SUBCHAPTER S BANK CAPITAL ACCESS LEGISLATIVE INITIATIVE

THE ISSUE

Subchapter S banks around the country are currently facing issues related to long-term capital accumulation. Under current law, Subchapter S corporations are limited in number and type of shareholders and may only issue one class of stock. In addition, today’s increasingly challenging regulatory environment is having a disproportionate impact on community banks in general, and Subchapter S banks specifically. As a result of organizational growth and the implementation of Dodd-Frank, Basel III and more stringent capital requirements, Subchapter S banks need access to additional capital sources.

THE SOLUTION

Issuance of Preferred Stock
This proposal would relax the single class of stock prohibition in the case of S corporation depository institutions and their holding companies and give Subchapter S banks access to a major source of capital. The proposal would allow depository institutions and their holding companies that have made an S-election to issue qualified preferred stock and would not treat qualified preferred stock as a second class of stock.

Increase of Shareholder Limit to 500
This proposal would increase the 100 shareholder limit to 500 for S corporation depository institutions and their holding companies. While the existing shareholder limits are rarely an issue for traditional S corporations, the capital intensive nature of the banking industry has caused many depository institutions and their holding companies that have made the S-election to quickly approach the current 100 shareholder limit. Expanding this limit to 500 would allow Subchapter S banks to take on additional shareholders, increase their capital and permit institutions desiring to merge or acquire other banks to maintain their S corporation status, promoting continued local ownership.

Focus on Safety and Soundness
Providing additional sources of capital to Subchapter S banks would increase the overall safety and soundness of the community banking industry – the backbone of the country’s banking system. Increasing the ability of these community banks to grow and prosper will, in turn, allow them to better serve their local communities across the country.

SUBCHAPTER S AND COMMUNITY BANKING

There are approximately 7,000 community banks across the country. Community banks (banks with assets up to $10 billion) make up 97% of all banks in the United States. Further, 90% of all banks have assets under $1 billion. These community banks are the primary source of lending for small businesses and have a direct impact on the local communities they serve. Subchapter S banks make up approximately a third of all community banks. They tend to be smaller in size and serve smaller and more rural communities across the nation. Ensuring the strength of these organizations is central to the vitality of these local communities and their small businesses and entrepreneurs.
SUBCHAPTER S BANK FACTS

WHO ARE THEY?
There are approximately 2,200 Subchapter S banks across the United States. One-third of all community banks in the United States (banks with assets less than $10 billion) are Subchapter S banks. Most of these are small, community banks as Subchapter S banks make up approximately 40% of all banks with less than $250 million in assets. Subchapter S banks are representative of the community banking industry in that they are focused on small business lending and services to smaller, rural communities throughout the United States. For many of the residents served by Subchapter S banks, they have no other local banking options. Therefore, creating a regulatory environment in which community banking institutions, and Subchapter S banks, specifically, are able to thrive, is vital to the growth and prosperity of these rural and underserved communities across the country.

WHO DO THEY SERVE?

Rural Communities
Subchapter S banks are overwhelmingly located in rural communities across the United States and are integral to serving the financial needs of these communities. Of the approximately 2,200 Subchapter S banks in the United States, 91.63% (or 2,015) of these banks are located in rural counties with a population density of 1,000 people per square mile. Further, 89% of Subchapter S banks are located in counties with a population density of 500 people per square mile. These statistics demonstrate the importance of Subchapter S banks to these rural, typically underserved communities.

Small Business Lending
The majority of Subchapter S banks are small, community banks. As such, Subchapter S banks provide a disproportionately large percentage of the country’s small business loans (loans of less than $5 million) when compared with their C corporation counterparts. In 2013, Subchapter S banks held approximately $27 billion in small business loans. On average, small business loans account for 8.57% of a Subchapter S bank’s total loan portfolio versus 3.52% for C corporation banks. Further, small business loans account for approximately 4.96% of an average Subchapter S bank’s assets versus 1.83% for C corporation banks.

