Subchapter S — A New Tool for Enhancing the Value of Community Banks

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INTRODUCTION

Beginning in 1997, many community banks became eligible to elect a new form of ownership, referred to as Subchapter S.[1] With this new ownership status, banks essentially retain their corporate form, while being treated as partnerships for tax purposes, effectively eliminating the double taxation of dividends and capital gains. The Subchapter S ownership form promises to significantly increase the after-tax returns to shareholders, and this, in turn, can make community banks a more desirable investment vehicle. At the same time, Subchapter S status creates incentives for banks to increase their dividend payout, which can reduce retained earnings and capital growth. Subchapter S banks may also make changes to their asset portfolios to make better use of their changed tax status.

Through June of 2000, 18 percent of the over 8,000 community banks (those with assets of under $1 billion) in the United States had changed to this new ownership status. In addition, there are bills pending in Congress to expand the number of banks eligible for Subchapter S status or ease the requirements that they need to meet to become eligible.

Our purpose in this paper is to analyze the effect that Subchapter S ownership has had on community banks, with particular emphasis on the effective after-tax earnings available to shareholders. We will examine the types of banks that are most likely to benefit from converting to Subchapter S and analyze any changes in behavior or performance that occur in those banks that have chosen to convert.

In the first part of the paper, we will describe the Subchapter S form of ownership and the require-

Box 1

Comparison of After-tax Earnings Subchapter S and Non-Subchapter S Banks

Assumptions — for both banks

- Beginning capital is $10 million.
- Bank earns $2 million pre-tax income.
- Bank pays dividend of $1,000,000.
- The non-Subchapter S Bank's tax rate is 35%.
- Individual shareholders' tax rates are all 39%.
- Subchapter S bank pays out additional dividends equal to the non-Subchapter S bank's income taxes to help defray individual shareholders' income taxes on bank earnings.

(all $ amounts are shown in 000s)

	Non-Sub-chapter S	Sub-chapter S	Differences
(1) Initial Capital	10,000	10,000	0
(2) Pre-tax Earnings	2,000	2,000	0
(3) Bank Taxes	700	0	700
(4) After-tax Earnings[1]	1,300	2,000	-700
(5) Dividends	1,000	1,000	0
(6) Added Dividends Equal to non-Subchapter S Bank's Income Tax Expense	0	700	-700
(7) Bank Ending Capital[2]	10,300	10,300	0
Individual Taxes:			
(8) On Bank Earnings	0	780	-780
(9) On Bank Dividends	390	0	390
(10) Total Taxes — Bank & Individual[3]	1,090	780	310
(11) Shareholder After-tax Cash Available[4]	610	920	-310

Summary of differences

- The non-Subchapter S bank has net income after taxes of $1,300 and pays a dividend of $1,000.
- The non-Subchapter S bank pays $700 in taxes, and the individual shareholders pay an additional $390 tax on the bank dividend of $1,000, for total taxes paid of $1,090.
- The Subchapter S bank has net after-tax income of $2,000 and pays a dividend of $1,700, of which $700 is intended to help cover the individual shareholders' tax liability on the bank's earnings.
- The Subchapter S bank pays no direct income tax, but the

ments banks must meet to qualify for Subchapter S status. We will then review the characteristics and performance of banks that have converted to Subchapter S, concentrating on banks in the states that encompass the Kansas City Federal Reserve District.[2] Finally, we will review the experience of selected banks that have converted to Subchapter S status, based on a survey conducted of a representative sample of those banks. This section will concentrate primarily on the reasons banks converted, the costs of conversion, and the banks' impressions of how well the conversions have met their needs.

Throughout the paper, an important consideration will be how Subchapter S status can be used as a tool for enhancing stockholder value in community banks. Based on the characteristics of banks that have converted and the sample banks' responses to our survey, it appears that certain types of banks can benefit the most from Subchapter S status. In particular, our findings suggest that slower growing, heavily capitalized banks, with concentrated ownership, have the potential to reap the most benefits from Subchapter S status.

SUBCHAPTER S OWNERSHIP

The Subchapter S form of ownership has existed for some time. However, until the passage of the Small Business Job Protection Act of 1996, commercial banks were required to organize as traditional corporations and were precluded from converting to Subchapter S. The Act allowed banks to begin converting in 1997, and by June 2000, 1,425 banks had converted, as shown in Table 1.

