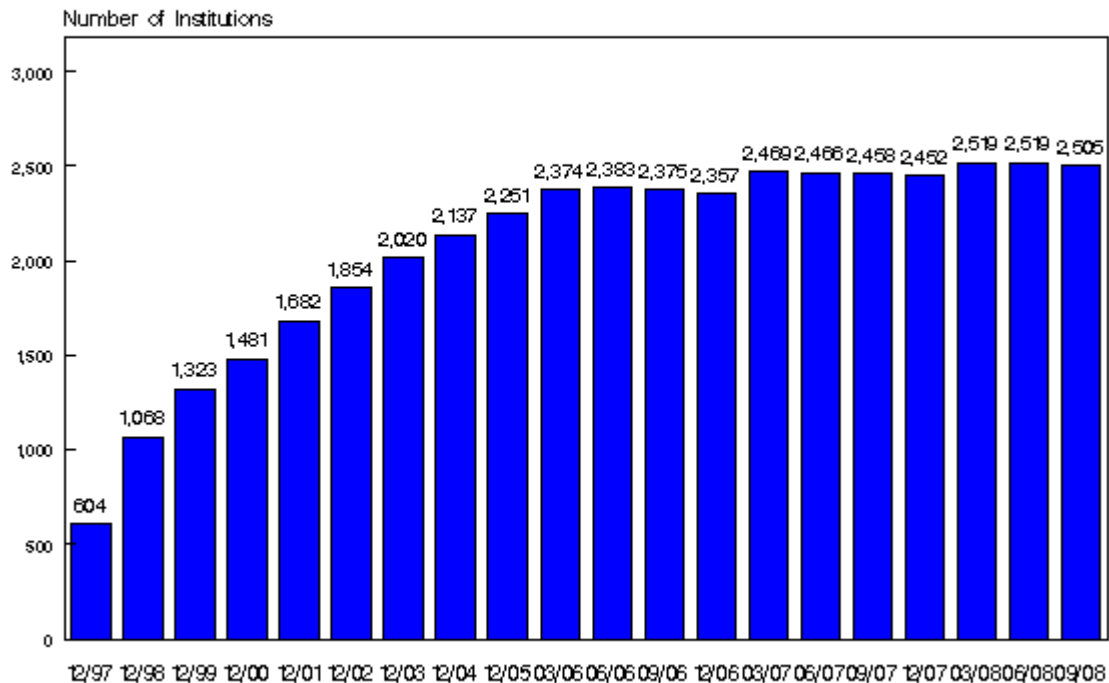
# CUNA Issue Summary

## SUBCHAPTER S CORPORATION BANKS

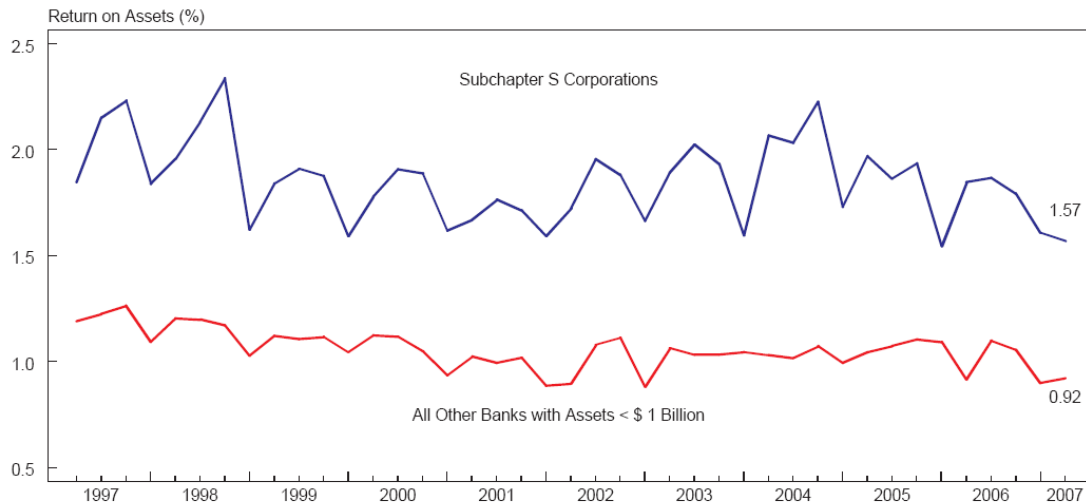
**ISSUE:** Subchapter S was added to the Internal Revenue Code in 1958 to reduce the tax burden on small business. It has allowed businesses, primarily small ones, to have the liability protection that comes with being incorporated. S-Corporations are not subject to the federal corporate income tax if they meet certain criteria. This helps many businesses avoid an entire layer of taxation and these entities are often referred to as “pass-through” organizations – that is, the profit or loss as well as the tax burden is “passed through” to the shareholders. As a result, profits from the company are not subject to “double taxation” – once on the corporate level and once on the personal level.