WHY IS PROTECTING THEM IMPORTANT?
Subchapter S banks differ from their C corporation counterparts in that they are not subject to federal income tax at the entity level. Instead, all of the earnings of the bank are taxed at the shareholder level regardless of whether dividends are paid to shareholders. This tax treatment increases shareholder value and, in turn, profitability of these S corporation banks. The benefit to the bank and its shareholders of this tax treatment allows these smaller community banks to remain viable and continue to thrive and serve the rural communities in which they are located.
Summary of Legislative Initiative

The Subchapter S Capital Access Coalition and Task Force has been organized for the specific purpose of increasing opportunities for banks, thrifts, trust companies and their parent holding companies that have elected Subchapter S federal tax treatment to raise capital and ensure the health and future success of their organizations. Our goal is to enact legislation that would (i) allow Subchapter S banks to issue “qualified preferred stock” and (ii) increase the maximum number of allowable S corporation bank shareholders from 100 to 500. Both measures are designed to enable S corporation banks, the majority of which are community banks, to significantly improve their ability to access vital sources of capital already available to other types of financial institutions. Given the significant limitations S corporation banks face in raising capital and the continued challenges associated with the economy and increasing regulation, both measures would alleviate many of the concerns currently facing S corporation banks.

Qualified Preferred Stock

S corporations are currently prohibited from issuing more than one class of stock. Under Internal Revenue Code (“IRC”) Section 1361(b)(1)(D) and Treasury Regulations (“Regulation”) Section 1.1361-1(l)(1), a corporation that has more than one class of stock will not qualify as a small business corporation, and thus, cannot be an S corporation. This prohibition precludes S corporation banks from participating in a major source of capital – issuance of preferred stock. The proposed legislation offers an alternative to this outright prohibition of “qualified preferred stock” in the case of S corporation depository institutions and their holding companies.

The holders of qualified preferred stock would not be treated as shareholders of the S corporation. The resulting benefits would be two-fold: it would (i) allow otherwise ineligible shareholders (e.g. corporations, partnerships, LLCs, and foreign persons) to invest in S corporations and (ii) enable S corporations to raise capital resources without having to terminate their S election (preserving their pass-through status).

Qualified preferred stock would not be treated as a second class of stock and would be specifically defined as stock that (i) is not entitled to vote; (ii) is limited and preferred as to dividends and does not participate in corporate growth; and (iii) has redemption and liquidation rights that do not exceed the price of the stock (except for a reasonable redemption or liquidation premium). Qualified preferred stock would be convertible into common stock of the corporation, and distributions made by the S corporation with respect to the qualified preferred stock would be taxed as ordinary income to the holder and deductible to the corporation as an expense – similar to “restricted bank director stock” that S corporation banks may now issue. Holders of qualified preferred stock would not be allocated any income, loss, deduction, credit or non-separately computed income or loss with respect to such stock. Further, purchasers of qualified preferred stock would be attracted by their preferred status and senior position to holders of common stock.

Shareholder Limit

Under IRC Section 1361(b)(1)(B), a Subchapter S corporation may not have more than 100 shareholders. The proposed legislative initiative would increase that limit to 500 shareholders for S corporation banks. This is the number that has historically been the threshold for non-public companies prior to the Jobs Act of 2012, which permitted shareholder numbers to grow to 2,000 before a company is required to register and be subject to the reporting requirements of the Securities Exchange Act of 1934. It is also the maximum number of allowable partners/members before a limited partnership or LLC becomes subject to SEC reporting obligations.
When Subchapter S of the Internal Revenue Code first came into existence in 1958, an S corporation was limited to 10 shareholders. This limit was first increased to 25 in 1976 and has grown progressively larger over the years, as advances in technology have reduced the cost and increased the ease with which these larger shareholder groups could be managed. The limit was most recently raised to 100 as a result of the American Jobs Creation Act of 2004. With shareholder management software and digital technology advances, managing 500 shareholders and generating 500 K-1s no longer presents a significant burden on many S corporations, including many banks that are already managing shareholder groups near the current 100-shareholder limit.

