



THE S CORPORATION:

General Information on Election and Operation

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Introduction

This document is prepared primarily to provide general information on topics relating to Subchapter S (or Sub S) corporations, such as benefits of making the S election, the disadvantages or other factors that should be considered prior to making the election, technical issues associated with the S status, and some statutory restrictions and limitations that are imposed on Subchapter S entities. In addition to the general information provided, this document also contains a number of questions that have been received in the past from ABA members along with answers to these questions. We hope that you will find this document useful either as a tool for making the S election or as a general information resource on issues you face as an S corporation. This document is provided as a general Sub S resource for ABA members and is not intended as tax or accounting advice — it should not replace your consultation with an accountant or tax counsel.

Background

In 1996, Congress passed the Small Business Job Protection Act (the “1996 Act”), which for the first time permitted banks to elect to be Sub S. There are several advantages associated with S corporation status, the most significant being the elimination of the corporate level tax. There are also a few disadvantages, one of which is the potential inability to raise capital because of the limitations on shareholder number and eligibility. The 1996 Act placed an important condition on banks seeking to take advantage of the new law — a bank must change its accounting method for bad debts from the reserve method of accounting to the specific charge-off method in order to make the S election. Generally, it is important to note that there are some significant restrictions and limitations in the rules applicable to Sub S corporations, which may somewhat reduce the attractiveness of the S structure.

ABA and others have requested that the Treasury revise its regulations (or that Congress enact laws) to permit a bank that is structured as a limited liability company (LLC) to receive the federal tax benefits associated with the structure. Because LLC laws do not have most of the limitations and restrictions that the Sub S rules currently have, it is generally believed that if permitted, many banks would prefer to use the LLC structure. Such banks would enjoy both the one level of tax that Sub S corporations have and the limited liability of C corporations. Based on ABA discussions and meetings with Treasury, this issue is still a long way from becoming law. However, many states have enacted laws that permit banks to structure as LLCs even though such banks cannot obtain the pass through federal tax structure that is available to other LLCs. Thus, the only option that is available for banks wanting to eliminate double taxation (the corporate level federal tax) is to operate as a Sub S corporation.

Statistics

Since the 1996 Act, many banks and thrifts have made the election to convert to Sub S status. As of December 31, 2007, approximately 29 percent of FDIC-insured institutions were operating as S corporations. While the majority of banks that have converted to S status are small institutions with total assets of less than \$100 million, a small number of banks with assets over \$100 million have also made the S corporation election. In October 2004, many favorable changes, supported by the ABA, were made to the Sub S rules in the Americans Jobs Creation Act (AJCA). (*See Appendix, Section 1a.*) In April 2007, the President signed the Small Business and Work Opportunity Act of 2007. This legislation made additional positive changes to the Sub S rules. (*See Appendix, Section 1b.*) Due to the favorable changes made by both the 2004 and 2007 legislation, it is expected that the number of financial institutions making the S election will continue to increase in the coming years.

Qualifications for S Corporation

In order to make the S election, a bank must obtain the consent of all its eligible shareholders, and must meet the definition of a small business corporation. To qualify as a small business corporation, the entity:



- Must be a domestic corporation — a corporation that is organized under the laws of the United States, any state or the District of Columbia.
- Must have no more than 100 shareholders — family members, up to six generations, are counted as one shareholder. (See explanation in Appendix, Section 1a.)
- Must have only natural persons, certain trusts, tax-exempt organizations and estates as shareholders. (See below for discussion of the types of entities that may be Sub S shareholders.)
- Must have only shareholders that are U.S. residents or citizens.
- Must have only one class of stock. (See Appendix, Section 1b for rules relating to this requirement.)

Certain corporations are statutorily ineligible to make the S election. An ineligible corporation is:

- A bank using the reserve method of accounting for bad debts.
- A possession corporation and a current or former DISC.

