



ABA Subchapter S News



February 25, 2009

American Bankers Association – 1-800-BANKERS

ABA members have access to more than two dozen ABA news and information e-mail bulletins on a wide variety of important industry topics. Tell your coworkers about ABA's 30-plus [E-Mail Bulletins](#) – free to ABA member bank employees. Visit www.aba.com or call 1-800-BANKERS.

■ American Recovery and Reinvestment Act

The ARRA, which was signed into law on February 17, 2009, contains a few provisions that impact S corporation banks. First, the provision that would allow a bank to hold tax-exempt bonds of up to 2 percent of its total assets without being subject to the interest expense disallowance rules of section 265(b) applies to a sub S bank. Second, the ARRA contains a provision that would reduce the built-in gains recognition period from 10 to 7 years for some S banks. Third, there are other bond provisions that apply to all banks, including S corporation banks.

- **Tax-Exempt Bonds:**

- As a general rule, under section 265(b), a bank is subject to a 100% interest expense disallowance on its tax-exempt obligations. This disallowance is not applicable to tax-exempt obligations that meet the definition of “qualified small issue.” Thus, while a qualified small issue is not included in the section 265(b) interest expense disallowance calculation, it is subject to a 20% interest expense disallowance under section 291(e).
- Under the ARRA provision, for tax-exempt obligations issued during 2009 and 2010, a bank will be allowed to exclude a specified amount of these obligations from its interest expense disallowance calculations under section 265(b). The bank can exclude an amount that is equal to 2% of its basis in its total assets. Such an amount will not be subject to the 100% interest expense disallowance rule under section 265(b). However, the amount excluded will be subject to a 20% interest expense disallowance under section 291(e).
- This 2% safe harbor is cumulative for tax-exempt obligations issued in 2009 and 2010. Thus, if a bank purchases tax-exempt obligations in excess of the 2% amount during 2009, none of the tax-exempt obligations purchased in 2010 will qualify for the exclusion.
- While the safe harbor applies only for tax-exempt obligations issued in 2009 and 2010, the exclusion would apply for the life of the obligations that qualify for the exclusion.
- The provision in essence treats the 2% excluded amount as “qualified small issue”.
- A second provision temporarily modifies the definition of “qualified small issue”. The modification increases for 2009 and 2010, the limitation on issuing bank qualified small issues from \$10 million to \$30 million. This modification would allow a bank to increase the amount of tax-exempt bonds that meet the definition of qualified small issue and which will not be included in the 265(b) calculation.
- Therefore, with the 2% safe harbor rule and the modification of the qualified small issue definition, a bank will be able to increase the amount of tax-exempt obligations that it can hold without being subject to a 100% interest expense disallowance.
- The benefits under the provisions apply to tax-exempt obligations “issued” in 2009 and 2010. There is nothing to indicate that such obligations must also be “purchased” in 2009 and 2010 in order to qualify.

- **Built-in gains:**

- As a general rule, if a C corporation converts to the S status, the S corporation will be subject to corporate level tax, at the highest marginal rate applicable to corporations (built-in gains tax), on gain recognized on the sale of any of its pre-S corporation assets if the sale occurs within the first 10 years of the conversion (the

- recognition period).
 - Under the ARRA provision, if during taxable year 2009 or 2010, an S corporation has reached its 7th year in the recognition period, such a corporation will not be subject to the built-in gains tax on the sale of its pre-S corporation assets.
 - In addition, no tax will be imposed where an asset with built-in gain is received by an S corporation from a C corporation in a carryover basis transaction, if such gain is
 - recognized after 7 years from the date of acquisition.
- **Build America Bonds:**
 - The ARRA provision would allow an issuer to elect to have an otherwise tax-exempt bond treated as a "Build America Bond." A Build America Bond is any obligation (other than a private activity bond) if the interests on such obligation would normally be tax-exempt, but has been designated by the issuer through an irrevocable election to be treated as taxable.
 - The holder of a Build America Bond will accrue a tax credit in the amount of 35 percent of the interest paid during the calendar year.
 - A special rule is provided for any Build America Bond that is issued by December 31, 2010. Such "qualified bonds" must be issued as part of an issue where 100 percent of the available project proceeds of such issue are to be used for capital expenditures. The issuer is required to make an irrevocable election to have this special rule apply. Rather than the tax credit to the holder, the special rule allows the issuer a 35 percent credit on each interest payment made under the qualified bonds.
 - Since these Build America Bonds are not tax-exempt, the section 265(b) and 291(e) interest expense disallowance rules would not apply.
 - In addition, the income from these taxable bonds is includible in the AAA for sub S banks (unlike other tax-exempt income, which is included in the OAA).