What has been the driving force behind such a large number of banks changing their ownership form in such a short period of time? The principal advantage of Subchapter S status is that it eliminates the taxation of earnings at the corporate level and pushes substantially all tax liability down to the individual shareholders on a pro-rata basis. Earnings are only taxed once, regardless of whether the bank declares a shareholder dividend or not. As an example of the potential tax savings, Box 1 compares the after-tax returns to investors of two banks that are identical except that one has elected Subchapter S

status and the other has not. Over a one-year period, the Subchapter S bank generates $310,000 more in after-tax returns to shareholders than the non-Subchapter S bank on pre-tax earnings of $2 million.

Subchapter S status was intended to benefit small businesses, and, therefore, there are certain restrictions placed on those corporations that are eligible to elect it. The principal restrictions are that there can be no more than 75 shareholders and all shareholders must unanimously agree to the election. In addition, Subchapter S corporations must have only one class of stock, and certain types of owners are precluded (see Appendix 1 for additional legal and accounting details). There are methods available for reducing the number of shareholders to meet these restrictions, but these can be costly and create ill will, most notably in small communities, if minority shareholders feel that they were forced out or poorly treated.

Possibly because of these restrictions, the number of banks newly electing Subchapter S status has declined in each year since 1997. Conversions have declined from a high of 598 in 1997 to only 144 through the first half of 2000.[3] There are currently two laws pending in the United States Congress that ease the restrictions and offer the potential for additional conversions. These bills raise the maximum number of shareholders from 75 to 150 and/or permit certain types of owners currently not allowed, such as Individual Retirement Accounts ("IRAs").[4]

Regardless of whether these bills become law, the costs to convert increase as the number of shareholders increases. The unanimous consent requirement is already a significant barrier, and, as the number of shareholders increases, banks must also increase the reports sent to shareholders for tax filing purposes. Under the Subchapter S form, taxes become more complicated for the individual shareholders, since they are treated essentially as limited partners for tax purposes. It can be difficult to convince small shareholders that the tax savings offset this additional complexity. Therefore, with the exception of banks with very few shareholders, there can be substantial costs associated with Subchapter S conversion, either to restructure ownership or to convince all minority shareholders of the benefits of conversion.[5]

Box 1 *(continued)*

shareholders pay $780 on their income derived from the bank. Shareholders pay no taxes on the bank's dividends, for total taxes paid of $780.[5]

- Total taxes paid by the Subchapter S bank and its shareholders are $310 less than those paid by the non-Subchapter S bank and its shareholders. This results in an additional $310 of cash available to the shareholders of the Subchapter S bank, compared to that of the non-Subchapter S bank's shareholders.
- Both banks have identical ending capital of $10,300. However, the shareholders of the Subchapter S bank experience an increase in the basis of their investment in bank of $300, equal to the increase in the bank's retained earnings. This increase in basis can be paid out in tax-free dividends in a future period or used to reduce capital gains, if shares are sold.

[1] Line (2) – (3).

[2] Line (1) + (4) – (5) – (6).

[3] Line (3) + (8) + (9).

[4] Line (5) + (6) – (8) – (9).

[5] Note that while the Subchapter S bank's increase in dividends ($700) was not enough to cover the individual shareholders' taxes on the bank's income ($780), the tax savings on the dividends ($390) more than made up the difference.

Table 1

Subchapter S Commercial Banks

Date	Number of Banks	Number Newly Elected	Average Asset Size All Sub S Banks ($ millions)
12/31/1997	598	598	74.0
12/31/1998	1,037	439	82.7
12/31/1999	1,281	244	88.7
6/30/2000	1,425	144	90.0

THE CHARACTERISTICS OF SUBCHAPTER S COMMERCIAL BANKS

Given that a large number of banks have converted to Subchapter S status, but an even larger number have not, a key question is whether there are material structural or financial differences between the two groups. Key areas where differences between Subchapter S and non-Subchapter S banks can occur are in size, initial condition, growth, capitalization, and ownership structure. A comparison of the Subchapter S banks' characteristics prior to conversion with those of non-Subchapter S banks' should help explain why banks chose to convert.