Subchapter S Shareholders

In general, only natural persons may be Sub S shareholders. However, certain types of trusts, estates and tax-exempt organizations¹ are permissible shareholders. These include:

- **Estate:** This includes not only the estate of a decedent, but also the estate of an individual in bankruptcy.
- **Trusts:** Only domestic trusts that are outlined in the Code are eligible to be S corporation shareholders. These include:
 - Qualified Subpart E Trust
 - Trust Receiving Stock under a Will
 - Qualified Subchapter S Trust (QSST)
 - Voting Trust
 - Electing Small Business Trust (ESBT)
- **Tax-exempt organizations:** These include:
 - A section 401(a) or 501(c)(3) organization (which is exempt from tax under section 501(a)) – i.e., qualified stock bonus, pension, and profit sharing plans of an employer, and an employee stock ownership plan (ESOP).
 - An individual retirement account (IRA), including a Roth IRA, may be an eligible shareholder of a Sub S bank or Sub S bank holding company. However, an IRA is eligible *only* with respect to the bank stock that it held as of October 22, 2004. An IRA that holds Sub S bank stock that was acquired after October 22, 2004 is not an eligible Sub S shareholder.

¹ See Appendix 2 for discussion of UBIT that is applicable to certain tax-exempt organizations that are subchapter S shareholders.

Subchapter S Subsidiaries

A Sub S corporation is permitted to hold the following types of subsidiaries:

- **C corporation subsidiary:** An S corporation may own as much C corporation stock as it wants, but cannot file a consolidated tax return with the C corporation and other affiliates of the C corporation subsidiary. Dividends received by the S corporation from its C corporation subsidiary will not be treated as passive investment income if:
 - The S corporation owns 80 percent or more of the stock of the C corporation.
 - The dividends are attributed to the earnings and profits of the C corporation; and
 - The earnings and profits of the C corporation are derived from the active conduct of a trade or business.
- **Qualified Sub S subsidiary (QSS or QSub):** To qualify as a QSub, an S corporation must hold 100 percent of the stock of the subsidiary corporation and must elect to treat the subsidiary as a QSub under the Subchapter S rules. *Note: The subsidiary must be a domestic corporation that is not an ineligible corporation under the Sub S rules.* If the election is made to treat the subsidiary as a QSub, the subsidiary is not treated a separate corporation — all its assets, liabilities, items of income and deduction would be treated as those of the parent Sub S corporation.

Sub S Advantages/Benefits

- **No corporate level income tax.** Unlike a C corporation, the S corporation is not subject to corporate level tax on its income. All items profits, losses and deductions of the corporation flow through to the shareholders. Because there is no tax on the corporation itself, for some of the shareholders, this could result in as much as 10-20 percent increase in their after-tax return. Additionally, the bank is generally not subject to the following types of taxes:
 - Corporate alternative minimum tax
 - Accumulated earnings tax
 - Personal holding tax
- **Shareholder basis.** Because the bank's income passes through to the shareholder, a shareholder's basis is increased by the shareholder's share of the bank's earnings. This increase in basis allows a shareholder to realize lower capital gains when the bank is sold. The shareholders are subject to tax on their share of the bank's profits whether or not such profits have actually been distributed to them. When the distributions are actually made, they are not subject to tax (unlike a C corporation distribution to shareholders). Also, these distributions reduce the shareholders' basis in their stock.
- **Cash method of accounting.** Because a Sub S corporation is generally treated as a small business corporation, many Sub S corporations are able to use the cash method of accounting for tax purposes. This is good for a bank that wants to use the cash method for tax purposes. However, it should be noted that all banks are required to use the accrual method (GAAP) for book accounting.
- **Character of pass through gain or loss.** The S corporation's items of gain or loss that pass through to the shareholders retain their character in the hands of the shareholders. For instance, if a capital gain/loss item of the corporation passes through to the shareholders, such item remains a capital loss/gain in the shareholders' hands.
- **Charitable contributions.** Because the S corporation is not generally a tax paying entity, the 10 percent charitable contribution limitation that applies to corporations does not apply to the S corporation. However, the limitations that apply to individual taxpayers also apply to the Sub S shareholders.