The *Small Business Job Protection Act of 1996* made banks and thrifts eligible to incorporate as or convert to S-corporations starting in 1997. Today, almost one third of all banks in the U.S. have elected Subchapter S tax treatment. In fact, today there are over 2,500 Subchapter S banks. These conversions have increased these bank's after-tax returns by an average of 17%. Not all Subchapter S banks are small. In fact, the largest has nearly \$15 billion in assets. (Source: FDIC).

**Number of Subchapter S Corporations**  
1997–2008



**Quarterly Return on Assets of Subchapter S  
Corporations vs. Other Banks, Annualized  
1997-2007**



SOURCE: FDIC

On June 19, 2003, the Ways and Means Subcommittee on Select Revenue Measures held a hearing on “S-Corporation Reforms”. Businesses and bankers, including the Independent Community Bankers of America, testified about pending legislation and how S-Corporation law could be changed to make it more attractive to business. CUNA made a submission for the record indicating that it supported easing the tax burden on banks. However, the statement also pointed out bank hypocrisy in seeking more taxation of credit unions.

The *American Jobs Creation Act of 2004 (AJCA)* included provisions to eliminate certain drawbacks that prevented some banks and thrifts from electing S status.

1. Before AJCA, all S-Corporations were limited to 75 shareholders (a husband and wife were considered one shareholder). AJCA increased that maximum number to 100. Banks often decided not to elect S status because being restricted to a maximum of 75 shareholders was seen as a hindrance to their growth potential and ability to obtain capital. In addition, AJCA allowed a whole family to be treated as one shareholder. A family was defined as a common ancestor, lineal descendants of that ancestor and the spouses (or former spouses) of the lineal descendants or common ancestor, for up to six generations. This is beneficial with respect to transferring shares among family members. Now, S-Corporations don’t have to worry about losing their tax-preferred status by exceeding the number of shareholders when family members gift, transfer, or will shares to other family members. In the past, such stock transfers would have created additional shareholders.

2. Before AJCA, many banks chose not to elect S status because Individual Retirement Accounts (IRAs) held stock in their companies. Federal law prevented IRAs from becoming S-Corporation shareholders. Some banks tried to buy out their IRA shareholders but that often proved to be difficult. Only individuals (U.S. citizens and resident aliens), estates, employee stock ownership plans, certain tax-exempt organizations, and certain trusts can be S shareholders. After AJCA, Individual Retirement Accounts (IRAs) could own bank S-Corporation stock. AJCA allowed traditional and Roth IRAs to own S bank shares.

One important restriction in AJCA was that banks with IRA shareholders and wanting to convert to S status had to prove that those IRAs had been shareholders in their banks prior to October 22, 2004. IRAs that became bank shareholders subsequent to that date are still not eligible to be S-Corporation shareholders. An oversight in AJCA allowed only IRAs that held bank stock to become S-Corporation shareholders. Those that owned bank holding company stock were ineligible. The *Tax Technical Corrections Act of 2005* made eligible IRAs that owned stock in bank holding companies or thrift holding companies. In general, bank holding companies, not their individual banks, issue stock.

The Joint Committee on Taxation estimated that this provision would cost the federal treasury \$394 million from fiscal years 2005 through 2014.

3. Bank S-Corporations that converted from C status are limited in how much passive income (for example, other company's stock) they can earn annually. If that income exceeded 25% of its overall gross receipts, the Subchapter S bank became subject to federal corporate tax on its passive income. In addition, the IRS could terminate that bank's S status if its passive income exceeded 25% in three consecutive years. Banks with many profitable investments saw this as a deterrent to electing S status.

AJCA changed the definition of passive income for banks to exclude interest income or dividend income that banks derive from stock that they are required to hold by federal regulators. For example, such stock holdings may be required for participation in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank or participation certificates issued by a Federal Intermediate Credit Bank. Other dividends and capital gains still apply to the 25% passive income test. The *Tax Technical Corrections Act of 2005* (P.L. 109-135) clarified that the depository institutions included both bank and thrift holding companies.

On March 8, 2006, the House of Representatives passed H.R. 3505, the *Financial Services Regulatory Relief Act*. The bill provided regulatory relief to credit unions, banks, and thrifts. Of interest to S-Corporation banks, the bill would have allowed the Office of the Comptroller of the Currency (OCC) to permit an individual to serve as director of a Subchapter S national bank if that person held at least \$1,000 of subordinated debt issued by that bank. If that bank dissolves, such subordinated debt is paid after depositors and other creditors are paid. Under current law, these Subchapter S national bank directors are required to hold capital stock ownership in that particular bank. This provision was dropped from the bill in the Senate.

Also dropped from the House-passed bill was a provision that would have allowed the OCC to permit national banks to be organized as [Limited Liability Corporations \(LLCs\)](#).