As shareholder groups have changed and increased in size over time, capital needs have also increased as banks grow and seek the ability to meet ever-evolving challenges. Many Subchapter S banks have reached or are close to approaching the current 100 shareholder limit. Both concerns about shareholder group size and access to capital can be met by an increase in the maximum number of shareholders to 500. The historical, progressive expansion of the shareholder limit demonstrates that its primary purpose is one of administrative convenience. As the sophistication of S corporation banks continues to grow, so should their capacity to take on and manage additional shareholders. Finally, this 500 shareholder limit is still far below the level at which corporations are subject to the reporting requirements of the SEC.

**Conclusion**

The ability to issue qualified preferred stock and expand a Subchapter S bank’s shareholder base would substantially increase opportunities to raise capital at an important time. Both measures should also be attractive to the regulatory agencies, which are closely monitoring bank capital. The strengthening of capital adequacy requirements under the Dodd-Frank Act and Basel III have created an environment in which community banks require additional avenues through which to raise capital so as to continue to thrive in today’s challenging economy.
S Corporation Bank Capital Access
Proposed Draft Legislation

The following proposed amendments to Internal Revenue Code ("Code") Sections 1361 and 1366 address the current constraints on raising capital faced by community banks that have made an election under Code Section 1362(a)(2) to be taxed as a small business corporation under Subchapter S of the Code.

Sec. 1 S CORPORATIONS PERMITTED TO HAVE 500 SHAREHOLDERS.
(a) Subparagraph (A) of section 1361(c) (imposing special rules for applying section 1361(b)) is amended by adding at the end the following new paragraph:

`(7) Bank Shareholder Limit - For purposes of subsection (b)(1)(A) a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(W)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)) shall not have more than 500 shareholders.

(b) Effective Date - The amendment made by this section shall apply to taxable years beginning after December 31, 2014.

Sec. 2 ISSUANCE OF PREFERRED STOCK PERMITTED.
(a) In General - Section 1361 (defining S corporation) is amended by adding at the end the following new subsection:

`(h) Treatment of Bank Qualified Preferred Stock-

`(1) IN GENERAL - For purposes of this subchapter--

`(A) qualified preferred stock issued by a bank or depository institution holding companies shall not be treated as a second class of stock, and

`(B) no person shall be treated as a shareholder of the corporation by reason of holding qualified preferred stock issued by a bank or depository institution holding company.

`(2) QUALIFIED PREFERRED STOCK DEFINED - For purposes of this subsection, the term "qualified preferred stock" means stock which meets the requirements of subparagraphs (A), (B), and (C) of section 1504(a)(4). Stock shall not fail to be treated as qualified preferred stock merely because it is convertible into other stock.

`(3) DISTRIBUTIONS - A distribution (not in part or full payment in exchange for stock) made by the corporation with respect to qualified preferred stock shall be includible as ordinary income of the holder and deductible to the corporation as an expense in computing taxable income under section 1363(b) in the year such distribution is received.'.
(4) COVERED ENTITIES - This subsection shall apply in the case of qualified preferred stock issued by a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(W)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1))

(b) Conforming Amendments -

(1) Paragraph (1) of section 1361(b) is amended by inserting `, except as provided in subsection (h),' before `which does not'.

(2) Subsection (a) of section 1366 is amended by adding at the end the following new paragraph:

`(3) ALLOCATION WITH RESPECT TO QUALIFIED PREFERRED STOCK - The holders of qualified preferred stock (as defined in section 1361(h)) shall not, with respect to such stock, be allocated any of the items described in paragraph (1).'`

(c) Effective Date - The amendments made by this section shall apply to taxable years beginning after December 31, 2014.