Sub S Disadvantages/Factors to Consider

- Specific charge off method for bad debts. A Sub S bank is prohibited from using the reserve method of accounting for loan losses. Therefore, in order to make the election, the bank must change from the reserve method to the specific charge-off method.
- Built-in-gains tax. A C corporation that converts to an S corporation is subject to the built-in-gains (BIG) tax. Generally, a valuation is required at the date of conversion to calculate the C corporation's net unrealized built-in-gain (NUBIG). Under the BIG tax rules, an entity that converts to Sub S status is subject to the BIG tax if it sells any assets within 10 years of the date of conversion. The BIG on any asset is determined on the date of conversion, and the tax is: 35 percent of the lesser of (a) the unrealized appreciation in value of the asset at the election date, or (b) the gain realized on the sale of the asset. (*Note that the recapture of the reserve for loan losses and any other transition adjustments for changes of accounting methods recognized after the election is built-in gain.*) The date-of-conversion asset appraisals is critical as it is used to determine the S corporation's BIG if it sells any assets with NUBIG with the ten-year period. Generally, an amount of BIG that is considered de minimis under the Code will not trigger the BIG rules.
- Attractive for acquisitions. Because S corporations have some favorable tax rules, they are considered to be attractive acquisition candidates. Therefore, Sub S corporations are frequently the target of unsolicited corporate acquisitions.
- Restrictions on shareholder types. There are severe restrictions on the types of entities and individuals that can be eligible S corporation shareholders. The corporation must continually be diligent in its efforts to avoid violating any of the Subchapter S rules, as that would result in termination of the S status. For instance, the bank must ensure that its stock is not transferred to an ineligible shareholder (such as a corporation or a nonresident). To achieve this, many corporations impose stock transfer restrictions on their shareholders. These stock transfer restrictions may be achieved in a number of ways, including the following:
 - The bank may amend its charter to include general prohibitions on transfers that would jeopardize the S status.
 - Without amending its charter, the bank may enter into agreements with the shareholders that would prevent undesirable transfers. For instance, right of first refusal agreements that would require a shareholder seeking to transfer its shares to first offer such stock to the bank or other shareholders. (*Note that the agreement should not hinder transfers to heirs or other eligible persons.*)
 - The bank may ensure that each certificate for outstanding stock to carry a stamp indicating restrictions on the transferability of such stock.
- One class of stock limitation: S corporations are not allowed to have more than one class of stock, and as such, cannot issue preferred stock. Thus, a bank seeking to convert must eliminate all ineligible classes of stock. (*Note that qualifying director shares no longer constitute a second class of stock. See Q&A 25.*)
- Limited access to capital: Because an S corporation cannot sell stock widely without jeopardizing the eligible shareholder rule or the maximum number of shareholder rule, there may be a problem of how to raise additional capital when needed. (*Note that the use of trust preferred securities has helped several banks raise additional capital.*)
- Raising capital via debt. The S corporation may be able to raise capital through debt, but faces the problem of having such debt treated as a second class of stock. Under IRS regulations, a convertible debt instrument is considered a second class of stock if either it:

- is treated as equity under general principles of federal tax law and is used to contravene the rights to distribution or liquidation proceeds or to contravene the limitation on eligible shareholders; or
- embodies rights similar to those of a call option that is substantially certain to be exercised and has a conversion price that is substantially below the fair market value of the underlying stock on the date of issuance, transfer to ineligible shareholder, or material modification.

In effect, convertible debt is subject to a two-fold test — first, the debt versus equity test and then the call option test. If either test triggers a second class of stock, the convertible debt would terminate S corporation status.