**So how are S-Corporation banks taxed?** They can completely avoid corporate-level federal income tax if they abide by the rules that govern S-Corporations, namely the "passive (investment) income rule" and the "Built-In Gains Rule". In addition, S-Corporations avoid the corporate Alternative Minimum Tax and undistributed income in an S-Corporation is not subject to federal payroll (FICA) taxes (although the employees are). Finally, S-Corporations are attractive not only because they provide the benefits of incorporation (like limited liability), but also because they are not taxed twice – once on the corporate level and once on the shareholder level – unlike C-corporations.

- **Passive (Investment) Income Rule:** These banks must not end the tax year having more than 25% of their gross receipts comprised of passive income. If they do, the excess gains above 25% are taxed at the highest corporate income tax rate (35%). H.R. 2206, the *U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007*, was signed into law on May 25, 2007 and excludes from this rule any gains realized by the sale or exchange of stock or other securities. This new law makes it much easier for S-Corporation banks to stay under the 25% cap.
- **Built-In Gains Rule:** When banks convert from a C-corporation to an S-Corporation, they often transfer assets that have appreciated in value. If the new S-Corporation sells such an asset within 10 years, it becomes subject to a 35% corporate tax rate on the realized gains that occurred while the asset was owned by the C-corporation. However, 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. If during 2009 or 2010, an S corporation bank has reached its 7th year in the recognition period, the bank will not be subject to the built-in gains tax.

**How are S-Corporation shareholders taxed?** They pay taxes at their individual tax rate (which is usually lower than the corporate rate) on the dividends they receive (and on their pro-rated dividends retained by the bank). However, sometimes dividends are distributed to the shareholders for the purpose of paying taxes. Bankers argue that credit union members should also be taxed on the retained earnings of the credit union. However, credit union members do not have access to these retained earnings. The portion of the institution's earnings that are retained are used to meet the capital requirements mandated by law or are reinvested into the credit union, for example, to provide better service or interest rates to the member/owners.

**How are S-Corporation bank customers taxed?** They must pay taxes on the interest they receive on their deposits -- just like C-corporation bank customers and credit union members.

**Do S-Corporations pay withholding taxes (Social Security and Medicare) for their employees?** Shareholder-employees of these corporations receive salaries with Social Security and Medicare taxes (FICA taxes) already withheld. They pay taxes on their salaries and on any profits distributed by the corporations. These profits are taxed as ordinary income instead of the qualified dividends (dividends already taxed at the corporate level) tax rate, which is lower. This is because S-Corporation profits are not taxed on the corporate level. This has led to some S-Corporations being tempted into squeezing through a legally-questionable tax irregularity. Many shareholder-employees prefer lower salaries and a higher distribution of the corporation's profits. This is because their salaries are subject to FICA withholding taxes (the employee's 7.65% payroll tax and the matching employer's 7.65%). However, their profit income is not subject to these withholding taxes, making it a much more attractive option for both the corporation and the shareholder-employee. The IRS states that such shareholder-employees must receive reasonable compensation for their services. Therefore, the IRS is on the lookout for S-Corporations that pay below-average wages.

**CUNA POSITION:** The banking industry's efforts to impose additional taxes on credit unions while aggressively lobbying to increase the tax advantages of Subchapter S for banks is hypocritical. However, CUNA does not oppose the efforts of the banking industry to expand its tax benefits.

**IMPACT ON CREDIT UNIONS:** The banking industry has stepped up its attempts to repeal credit union tax-exempt status, while simultaneously lobbying to dramatically increase its tax breaks. The industry's success weakens its arguments against the credit union tax exemption.

**STATUS/OUTLOOK:** In the 110<sup>th</sup> 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 were six tax provisions in the 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.

- (BANK SPECIFIC) 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 law clarified that this type of arrangement does not constitute a second class of stock.
- (BANK SPECIFIC) 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 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

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. If during 2009 or 2010, an S corporation bank has reached its 7th year in the recognition period, the bank will not be subject to the built-in gains tax.

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.

On May 22, 2009, the Federal Reserve Board announced that it would allow S corporation mutual bank holding companies to include government funds provided through the Troubled Asset Relief Program in Tier 1 capital calculations. The Federal Reserve also decided that subordinated debt issued by S Corporation banks in exchange for TARP funds would not be treated as debt in calculations of whether the bank meets federal debt-to-equity requirements.

**CONTACT:** [John Hildreth](#), (202) 508-6724, [jhildreth@cuna.coop](mailto:jhildreth@cuna.coop)

#### **RELATED DOCUMENTS:**

[June 14, 2004: CUNA Letter to the Speaker of the House, J. Dennis Hastert, regarding the American Jobs Creation Act Subchapter S Provisions](#)

[June 19, 2003: CUNA Statement for the Record for Ways and Means Subcommittee on Select Revenue Measures - Hearing on S Corporation Reforms](#)

**LAST UPDATED:** August 27, 2009

Copyright © 2009 - Credit Union National Association, Inc.