Ownership structure significantly influences the decision to convert, since banking organizations with fewer shareholders find conversion easier to accomplish and ongoing reporting to shareholders less burdensome and expensive. Growth and capitalization are also key factors in determining the desirability of Subchapter S status. Slower-growing, highly capitalized banks have less need to retain earnings in the bank to support asset growth or raise capital levels. As such, they have more incentives to pay out a high percentage of their earnings in the form of dividends. Banks paying high dividends experience immediate and obvious tax savings benefits from Subchapter S status. Therefore, we expect to see that slow-growing, well-capitalized banks have been more likely to convert to Subchapter S status.

Table 2 compares banks that converted to Subchapter S through year-end 1999 to banks that have not converted. It includes banks in the states comprising the Kansas City Federal Reserve Bank District. New banks, those opened since 1993, were excluded because their operating characteristics are significantly different than those of established banks.[6] In addition, banking organizations with assets of over $1 billion were excluded.[7] Virtually all banking organizations that converted to Subchapter S status have assets of under $1 billion due to the restrictions on the number of shareholders, classes of stock, and type of shareholders that are eligible for Subchapter S status.[8]

Table 2 shows that banks that have converted were slightly smaller, on average, at the time of conversion than those banks that have not converted. The Subchapter S banks had average assets of $63.2 million, while non-Subchapter S banks had assets of $66.7 million. The second comparison variable, "Average Examination Composite Rating" for the banks' most recent examination prior to the year of conversion, is a strong indicator of a bank's overall financial condition. The Composite rating is a numeric value ranging from 1(best) to 5 (worst) assigned at the time of a bank's examination by either the state or federal bank supervisory agency. Both groups of banks exhibited very strong average composite ratings, with the Subchapter S banks' average rating of 1.38 as of conversion being slightly better.

The next three variables are indicators of the banks' capital adequacy and earnings. The Subchapter S banks show a slightly lower level of total capital as of the year-end prior to conversion than the non-Subchapter S banks, 10.13 percent of assets versus 10.66 percent. However, both values are quite high. Over 98 percent of banks in both groups had the highest regulatory capital designation of "well capitalized."[9] Both groups of banks exhibited strong earnings, with the Subchapter S banks' return on average assets of 1.33 percent in the year prior to conversion, slightly outpacing the non-Subchapter S banks' average return.

The next variable, "Dividends-to-Net Income," shows that there is a clear and significant difference in the behavior of the two groups of banks in the area of dividend payouts. With a dividend payout rate of 71 percent of earnings in the year prior to conversion, the Subchapter S banks paid out a much higher percentage of their earnings than the non-Subchapter S banks' 47 percent. This is consistent with our expectation that banks paying high dividends are more likely to convert.

The next four variables compare the asset growth rates of Subchapter S and non-Subchapter S banks for 1 and 2-year time frames before and after conversion. Banks that have been slow growing and/or expect to be slow growing in the future usually have less need to retain earnings and are more likely to

pay higher dividends. Therefore, banks that have converted to Subchapter S should exhibit slower asset growth rates both before and after conversion than non-Subchapter S banks. In all four asset growth comparisons, the Subchapter S banks grew at substantially slower rates than the non-Subchapter S banks.[10]

The remaining variables in the table refer to banks that are also subsidiaries of bank holding companies. At the time of conversion, 85 percent of Subchapter S banks were holding company subsidiaries, while 80 percent of the non-Subchapter S banks were. The next variable, "Parent Company Debt-to-Equity," is a measure of how much of the company's investment in bank is supported by borrowings. A higher value indicates more borrowings and thus indicates a lower level of organization-wide capitalization. Values are very low for both groups of banks, 9.15 percent for Subchapter S banks and 16.89 percent for non-Subchapter S banks. The lower value for the Subchapter S organizations is indicative of greater capitalization in these organizations. It also indicates that they have less need to retain earnings in the organization for interest and principal payments on debt. With lower cash requirements at the parent level, the organization is freer to pay out dividends to its shareholders. Therefore, it is not surprising to see that organizations that convert to Subchapter S status have lower debt levels in their parent companies prior to conversion.[11]

