RE: Proposed legislation to permit financial institutions to organize as limited liability companies and be taxed as partnerships under federal income tax law

Introduction

In response to issues faced by S corporation banks regarding long-term capital accumulation, legislative changes to Subchapter S of the Internal Revenue Code of 1986, as amended (the “Code”), have been proposed to (i) increase the shareholder limit to 500, and (ii) allow for the issuance of preferred stock by S corporations. These changes were designed to increase the flexibility of the S corporation structure and provide greater access to capital for financial institutions organized as S corporations—many of the community banks that serve small businesses across the nation.

An additional opportunity would be to allow financial institutions, including banks and bank holding companies, to organize as limited liability companies, taxed as partnerships for federal income tax purposes. This alternative structure would retain the primary benefit enjoyed by financial institutions and holding companies organized as S corporations—pass through tax treatment. The change would also achieve the flexibility and capital access goals sought by proposed legislative changes to Subchapter S of the Code since limited liability companies do not have comparable limits on membership interests or number of members. Such a reform also has the potential to benefit all community banks, rather than just those that have elected tax treatment under Subchapter S.

Income Tax Treatment of Banks

Currently, for federal income tax purposes, banks are prohibited from organizing as other than corporations based on Treasury Regulation Sections 301.7701-2(b)(5) and 1.581-1. As part of the business entity classification or “check-the-box” regulations, Treas. Reg. § 301.7701-2(b) provides a list of entities that are considered per se corporations. This list includes “a State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute.” Subchapter H of the Code (Section 581 et seq.) provides special rules for banking institutions. Under Treas. Reg. § 1.581-1 “in order to be a bank as defined in section 581, an institution must be a corporation for federal tax purposes…” This regulation goes on to refer to Treas. Reg. § 301.7701-2(b) for the definition of a corporation.

The treatment of banks as per se corporations derives from the Federal Deposit Insurance Act and the National Banking Act. Both pieces of legislation were the foundation for our modern banking system and were drafted in the midst of the Great Depression with a principle goal in mind—to ensure the safety and soundness of the nation’s financial institutions. At that time the corporate form was the only viable organizational structure that could accomplish that goal as it provided (i) perpetual succession, (ii) centralized management, (iii) limited liability, and (iv) free transferability of interests. Today, however, these corporate attributes can be achieved through an appropriately structured limited liability company.
The Federal Deposit Insurance Corporation (“FDIC”) has acknowledged that fact by extending federal
deposit insurance, through 12 C.F.R. 303.15, to certain limited liability companies that organize with
these traditional corporate attributes.

Proposed Legislation

Legislation to allow banks and bank holding companies to organize as limited liability companies and
obtain passthrough federal income tax treatment would require few changes to the Code and Regulations
thereunder. The Code and Regulations should be amended to allow banking institutions and bank holding
companies to organize as limited liability companies and a transition period should be enacted to allow
existing banks organized as corporations to reorganize as limited liability companies without the tax
burden associated with disincorporation. This transition period would prevent the legislation from
effectively benefitting only de novo banks.

First, banks should be removed from the list of per se corporations via repeal of Treas. Reg. §§ 301.7701-
2(b)(5) and 1.581-1. Second, the Treasury Department should adopt the FDIC’s view of the term
“incorporated” referred to in 12 C.F.R. 303.15. This rule could be adopted as an amendment to the entity
classification regulations and provide that a state-chartered business entity that is conducting banking
activities and whose deposits are insured under the Federal Deposit Insurance Act, or similar federal
statute, can elect its classification for federal tax purposes under Treas. Reg. § 301.7701-3 provided:

(i) The institution is not subject to automatic termination, dissolution, or suspension upon
the happening of some event (including, e.g., the death, disability, bankruptcy, expulsion,
or withdrawal of an owner of the institution), other than the passage of time;

(ii) The exclusive authority to manage the institution is vested in a board of managers or
directors that is elected or appointed by the owners, and that operates in substantially the
same manner as, and has substantially the same rights, powers, privileges, duties,
responsibilities, as a board of directors of a bank chartered as a corporation in the State;

(iii) Neither State law, nor the institution’s operating agreement, bylaws, or other
organizational documents provide that an owner of the institution is liable for the debts,
liabilities, and obligations of the institution in excess of the amount of the owner’s
investment; and

(iv) Neither State law, nor the institution’s operating agreement, bylaws, or other
organizational documents require the consent of any other owner of the institution in
order for an owner to transfer an ownership interest in the institution, including voting
rights.

Such a rule would ensure that the attributes of a corporation that address safety and soundness concerns
with respect to a banking institution would be preserved, while allowing such an institution to elect
passthrough federal income tax treatment, much like existing bank that have elected treatment under
Subchapter S of the Code.

Finally, a two-year transition period should be implemented during which banks currently organized as
 corporations can reorganize as limited liability companies without the associated tax burden. Under
current law, such a transaction would be treated as a liquidation of the corporation, a distribution of the
corporation’s assets to its shareholders, and a contribution of the assets to a new limited liability company. In the case of a C corporation, the corporation will recognize gain or loss under Code Section 336 as if it had sold its assets distributed to its shareholders for fair market value. Additionally, each shareholder will recognize gain or loss on receipt of the corporation’s assets under Code Section 331 in an amount equal to the fair market value of the assets received (less liabilities assumed) minus the basis in each shareholder’s corporate stock. In the case of an S corporation, there will be no tax liability at the entity level, unless the corporation has built-in gains that have not exceeded the applicable holding period. This tax burden associated with disincorporation would effectively limit these reforms to de novo banks and would frustrate the purpose of the reforms. The transition period is necessary to induce existing banking institutions to take advantage of the limited liability company form. To alleviate concerns that banks might use this transition period to effect a tax-free sale of an institution, certain continuity of ownership requirements and other safeguards can be put in place.

During the two-year transition period, eligible banks and bank holding companies could reorganize as limited liability companies in a tax free transaction that would preserve appreciation of the corporate assets and membership interests for taxation in the future. Organized as limited liability companies, these entities would be eligible to elect passthrough tax treatment, and would not be subject to the shareholder limit, single class of stock rules, and other restrictions currently imposed on S corporations that create concerns for banks—inhertently capital-intensive organizations. Successful implementation of these changes would (i) alleviate many of the concerns regarding access to capital held by community banks, (ii) provide community banks with a greater ability to compete with larger financial institutions and remain viable, and (iii) preserve the safety and soundness associated with the corporate form.