- Regulatory approval. Although a bank is not required to notify any regulator of its intent to convert, it may be required to obtain prior regulator approval for any changes in the structure of the company.
- Eliminating shareholders. A bank seeking to convert must eliminate ineligible and excess shareholders. The cost associated with this may be significant, as the corporation may be subject to lawsuits by the shareholders that are being eliminated.
- Shareholder basis. More often than not, distribution of profits must be made to shareholders, otherwise shareholders get stuck with lots of taxable pass-through income and no money to pay the tax bill. Distributions to shareholders decrease their basis in the corporation's stock. Decreased basis due to shareholder distributions has the potential to increase the capital gains tax when shares are sold. .
- IRA shareholders. IRA shareholders may not get the benefit of being Sub S shareholders — two levels of tax apply (once when the bank's income is allocated to the IRA, and second, when the account holder receives the income).²
- Dividend- received-deduction does not apply. An S corporation does not qualify for a dividends received deduction from affiliates.
- Deduction disallowance for fringe benefits. An S corporation is subject to the rules for disallowance of deduction of fringe benefits provided to or for the benefit of its 2 percent shareholders.
- State level tax. In many states, banks are subject to a state franchise tax separate from the state income tax, and S corporation banks are subject to such tax.
- Calculation of basis for state tax. After a sale of their S corporation stock, shareholders may face the problem of how to calculate the gain or loss on the sale or, how to calculate the adjusted basis of their interest in the S corporation. Many states use different methods for calculation of a shareholder's adjusted basis and this variety in method can create computational nightmares for the shareholder trying to track adjusted basis in different states. To further complicate issues, some of the states that do not follow the federal tax regime of the S structure, ironically, also use the federal adjusted stock basis with either no or only slight modification for S corporation items.

² “[P]resent-law rules treating S corporation stock held by a qualified retirement plan (other than an employee stock ownership plan) or a charity as an interest in an unrelated trade or business apply to an IRA holding S corporation stock of a bank.” See H.R. 4520 Conf Rep., fn 64. See also, PLR 9703026.

Making the Election

- To make the election, the corporation must file IRS Form 2553. It is not enough that the corporation attaches the form to its tax return (Form 1120S). Form 2553 must be filed separately with the IRS Service Center where the corporation files its tax return.
- Form 2553 must be filed by the 16th day of the 3rd month of the year in which the election is to be effective. Thus, for a calendar year corporation, the election must be made by March 16.
- All shareholders must consent to election.³ Consent is made either on Form 2553 or on separate statement. If a separate statement is used, for each shareholder, it must set forth the name, address, and taxpayer identification numbers of the corporation and the shareholder, the number of shares of stock owned by the shareholder, the date(s) on which the stock was acquired, and must be signed by the shareholder under penalties of perjury. The separate shareholder consent statements must be attached to the S election form.
- The shareholder's consent is binding and cannot be withdrawn once a valid S election is made by the corporation.
- The election form must be signed by any person authorized to sign the corporation's Form 1120S.
- The IRS has the authority to approve or validate an election that would otherwise be invalid either because the election was filed late or because the election was filled without all the shareholder consents. (§1362(b)(5))
- While it is not required that the federal or state chartering authority approve the election, it is a good idea for the bank to notify the bank regulators. Furthermore, a bank should check to see if the state in which it operates follows the federal Sub S taxing model. In some states, Sub S banks are taxed the same way as C Corporation banks, i.e., they are taxed both at the corporate and individual levels.

³ The persons who must consent to an S election are the beneficial owners of the stock. In general, the beneficial owners are those persons who would have to recognize the income and loss items, and who possess the right to vote and receive distributions. Nominees, guardians, agents, and custodians who merely have record ownership of stock are not considered to be shareholders. The persons for whom the stock is held are the shareholders and, therefore, must consent to the S corporation election.

Questions and Answers

Shareholder Eligibility and Family Election

1. Explain the rules of “family members.”

A family (for purposes of counting shareholders) is defined as the common ancestor and all lineal descendants of the common ancestor (up to six generations). This includes spouses and former spouses of the common ancestor or lineal descendants, legally adopted children, half children, and in some circumstances, step children and foster children.