The last two variables represent an attempt to measure the number of shareholders in the organizations. Since the costs of conversion are generally higher the greater the number of shareholders, these variables indirectly measure the potential costs of converting to Subchapter S status. The first variable measures the average number of shareholders that each hold at least a five-percent interest in the holding company. The second variable indicates the total percentage of stock held by all shareholders that each have at least a five-percent interest in the company's stock.[12] It is not possible to infer the exact number of shareholders holding less than a five-percent ownership stake. However, the higher the percentage of total stock held by the larger shareholders and the fewer the number of large shareholders, the easier it may be for an organization to meet the requirements for Subchapter S status. If, for instance, a small group of shareholders holds a large percentage of a company's stock, there are likely to be relatively fewer small shareholders. Even if there are many small shareholders, it should still prove easier to buy out those shareholders who are reluctant to approve a Subchapter S election, since their total ownership share is quite small.

Perhaps surprisingly, there is very little difference between the Subchapter S and non-Subchapter S

Table 2

Characteristics of Subchapter S and Non-Subchapter S Banks

Kansas City Federal Reserve Bank District States

	Subchapter S Banks	Non-Subchapter S Banks
Year prior to conversion[1]		
Number of Banks	340	1,017
Average Asset Size ($000s)	63,189	66,651
Average Examination Composite Rating	1.38	1.58
Total Capital-to-Assets (%)	10.13	10.66
Percentage of Banks "Well" Capitalized	98.55	98.24
Net Income-to-Average Assets (%)	1.33	1.21
Dividends-to-Net Income (%)	71.49	46.83
Total Asset Growth		
1st Year Prior to Conversion (%)	8.24	11.13
1st & 2nd Years Prior to Conversion (%)	17.28	22.16
1st Year After Conversion (%)	9.75	11.19
1st & 2nd Years After Conversion (%)[2]	19.74	24.54
Holding Company Status — Year prior to conversion		
Percentage That Are Subsidiaries of a Holding Company	85.29	79.81
Parent Company Debt-to-Equity (%)	9.15	16.89
Number of Owners With Over 5% Share of Company Stock	4.16	4.18
Percentage of Company Stock Owned by Those With Over 5% Share	90.95	84.69

[1] Values for Subchapter S banks are as of the year prior to conversion. For instance, if a bank converted in 1997, its values are for 1996. For the non-Subchapter S banks, the values are the averages for 1996 through 1998.

[2] Excludes those banks that converted in 1999, since they had not yet experienced two years of operations since conversion.

banking organizations either in the number of five-percent shareholders or the percentage of total holding company stock which the five-percent shareholders control. The number of shareholders owning five percent or more of the company averaged 4.16 shareholders for the Subchapter S group and 4.18 percent for the non-Subchapter S group. For both sets of organizations, the share of total stock held by the over-five-percent shareholders was very high, 91 percent for the Subchapter S organizations and 85 percent for the non-Subchapter S organizations.

It is possible that the non-Subchapter S banks have, on average, many more small shareholders (owning less than five percent each) than the Subchapter S organizations, thus raising their potential costs of conversion. However, the ownership structure of the non-Subchapter S organizations suggests that a large pool of potential conversion candidates still exists. The very small average number of large shareholders and the high percentage of total shares owned by these larger shareholders indicate that potential conversion costs may not be prohibitive.

THE PERFORMANCE OF SUBCHAPTER S COMMERCIAL BANKS

With 18 percent of community banks nationwide having converted to Subchapter S status since 1997, it is natural to ask whether their performance has changed in some material way since conversion. Have Subchapter S banks been able to provide higher after-tax returns to their shareholders while maintaining adequate capital and an acceptable level of risk? Therefore, we compared the after-conversion condition and performance of Subchapter S banks and non-Subchapter S banks, concentrating on earnings, dividends, capitalization, asset quality and balance sheet structure.

Theoretically, Subchapter S status should have very little impact on a bank's decisions or on its subsequent performance. The conversion affects only one dimension of the bank directly — whether the earnings are taxed at the corporate or individual level. However, this direct effect can lead to indirect changes. In many cases, Subchapter S banks increase their dividends to help the shareholders pay their increased personal taxes.[13] To the extent that these increases in dividends just offset the taxes that banks would otherwise pay directly had they not converted, there is no net effect on the banks. For instance, assume a bank with pre-tax earnings of $1 million has a tax liability of $300,000. Organized non-Subchapter S, the bank pays the $300,000 tax directly. Organized Subchapter S, the bank passes the $300,000 through to its shareholders in the form of a higher dividend to offset their personal tax liability on the bank's earnings. If in both cases the bank paid no further dividends, retained earnings would be $700,000 in either case.