■ Tax Issues for S Corporations Participating in the Capital Purchase Program

By Kevin F. Powers, CPA^[1]

S Corporation banks and bank holding companies (S Corp banks) were required to submit by Friday, Feb. 13, 2009, their applications to participate in the TARP Capital Purchase Program (CPP) that was announced in October 2008. Although the U.S. Department of the Treasury has released a term sheet for S Corp banks intending to participate in the CPP,^[2] a draft of the definitive agreement has yet to be made available. The remaining questions are not likely to be answered until the S Corp banks receive approval for the CPP funding – which could be weeks or months from now – and have an opportunity to review the specific terms of the definitive agreement. Of particular concern to S Corp banks is the ability to make distributions to cover the federal and applicable state income tax liabilities of their shareholders.

Summary

This discussion is intended to provide S Corp banks with an overview of the relevant tax issues that might affect the decision of whether to participate in the CPP. As with most decisions, however, consideration must also be given to non-tax factors. For example, the bank might have no other way to obtain the funds they need to meet regulatory capital requirements. Although many S Corp banks have already applied for the funding, they still have time to sort through these and other issues before making a final decision to accept the Treasury's terms or not.

S Corp banks that have applied for funding under the CPP should pay particular attention to the following tax issues, for they could have an impact on their decision about whether to accept the Treasury's terms.

- **Basic Terms:**
 - The terms of the CPP program for S Corp banks require the Treasury to acquire subordinated debentures, with each note having a principal amount of \$1,000. The debentures are being used in place of preferred stock because of restrictions that prohibit S corporations from having more than one class of stock. S Corp banks are also required to grant warrants to the Treasury for the purchase of additional debentures, equal to 5 percent of the amount purchased, with an exercise price of \$0.01. The Treasury is expected to exercise these warrants immediately upon receiving them.
 - For example, an S Corp bank issuing \$10 million of subordinated debentures would issue an additional \$500,000

- of warrant debentures. In all, the S Corp bank would have to repay \$10.5 million while receiving only \$10 million. This situation would likely result in the S Corp bank having original issue discount, which would be amortized and provide an additional tax deduction over the term of the debt.
- The interest rate on the subordinated debt will be 7.7 percent for each of the first five years of the program and 13.8 percent afterward. These rates contrast with 5 percent and 9 percent, respectively, for the preferred stock issued to participating corporations under the earlier rounds of the CPP. The warrant debentures will carry an interest rate of 13.8 percent for their entire term.
 - The Treasury justifies the higher interest rate with the fact that S Corp banks will receive a tax deduction for the interest payments on the debt. Interestingly (no pun intended) enough, the increased rate was based on the highest current marginal federal income tax rate for individuals – 35 percent. However, this rate fails to take into consideration that not all shareholders will necessarily be in the highest marginal tax rate. The impact of state income taxes also was not considered.

