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IMPORTANT NEWS FROM JONES WALKER

JONES WALKER

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FEDERAL TAX-SAVING OPPORTUNITIES FOR FINANCIAL INSTITUTIONS UNDER SUBCHAPTER S OF THE INTERNAL REVENUE CODE

Since 1997, insured depository institutions, their holding companies, and the shareholders of such businesses have been eligible to achieve significant savings on income taxes by converting those businesses into "small business corporations" ("S corporations"), which are taxed for federal income tax purposes in a manner similar to partnerships. Generally, the income of the organization is *not* taxed at all to the corporation but instead "flows through" to the corporation's shareholders. The income of the S corporation is taxed to the corporation's shareholders, according to their proportionate interests in the corporation, at federal income tax rates that apply to individuals.

Since all of the income of an S corporation flows through to its shareholders, there is no tax imposed on the S corporation itself except in the limited circumstances discussed below. This differs from traditional corporations ("C corporations"), because C corporations must pay corporate taxes on their income, and then the shareholders of C corporations must pay tax on dividends received from the C corporation. The taxation of S corporations also may generate substantial financial benefits to the corporation's shareholders in the event the corporation is acquired by another company, as discussed more fully below.

In addition, a wholly-owned subsidiary of an S corporation can be disregarded for federal income tax purposes, allowing all of the subsidiary's income to flow through to the shareholders of the parent without being subject to corporate taxes. To be disregarded, an election must be made to treat the subsidiary as a "qualified Subchapter S subsidiary" (a "QSub").

Requirements for converting to an S corporation

To be eligible to elect Subchapter S treatment, a corporation must:

1. Have no more than 100 shareholders (though multiple members of the same family may be counted as a single shareholder for these purposes);

2. Have as shareholders only individuals, estates, and certain kinds of trusts, individual retirement accounts, or tax-exempt organizations;

3. Have no shareholder that is a nonresident alien;

4. Have no more than one class of stock (although shares may be issued with different voting rights); and

5. Not use the reserve method of accounting for bad debts.

An election to be taxed under Subchapter S must be signed by all of a corporation's shareholders. Typically, there also will be agreements among shareholders to restrict sales of stock to non-shareholders that could jeopardize the company's continued eligibility for Subchapter S treatment.

Many smaller banking organizations, of course, already satisfy—or, with some straightforward restructuring of share ownership, can be brought into compliance with—the requirement that the corporation have no more than 100 shareholders. No application to or approval from financial regulatory agencies is required for a depository institution to convert to an S corporation, although some steps that may be necessary in order to qualify for such a conversion would require obtaining such approval.

An S election will remain effective until it is voluntarily terminated or until it is revoked or something occurs that causes the company to cease to be eligible to elect Subchapter S treatment. Once the S election becomes ineffective, the corporation immediately reverts to being taxed as a C corporation, and it cannot make another election under Subchapter S for five years except with the consent of the Department of the Treasury.

A financial institution that accounts for bad debts using the experience reserve method must, in order to be eligible to elect Subchapter S treatment, change its accounting to the specific charge-off method. Such institutions usually find that the benefits of Subchapter S treatment outweigh the advantages of using the reserve method.

Any such accounting change requires the consent of the Commissioner of the Internal Revenue Service, and the company ordinarily will be required to take into income, over six years, any excess reserves that it holds. S corporations also are required to adopt the calendar year as their fiscal year.

Once an institution converts to S corporation status, it should carefully monitor its balance sheet and income statement. An S corporation that converted from a C corporation may be limited in the amount of passive investment income that it is permitted to receive in a year. However, in recent years changes have been enacted to the Internal Revenue Code to provide that interest, as well as dividends received by banks or thrifts on assets that they are required to hold (such as shares of a Federal Reserve Bank or a Federal Home Loan Bank), are *not* considered passive investment income for these purposes.

S corporations remain subject to taxation at the corporate level on certain income items

Corporations that convert to Subchapter S remain subject to federal income taxation at the corporate level on certain "built-in gains." The built-in gains that will be taxable to the corporation are any gains (1) attributable to property owned on the date of the corporation's S election, (2) realized during the ten-year period following election, and (3) attributable to appreciation in the value of the property that occurred prior to the date of election. Such built-in gains may be offset by deductions or losses attributable to pre-conversion property or activities if realized in the same year. (The portion of any such appreciation in the value of the property that occurred after the S election will, like other post-election corporate income, flow through to shareholders and be taxable solely to them.) For financial institutions, such built-in gains may include:

- Unrealized gains attributable to assets held at the time of conversion to S corporation status;

- Unrealized gains in the institution's securities portfolio; and
- Recapture of the bad-debt reserve upon change to the specific charge-off method of accounting for bad debts.

Advantages for shareholders of an S corporation that is acquired

S corporation treatment also may provide substantial financial benefits to a corporation's shareholders in the event the corporation is acquired. An acquiring company generally wishes to buy only the assets of a corporation in order to allow the acquiring company to recover the cost of the purchased assets through depreciation and amortization deductions, including amortization of the cost of purchased goodwill. However, since C corporations and their shareholders are both subject to federal tax on the sale of the corporation's assets followed by liquidation of the corporation, the shareholders of a C corporation generally wish to sell their stock, in order to avoid corporate income taxes on the sale.

Where an S corporation is acquired, however, the acquiring company and the shareholders of the S corporation may make an election under Section 338(h)(10) of the Internal Revenue Code to treat the acquiring company as having purchased the assets of the S corporation, even though the acquiring company purchases the stock of the S corporation. This allows both the acquiring company and the S corporation shareholders to achieve their desired federal income tax results. In addition, since the acquiring company will be able to recover the cost of the corporation's assets through depreciation and amortization deductions, the acquiring company may be willing to pay a higher purchase price to acquire the corporation.

Even if the acquiring company wishes to purchase only the assets of the corporation in order to avoid potential liabilities of the corporation, the absence of a corporate tax on the S corporation generally permits the shareholders of the corporation to obtain better tax results than if the corporation were a C corporation. A C corporation would be subject to federal income tax on the income from the sale of the assets, thereby reducing the sales proceeds available to be distributed to the corporation's shareholders; an S corporation is not subject to a corporate tax, and the sales proceeds are available for the corporation to distribute to its shareholders unreduced by corporate taxes.

As mentioned earlier, as an exception to the above rules, there will be a corporate level tax on certain built-in gains if the S election was made fewer than 10 years prior to the sale. However, the corporate-level tax does not apply to gain on assets not held on the date of the S election or to gain attributable to appreciation after the date of the S election of assets held on the date of the election. Frequently, therefore, much of the gain is not subject to the built-in gain tax.

The foregoing presents only an abbreviated summary of the financial benefits that can be obtained through an S election for a corporation and its shareholders, both in the company's ongoing operations and in the event that it should be approached by a prospective acquirer. The available advantages will vary according to the particular circumstances of every company, and the state and local income tax treatment of S corporations may differ from the federal income tax treatment discussed above. However, the possibilities make it clear that an S election merits serious consideration by every business that is eligible to make such an election.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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