However, there are other reasons why Subchapter S banks may perform differently after conversion. Previously, we indicated that Subchapter S banks generally exhibited slower growth and higher dividends prior to conversion than non-Subchapter S banks. Banks that perceive themselves as slower growing and perhaps over capitalized can choose a strategy to increase future dividends and reduce capital. A Subchapter S conversion can be an important part of such a strategy. Therefore, after Subchapter S conversion, banks could increase dividends above the level required to pay the increase in individual taxes, leading to decreasing bank capitalization.

Other potential changes in bank performance after Subchapter S conversion include reductions in state and municipal securities and personnel expense. With reduced overall taxation at the combined corporate and individual level, tax-free income can become less important to the bank. Thus, the bank might reduce its holdings of state and municipal securities, which generally are not subject to Federal income tax. The bank may also attempt to reduce personnel expense. With the elimination of the double taxation of dividends, owner-manager salaries no longer have a tax advantage over dividends as a means of taking earnings out of the bank.

Finally, Subchapter S status may increase the shareholders' appetite for risk, since the potential after-tax returns at the shareholder level are greater with the

elimination of double taxation.[14] This, in turn, could lead to greater risk taking on the part of the bank. Potential reflections of greater risk include higher levels of loans, higher levels of nonperforming loans and of loan losses, increases in reliance on volatile sources of funding, and poorer examination ratings.

To address these questions, we analyzed the 1999 performances of the Subchapter S and non-Subchapter S banks described in the previous section. We compared the performance of the two groups for 1999 and for changes since 1996, the year before Subchapter S conversions began. The critical consideration is whether there were changes in the performance of the Subchapter S banks after conversion relative to the performance of the non-Subchapter S banks. The full results of the analyses are available in the table in Appendix 1, as are definitions of key terms. The more important findings include the following:

Balance Sheet and Asset Quality

State and municipal securities as a percentage of assets grew 2.78 percent at non-Subchapter S banks, but declined 14.81 percent at Subchapter S banks from 1996 through 1999. This is one indication that Subchapter S banks are making adjustments in their asset mix consistent with their changed tax status. The asset quality of both groups of banks appears to remain strong. Noncurrent loans are very low and have been declining at both groups of banks. Loan loss ratios remain very low at both groups and have changed very little.

Earnings and Dividends

The Subchapter S banks reduced their personnel expense relative to non-Subchapter S banks. In addition, their pre-tax earnings remained higher than non-Subchapter S banks. Both these findings are consistent with their changed tax status. It appears that Subchapter S banks' dividends increased more than enough to cover the increase in individual taxes owed by shareholders on their portion of bank profits. After reducing stated dividends sufficiently to cover taxes on the bank's profits, the average Subchapter S bank's "adjusted" dividend payout of 70 percent remained much higher than the 46 percent value of the non-Subchapter S bank's. In addition, the Subchapter S bank's "adjusted" dividend payout ratio grew 15.48 percent from 1996 through 1999, while the non-Subchapter S bank's ratio declined 0.32 percent. Therefore, Subchapter S banks paid substantially higher dividends than comparable non-Subchapter S banks even after adjusting for tax effects.

Capital Adequacy

Subchapter S banks reduced their levels of capital relative to the non-Subchapter S banks, which is expected given their higher dividend payout rates. As of year-end 1999, non-Subchapter S banks had an average total capital-to-assets ratio of 10.12 percent, while Subchapter S banks had a value of 9.50 percent. In addition, the average ratio value declined 9.00 percent since 1996 for the Subchapter S banks, while the ratio for non-Subchapter S banks declined 5.13 percent. Despite the reduction in capital, both groups of banks remained strongly capitalized with 97 percent of non-Subchapter S banks and 96 percent of Subchapter S banks in the "well capitalized" category.

Overall Condition

Finally, an analysis of bank examination ratings indicates that both groups of banks are, on average, in good condition and that their condition has not deteriorated since 1996. Based on their most recent bank examinations prior to year-end 1999, the ratings of Subchapter S banks remained strong and slightly better than those of non-Subchapter S banks.