2. How do you determine whether a “person” is included in a common ancestor’s generation?

Common ancestor can be no more than six generations removed from the youngest shareholder. The determination of whether a common ancestor is no more than six generations removed is made at the earliest of: (1) the date the S election was made; (2) the date the first family member held the stock; or (3) 10/22/04.

3. How many shareholders can a Sub S bank have?

One hundred (100). (Note that a husband and wife count as one shareholder.)

4. Can a Sub S corporation have an out of state shareholder?

Yes, as long as the shareholder is not an ineligible shareholder (e.g., corporation or nonresident alien).

5. How are new shareholders added to a Sub S corporation?

Shareholders are added in the same way as in any other corporation. However, the corporation must always ensure that ineligible shareholders do not own stock in the corporation or that the total number of eligible shareholders does not exceed 100, as this may result in the termination of its S status.

6. Can an LLC be an S corporation shareholder?

Generally, an LLC is an ineligible shareholder. However, a single owner LLC, which is a disregarded entity, may be an eligible shareholder. In this case, the single owner will be considered the Sub S shareholder.

7. How are new directors added to the Board of Directors of an S corporation?

Directors are added in the same way as in any other corporation. However, for S banks chartered under the National Bank Act, the directors of such banks are required to own a certain amount of stock in the bank. Recent legislation clarified that these “director shares” arrangements will not result in a second class of stock if they meet certain requirements (*see Appendix, section 1b*) and where the shares do not carry different economic rights from shares held by other shareholders.



8. *Can an IRA be a Sub S shareholder? If so, if John Doe is a shareholder individually and holds shares in an IRA, would this be counted as two shareholders or one?*

An IRA can be a shareholder of a Sub S bank or bank holding company as long as the shares were held in the IRA as of October 22, 2004. Under IRS regulations, the owner of the IRA is treated as the shareholder. Therefore, if John Doe is a shareholder individually and holds shares in an IRA, this would be counted as one shareholder (i.e., John Doe the IRA owner and John Doe the individual will be counted as one shareholder).

9. *What happens if the shares are held in a street name?*

Most shares held by brokerages are in IRAs, and some may be held in street names. However, in order for an IRA to be an eligible shareholder, the S corporation must know the identity/character of the IRA owner. If the owner (who is considered to be the shareholder) is not an eligible shareholder, the corporation will be unable to make a valid S election.

10. *Explain the unrelated business income tax (UBIT) with respect to IRA shareholders.*

An IRA is a tax-exempt entity, which unlike the ESOP, is subject to UBIT on its share of the S corporation income. Therefore, any S corporation income or gain that flows through to the IRA shareholder, including gain or loss on the disposition of the S corporation stock by the IRA, is treated as income from an unrelated business, which is subject to UBIT. (Note that distribution of stock to the IRA beneficiary may be considered a taxable disposition subject to UBIT). The effect of the UBIT rule is that the IRA will be subject to tax attributable to its S corporation investment. If the beneficiary has no other means of paying the UBIT, he/she may have to take a taxable distribution from the IRA in order to pay the unrelated business tax, thereby resulting in two levels of tax. For many taxpayers, this may diminish the attractiveness of having an IRA as a Sub S shareholder.

11. *Can an IRA that held stock in the corporation as of 10/22/04 purchase additional stock after 10/22/04? If so will the post-10/22/04 shares be considered qualified Sub S shares?*

An IRA cannot make any new (post-10/22/04) investment in a Sub S bank. Thus, the post-10/22/04 shares will not be considered qualified Sub S shares, and will cause termination of the corporation's S status.

