



1120 Connecticut Avenue, NW
Washington, DC 20036

1-800-BANKERS
www.aba.com

*World-Class Solutions,
Leadership & Advocacy
Since 1875*

Cristeena G. Naser
Senior Counsel
Regulatory & Trust Affairs
Phone: 202-663-5332
Fax: 202-828-4548
cnaser@aba.com

October 18, 2002

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, D.C. 20429
Attention: Comments/OES

Re: Proposal on Insurance Eligibility of Limited Liability Companies
67 Federal Register 48054 (July 23, 2002)

Dear Mr. Feldman:

The American Bankers Association is responding to the proposal by the Federal Deposit Insurance Corporation (“FDIC”) clarifying that a state bank organized as a limited liability company (“LLC”) could be considered eligible for federal deposit insurance.

The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country. ABA’s community bank members are keenly interested in this proposal because it would resolve an important deposit insurance issue in the event the option of organizing in the form of an LLC becomes more widely available.

LLCs are entities organized under state law, which share both partnership pass-through and corporate limited liability characteristics. While LLCs are treated in the federal tax code as partnerships, the owners or members of the LLC benefit from the limited liability protections generally granted to corporate shareholders. In addition, unlike an S corporation, there are no restrictions on the size and classes of members. This arrangement allows for increased flexibility to allocate income or losses to different investors. Thus, the LLC structure potentially could provide tax benefits similar to those of a Subchapter S corporation without the attendant restrictions on the number and type of shareholders.

Under the proposal, FDIC would interpret the term “incorporated” as used in the definition of “State Bank” in the Federal Deposit Insurance Act¹ (“FDI Act”) to

¹ 12 U.S.C. § 1813(a)(2).

include state banks established as LLCs under state law so long as such LLCs have four key attributes of corporations:

- Perpetual succession;
- Centralized management;
- Limited liability; and
- Free transferability of ownership interests.

Background

The proposal results from the request by two entities interested in obtaining federal deposit insurance for state banks chartered as LLCs. One of the statutory requirements for eligibility for deposit insurance for state banks is that such bank be “incorporated” under state law.

Traditionally, the term “incorporated” has been interpreted to mean that only legal entities identified as corporations under state law, and the FDIC has found no legislative or judicial guidance on the meaning of “incorporated” in the FDI Act. Common law generally accords to corporations the four key attributes listed above.

In addition, prior to 1997, the Internal Revenue Service (“IRS”) used the same attributes in determining whether entities would be treated as corporations for tax purposes.² The 1997 amendments liberalized the rules to permit business entities other than corporations, including LLCs, to elect partnership tax treatment.³ Those same rules, however, require that certain business entities, including state-chartered banks holding insured deposits, be treated as corporations for tax purposes. Thus, state banks organized as LLCs would not be eligible for federal tax treatment as partnerships.⁴ The IRS has, in a private letter ruling, denied partnership tax treatment for a Texas bank chartered as a limited banking association (the equivalent of an LLC under Texas law)⁵ based in part on IRS’ own interpretation of the term “incorporated” in the FDI Act.

Given the lack of interpretive guidance, FDIC has reviewed the importance of the four corporate attributes to aid the agency in carry out the purposes of the FDI Act. FDIC has determined:

- Perpetual succession is very important (i) so that depositors can be assured that their bank will not suddenly cease to exist and (ii) to facilitate resolving a bank that fails.
- Centralized management is important to aid FDIC in its supervision of state banks;

² Treas. Reg. § 301.7701-2.

³ Treas. Reg. § 301.7701-2, 7701-3 (1997).

⁴ Treas. Reg. § 301.7701-2(b)(5) (1997).

⁵ Priv. Ltr. Rul. 9551032 (Sept. 27, 1995).

- Limited liability encourages investments in business entities and is important to banks because of the cyclical nature of the banking business; limited liability also encourages the maintenance of adequate capital by limiting the exposure of individual owners to their actual investment in the bank.
- Free transferability of ownership interests attracts new capital, while prior consent restrictions will, at worst, limit the pool of investors or, at best, delay additional investment in the bank.

For these reasons, FDIC has determined that a state bank chartered as an LLC must have these four corporate attributes. No other agency is better suited or authorized to interpret terms in the FDI Act.

ABA Position

ABA strongly supports the proposal because we believe community banks, in particular, would benefit from the favorable tax treatment accorded LLCs. In an era of rapid change and consolidation in the banking industry, community banks find it increasingly difficult to provide a personal level of service while remaining competitive with larger banks and other tax-advantaged financial institutions. Unfortunately, many community banks have been unable to elect Subchapter S status and its favorable tax treatment because of outdated limitations on the number and type of owners. Moreover, even if community banks organized as LLCs were not eligible for tax treatment as partnerships at the federal level, they could nonetheless obtain significant state tax benefits.

Accordingly, ABA believes that LLC status is a potential route to achieve more favorable tax treatment and enhance the competitive position of community banks. At the same time, ABA recognizes that some state statutes authorizing the LLC structure may impose restrictions that could disqualify state banks chartered under those state statutes from being treated as corporations for deposit insurance purposes. However, FDIC's action may spur attempts to amend any such restrictive legislative provisions.

The effect of the proposal will be to recognize different types of business structures that did not exist when the FDI Act was adopted. ABA recognizes that when state banks were permitted to elect Subchapter S status, there were concerns about this new structure, and what it would mean for supervision and performance. As of June 30, 2002, 1,859 banks and thrifts have elected Subchapter S status, and experience demonstrates that these institutions are performing well.⁶ The Subchapter S status has posed no supervisory problems for FDIC or the other bank supervisory agencies. Accordingly, ABA believes the proposal represents an important first step toward granting community banks the same range of corporate tax structures that are available to other small businesses. For all of the above reasons, ABA strongly supports this proposal.

⁶ FDIC Call Report, Second Quarter, 2002.

If you have any questions or would like additional information, please contact the undersigned or Mark Baran at 202-663-5317.

Sincerely,

Cristeena G. Naser