Our review of the after-conversion performance of Subchapter S banks indicates the types of changes that would be expected based on the characteristics of banks most likely to convert. The Subchapter S banks made noticeable adjustments to their asset/liability mix consistent with their lower tax status, increased dividends in excess of what was needed to pay shareholder taxes, and reduced capital levels. However, there was no indication that average capital levels have been reduced to unsatisfactory levels or that the Subchapter S banks have taken on additional risk.

THE EXPERIENCE OF BANKS THAT HAVE CONVERTED

To determine the actual experience of Subchapter S banks, we conducted a telephone survey of selected banks that had converted through year-end 1999. The survey included both large and small banks, as well as banks in both sound and weak condition. Twenty-two Kansas City Federal Reserve District banks were questioned on their motivation for converting and their experience of the costs and difficulties of converting. They were also asked whether their expectations concerning the effects of conversion were met.

Concerning their reasons for converting, 20 of the 22 banks were motivated by lower taxes. Four banks also mentioned estate or retirement planning.[15] When asked if they encountered any difficulties with the conversion process, 10 of the 22 responded that they had. Eliminating shareholders was mentioned by 9 of the 10, while eliminating a class of stock was mentioned by one. Of the nine banks that needed to eliminate shareholders, six eliminated shareholders that were ineligible to be owners, such as IRAs, and four eliminated shareholders that did not want to elect Subchapter S status. In addition, five of the nine indicated there were just too many initial shareholders. Six banks found that convincing shareholders of the benefits of Subchapter S status was difficult. Only four banks indicated that conversion was expensive, but many banks did not have a good estimate of what their actual costs were.

When asked about their experience to date, 11 banks indicated that tax savings were what they had expected; three banks indicated that taxes were higher than before or that there had been no savings. However, given the short period of time since some banks had converted, it is possible that savings had yet to materialize, especially if there were significant up-front reorganization expenses.[16] Three banks mentioned that it was now harder to analyze their financial performance, presumably due to the fact that they were no longer paying significant corporate income taxes.[17] Fourteen of the banks replied that they were paying sufficient dividends to cover the personal tax liability of their shareholders, but only five were providing their shareholders with quarterly statements for estimating taxes.

With regard to changes in bank performance, 9 of the 22 banks had reduced or planned to reduce their holdings of municipal securities, with one bank mentioning the alternative minimum tax for its shareholders as a reason.[18] Of the banks that were not reducing securities, four said that they were already "loaned up." In other words, they already had few securities and were, therefore, not in a position to significantly alter their security holdings. No other changes in bank performance were mentioned, except for increasing dividends with the intent in some cases of reducing capital.

None of the 22 banks was considering revoking its Subchapter S status. When asked if they were happy with the conversion, 6 of 7 banks indicated that they were.[19]

Many bankers elaborated on their reasons for conversion beyond the specific survey questions. These responses appeared to give the best insight into the bankers' motivations and into the banking environment that they face. Eight of the bankers indicated that Subchapter S was a vehicle for taking more money out of the bank in a tax-efficient manner. The key motivations for so doing appeared to be slow growth and high capital. One banker responded that the bank was paying a 90 percent dividend because the bank had 13 percent capital and had no growth prospects. He was using the dividends for personal investments. Another indicated a large increase in dividends due to a surplus of capital, and another cited Subchapter S as a vehicle to take money out of the bank for estate planning. One banker was using higher dividends to improve his personal life style and "would have sold out if not electing Sub S." Finally, one banker indicated that Subchapter S was a method for staying independent. He went on to explain that the increased after-tax cash flow was a major factor in retaining existing shareholders, thus reducing or eliminating the need to sell the bank. All of these responses seemed to indicate that the Subchapter S status enhanced the value of the bank by increasing after-tax returns to shareholders and thereby making the bank a more desirable investment vehicle.

CONCLUSIONS

Our purpose in this paper was to review the characteristics of banks that have converted to Subchapter S status and identify changes in their behavior or performance subsequent to the conversion. We found that banks that convert to Subchapter S status tend to be well capitalized, but slower-growing than other banks prior to conversion, and to have a history of higher levels of dividends. These tendencies continued after conversion with dividend payout rates actually increasing, leading, on average, to reduced levels of capital in Subchapter S banks.