12. *What is the effect of a qualified plan (e.g., ESOP) on the number of shareholders? Is the plan itself considered one shareholder or is each participant considered an individual shareholder? What if participants hold additional shares outside the plan?*

An ESOP is an eligible Sub S shareholder, and it is the plan itself that is the shareholder. Thus, a plan with a large number of participants will not have a negative impact on the S corporation. However, if a plan participant holds additional shares outside the plan, the participant will be counted as a shareholder separate from the plan.

13. *What is the effect of a deferred director plan (i.e., a nonqualified plan) on the number of shareholders? Is the plan considered one shareholder or is each participant considered an individual shareholder?*

A nonqualified plan is not an eligible Sub S shareholder. Therefore, each plan participant will count as an individual shareholder.

14. What are the effects or benefits to the ESOP holders?

An ESOP is a tax-exempt entity that is not subject to the UBIT rule. Therefore, the ESOP's share of the S corporation's income and gain is not subject to tax. However, when such income is distributed to the participants, the participants are subject to tax like the other Sub S shareholders.

Although an ESOP is an eligible Sub S shareholder, S corporations are specifically excluded from three rules relating to ESOPs:

- The deduction for certain contributions to an ESOP does not apply to an S corporation;
- The deduction for dividends paid on employer securities held by an ESOP does not apply to an S corporation; and
- For purposes of the §1042 nonrecognition rule on the sale of qualified securities to an ESOP, the qualified securities sold must be those of a C corporation.

15. What is the effect of Sub S stock issued in exchange for performance of service?

Stock that is issued in connection with the performance of service and that is substantially nonvested is not treated as outstanding stock, and the holder of the stock is not treated a shareholder. However, if the holder of the stock makes a section 83(b) election to include the value of the stock in income, the stock is treated as outstanding and the holder must be treated as a shareholder. In that case, the holder must meet all the requirements of an eligible Sub S shareholder.

Pre Election**16. Are there any tax law restrictions on insiders buying stock prior to the S election date?**

No. A corporation that plans to elect Sub S may enter into transactions that will help eliminate ineligible shareholders or reduce shareholder numbers. This may include eligible shareholders acquiring the shares of the ineligible shareholders.

17. Can treasury stock be sold to shareholders or directors prior to the time the S election is made?

Yes. However, all ineligible and excess shareholders must be purged at the time of election.

18. Are there any problems with buying out non-eligible shareholders and selling the redeemed shares to eligible persons before making the election (e.g., directors, insiders, others)?

No.

19. What if a large shareholder sells out before the election is made?

This would have no effect on the corporation making the election as long as the shareholder does not sell the stock to an ineligible shareholder.

20. When buying out ineligible or non-consenting shareholders, is there usually a market premium or discount on the stock price?

Possibly. Please contact your legal advisor or CPA regarding valuation issues when buying out ineligible shareholders.

21. *What are the approximate out of pocket costs to convert?*

This is difficult to say because it is different for each bank.

Election

22. *Does the statute require consent of all shareholders for the S conversion?*

Yes. All shareholders of record must consent to the election.

23. *What do you do if one or more shareholders refuse to give consent?*

There are several options available, including a phantom merger. This is a complicated issue and you would need to consult your tax counsel or CPA to address it.

Raising Capital/Stock

24. *How does a sub S bank raise additional capital?*

Debt has been used by many Sub S banks. A benefit to using debt is that debt allows the shareholders to take out the S corporation's earnings tax free as repayments of principal instead of potential taxable dividends. Other alternatives are trust preferred securities and using the S corporation in combination with a partnership – i.e., the S corporation becomes a partner in a partnership. However, the S corporation constantly faces the problem of whether debt may be recharacterized as equity, in which case, the equity may be treated as a second class of stock, which will result in the termination of the S status.

25. *Does the “director stock” create a second class of stock?*

A provision included in the Small Business and Work Opportunity Act of 2007 clarified that “director stock” will not be considered a second class of stock if: (1) the stock is required to be held by an individual under applicable Federal or State law in order to permit such individual to serve as a director, and (2) there is an agreement between the bank and the director pursuant to which the director is required to sell back such stock (at the same price as the individual acquired such stock) upon ceasing to hold the office of director.