- **Restrictions on Shareholder Distributions**

- One of the biggest concerns, if not *the* biggest concern, of S Corp banks is their ability to make dividend distributions to cover the federal and applicable state income tax liabilities of their shareholders. The CPP term sheet provides that S Corp banks cannot increase their dividend rate without the consent of the Treasury until the third anniversary date of the Treasury's investment. After that, but prior to the 10th anniversary date, the dividend rate can be increased by 3 percent annually without the consent of the Treasury. After the 10th anniversary, S Corp banks are completely prohibited from making dividend distributions, including distributions to cover shareholders' tax liabilities. Of course, by that time, it is unlikely that any of these debentures would be outstanding. In addition, no dividends can be paid if there is any unpaid interest on the debentures.
- The term sheet for S Corp banks provides that the Treasury consent shall not be required for any increase in dividends where the increase is based solely on a proportionate increase in taxable income and the increased dividends are distributed to shareholders in order to fund their individual tax payments on such allocable taxable income. However, the Treasury (and subsequent investors that purchase the debt) shall have the right to challenge the amount of the proposed tax distributions to the extent that the Treasury believes the distributions exceed the amount necessary for shareholders to pay their allocable share of income taxes. Presumably, procedures outlined in the definitive agreement will resolve this apparent contradiction between not needing consent yet allowing for the challenge of proposed dividend increases.
- Second, the term sheet does not address any increases in taxable income as a result of extraordinary transactions, such as acquisitions or business transactions in new states. Presumably, the definitive agreement will not provide special exclusions or other restrictive provisions for these situations.
- Finally, the term sheet provides no discussion related to S Corp banks that had losses in pre-CPP periods but might become profitable during their years of CPP participation. Again, we would have to presume that the definitive agreement would allow for an increase in dividends even if the "base" dividend rate in the pre-CPP period was zero.
- Whether or not clear answers are forthcoming, S Corp banks are well advised to prepare projections of taxable income and required dividend distributions (both federal and state) for the CPP participation years. These projections might be required to thwart a possible challenge by the Treasury of the annual dividend distribution but another reason to prepare them is so that S Corp banks can make an informed decision about accepting the terms of the CPP funding in the first place.

- **Compensation Limits**

- Based on the term sheet released by the Treasury, S Corp banks will be subject to executive compensation restrictions similar to those applicable to corporations issuing preferred stock under the earlier rounds of the CPP – which, based on the recently enacted *American Recovery and Reinvestment Act of 2009*, include:
 - \$500,000 tax deduction limit for compensation paid to the top five highest-paid senior executive officers
 - No payments for departures for any reason, except payments for services performed or benefits accrued to the 10 most highly paid employees;
 - No bonus, retention or incentive compensation awards to certain employees (based on the amount of CPP funding received), except for limited amounts of long-term restricted stock; and
 - Recovery of incentive compensation paid to the 25 highest-paid employees if it is later found to be based on materially inaccurate statements of earnings, revenue, or other criteria.

- There are also restrictions on compensation plans encouraging excessive risk taking or manipulating earnings reports, as well as requirements for various corporate oversight and annual certification procedures. S Corp banks will have to examine these restrictions carefully when deciding whether to participate in the CPP.
- **Interest Expense Disallowance**
 - S Corp banks may be subject to certain interest expense disallowance provisions by investing in tax-exempt municipal obligations. The interest expense incurred from the subordinated debentures could have an impact on the interest expense disallowance related to these investments if the bank is actually the entity issuing the debt. However, if the bank holding company issues the debt, the bank will not be the debtor and thus will not directly incur the interest expense. It is possible that the Internal Revenue Service could put out some specific guidance related to this issue, but nothing has been published so far.



Subchapter S News and Special Reports are published by the American Bankers Association as a member service. For questions, please contact Fran Mordi, Tax Counsel (202-663-5317, fmordi@aba.com) or call 1-800-BANKERS. ABA Members: To unsubscribe and to manage your subscriptions, please visit ABA E-Mail Bulletins (<http://www.aba.com/Members+Only/bulletin.htm>) and check or uncheck the appropriate boxes.

American Bankers Association, 1120 Connecticut Avenue NW, Washington, DC 20036

^[1] Kevin Powers is an executive with Crowe Horwath LLP in the Oak Brook, Ill., office - 630.586.5140 or kevin.powers@crowehorwath.com.

Under U.S. Treasury rules issued in 2005, we must inform you that any advice in this communication is not intended or written to be used, and cannot be used, to avoid any government penalties that may be imposed on a taxpayer.

^[2] www.treas.gov/initiatives/eesa/docs/scorp-term-sheet.pdf.