References

26. *Can you provide references for banks that have questions about different aspects of making the election?*

ABA staff can often provide answers. In addition, ABA has a Sub S peer group that serves as a resource group on Sub S issues. In some cases, bankers who have some knowledge on a particular Sub S issue may be willing to talk to other bankers who need information on the issue. We are able to connect these bankers.

27. *Can you provide names of consultants (accountants or legal advisors) who provide consulting service on Sub S conversion?*

ABA often works with outside lawyers and accountants on Sub S issues. While we do not specifically endorse any consultants, we are happy to provide a list of practitioners whom you may choose to contact.

28. *Can ABA meet with board of directors by phone or in person? If so what are the costs?*

ABA staff is available to answer questions on the phone any day during business hours at no cost. However, in person visits to a bank may be limited by time or other cost constraints, including travel expenses.

Appendix

1 *Significant Changes Made by Legislation*

(a) **The American Jobs Creation Act of 2004**

- **Number of shareholders:** The Act increased the maximum number of shareholders a Sub S corporation can have from 75 to 100.
- **Family members:** The Act included a provision that would allow for an election to treat family members as one shareholder (up to six generations) for purposes of determining the number of shareholders. The election may be made by a family member who is a shareholder of the S corporation. The election is made by notifying the corporation to which the election applies. The notification should identify the member of the family making the election, the "common ancestor" of the family to which the election applies, and the first taxable year of the corporation for which the election is to be effective. Nevertheless, each family member is free to exercise individual rights. For instance, each member may vote shares in his or her individual capacity and receive pro-rata income and distributions as an individual shareholder.
- **Eligible shareholders:** The Act expanded the eligible Sub S shareholders to include certain trusts and IRAs holding bank, bank holding and savings institution holding company stock as of the date of enactment (Oct. 22, 2004). Also, sale of bank stock by an IRA to the IRA beneficiary is exempted from the prohibited transaction rule if the following conditions are met: (1) the sale occurs as a result of an S election made by the bank; (2) the sale is for fair market value, and is based on an arm's length transaction (FMV must be determined by an independent appraiser); (3) the IRA does not bear any costs associated with the transaction; and (4) the stock is sold for cash, and occurs in a single transaction not later than 120 days after the S corporation election is made.
- **ESBT disposition of Sub S stock:** The Act increased the period during which an electing small business trust (ESBT) can dispose of S corporation stock, after an ineligible shareholder becomes a potential current beneficiary, from 60 days to one year.
- **Passive income:** The Act clarified that certain S corporation bank income will not be classified as passive activity income (i.e., certain dividends and interest income).
- **Invalid Sub S elections:** The Act gave the IRS authority to waive inadvertent invalid Sub S elections and terminations.
- **ESOP shareholders:** S Corporations were allowed to have ESOPs as shareholders after Dec. 31, 1997. However, unlike a C Corporation ESOP, an S Corporation ESOP could not use dividends on qualifying employer securities collateralizing the ESOP's borrowing to make payments on the ESOP's loan that was used to acquire employer securities. The Act made the C Corporation ESOP benefit available to S Corporation ESOPs.
- **Transfer of stock:** The Act clarified that where stock is transferred to a former spouse incident to divorce, any suspended loss or deduction with respect to that stock is treated as incurred by the corporation with respect to the transferee in the subsequent year.

(b) **The Small Business and Work Opportunity Act (SBWA) of 2007**

- **Director stock:** In general, national banking law requires that a director of a national Sub S bank own stock in the bank and that the bank have at least five directors. A number of states have similar requirements for state-chartered sub S banks. In some cases, a bank director enters into an agreement under which the bank will reacquire the stock at fair market value upon the director's ceasing to hold the office of director. A provision included in SBWA clarified that these "director shares" do not constitute a second class of stock if they meet the definition of "restricted bank director stock". Restricted bank

director stock is stock in a bank that is required to be held by an individual under applicable Federal or State law in order to permit the individual to serve as a director of the bank or holding company and which is subject to an agreement with the bank or holding company (or corporation in control of the bank or company) pursuant to which the holder is required to sell the stock back upon ceasing to be a director at the same price the individual acquired the stock.

Under the provision, the director shares are not treated as a second class of stock and the director is not treated as a shareholder of the S corporation. Therefore, these director shares are disregarded in allocating items of income, loss, etc. among the shareholders, and the stock is not treated as outstanding for purposes of counting the S corporation's shareholders or determining whether an S corporation has 100 percent of the stock of a qualified subchapter S subsidiary. A distribution (other than a payment in exchange for the stock) with respect to the restricted stock is includible in the gross income of the director and is deductible by the S corporation.

Prior to this clarification, these director shares had created S invalidation issues for many Sub S banks because the shares had been treated by the IRS as a second class of stock due to the fact that these shares would typically confer a different type of distribution and liquidation rights on the directors from the other shareholders of the corporation. Under the Code (section 1361(c)(4)), all holders Sub S stock must have the same distribution and liquidation rights.⁴

- **Passive income:** Capital gain (gain from the sale of stock or securities) is not treated as passive investment income. In general, an S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive investment income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. Passive investment income generally does not include interest on accounts receivable, or certain interest and dividend income of banks and depository institution of holding companies. In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income. A provision in the SBWA eliminates gains from sales or exchanges of stock or securities as an item of passive investment income.
- **Change in accounting method for S election:** A bank that changes from the reserve method of accounting for bad debts for its first taxable year for which it is an S corporation may elect to take into account all §481 adjustments resulting from the change in the last taxable year for which it was a C corporation.
- **Termination of QSub:** If a QSub election terminates as a result of stock sale, the QSub is treated as if it is a new corporation that has acquired all of its assets and liabilities from the S corporation parent in exchange for stock of the new corporation immediately before the termination.

⁴ Treasury regulations provide that buy-sell and redemption agreements are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of, or below, the fair market value of the stock. Treas. Reg. sec. 1.1361-1(l). See *Private Letter Ruling 200217048* (January 24, 2002) describing such an agreement and holding that it creates a second class of stock. Nonetheless, the ruling concluded that the election to be an S corporation was inadvertently invalid and that an amended agreement did not create a second class of stock so that the corporation's election was validated.

2 *Unrelated Business Income Tax (UBIT)*

Earnings in an IRA are generally exempt from tax, but may be subject to tax when distributed. Certain investments by an IRA will result in taxable income called “unrelated business taxable income” (UBTI). UBTI is income from a trade or business regularly carried on by the IRA that is not substantially related to the exercise by the IRA of its tax-exempt purpose. It appears that any trade or business would be unrelated to the IRA's purpose. For instance, IRAs may hold a wide variety of investments that are not related to the IRA's exempt purpose, such as cash, stock, bonds and certificates of deposit. These types of investments will incur unrelated business income tax (UBIT). An IRA may be a shareholder of a bank that is an S corporation, but only to the extent of bank stock held by the IRA on October 22, 2004. The IRA owner is generally treated as the S corporation shareholder. Under the UBIT rules, the IRA's share of the S corporation income will be subject to tax. However, such tax is imposed only if the income generated from an unrelated trade or business exceeds \$1,000. The IRA is then required to file IRS Form 990-T, which is due on or before the 15th day of the fourth month following the close of the taxable year (April 15 for a calendar year IRA). ***Note that this rule does not apply to an ESOP shareholder.***

An IRA subject to UBIT must make quarterly estimated tax payments, just as corporations do. The estimated tax is computed using IRS Form 990-W. This form is a worksheet only and is not filed with the IRS. The quarterly estimated tax payments must be deposited with an authorized depository of federal taxes together with IRS Form 8019 (the Federal Tax Deposit Coupon).



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