These findings are consistent with our hypothesis that the banks that convert to Subchapter S status are well capitalized and slow growing. Such banks have the most reason to pay higher dividends, since earnings do not need to be retained at the bank level to maintain adequate capital or to support future growth. Therefore, returning the earnings to the shareholders in the form of dividends is an economically rational decision. The Subchapter S status provides a vehicle for doing so while eliminating double taxation of earnings. It, therefore, enhances the value of the bank for shareholders or potential investors. These findings are further strengthened by the survey results, where virtually all respondents cited tax savings as the principal reason for conversion. Many bankers went on to describe how the Subchapter S status gave them a means for taking more earnings out of the bank in a tax-efficient manner.

We also analyzed whether the conversion to Subchapter S status contributed to changes in bank behavior or performance, especially changes which could be detrimental to the banks' condition. While the increased dividends clearly led to reduced capital in the Subchapter S banks, capital levels still remained strong. Other indications of decreased performance or increased risk taking were not found. In fact, the Subchapter S banks had better current examination ratings on average than did the non-Subchapter S banks.

Finally, although over 1,400 community banks have converted to Subchapter S status, over 6,600 have not, and the rate of conversion has slowed substantially. Clearly, some banks are waiting to see what the experience of those banks that have converted will be. This paper gives some indication of what that experience has proven to be so far. How many more banks will convert depends upon whether they perceive the benefits to their shareholders offsetting the expenses of conversion. Our analysis suggests that there are three key factors in that decision: the number of shareholders, the growth prospects of the bank, and the bank's level of capitalization. Especially for well capitalized, slow growing, and closely held community banks, the Subchapter S form of ownership offers an opportunity for maximizing shareholder returns and enhancing the franchise value of their banks.

APPENDIX I

Legal and Accounting Details of Subchapter S Banks

There are specific criteria that must be met for a bank or bank holding company to elect Subchapter S status. For instance, a bank can have only one class of stock and no more than 75 shareholders.[20] All shareholders must be eligible shareholders, and each shareholder must consent to the corporation's S status election. Eligible shareholders are restricted to U.S. citizens and residents, estates, certain charitable organizations, profit-sharing and stock bonus plans, electing small business trusts, and Employee Stock Option Plans (beginning in 1998). Nonresident aliens, partnerships, IRAs, non-Subchapter S Corporations and most Subchapter S corporations are ineligible shareholders. A parent Subchapter S can own a subsidiary bank that has made a qualified Subchapter S subsidiary election, only if it owns 100 percent of the subsidiary bank. When this election is made, the subsidiary bank is not treated as a separate corporation.

In many cases, the organization needs to reduce the number of shareholders or eliminate ineligible shareholders before electing Subchapter S status. Redeeming and retiring their shares can easily eliminate cooperative shareholders. However, eliminating uncooperative or unwanted shareholders is more complex and requires considerable planning. The most common method of cashing-out shareholders is to merge the bank or the holding company into a so-called phantom or interim bank or company. The existing bank or company survives, with the ineligible shareholders receiving cash for their stock and the remaining shareholders receiving stock of the surviving entity. A second method of cashing-out shareholders is a reverse stock split. In a reverse stock split, for example, shareholders are given 1 share for every 100 shares they own. All shareholders owning less than 100 shares would receive cash rather than fractional shares. With both of these methods, shares are generally purchased for an appraised value, and minority shareholders receive a fair price for their stock. Both transactions are legal but are frequently distasteful to bank owners who are reluctant to force out minority shareholders.

Once the organization has less than 75 eligible shareholders, it must ensure that shares are not transferred in a manner that will result in the bank's disqualification from Subchapter S status. Any transfers to an ineligible shareholder or an increase in shareholders above the 75 shareholder limit will automatically terminate the organization from Subchapter S status. Once a termination has occurred, the organization cannot make another Subchapter S election for five years, unless the U.S. Department of Treasury consents. Most organizations require that shareholders enter into an agreement that requires that shares only be sold or transferred to the corporation and/or existing shareholders.

The major advantage of Subchapter S status is the elimination of double-taxation of corporate earnings. This advantage remains in effect as long as the organization retains its Subchapter S status. There are significant disadvantages as well, some of which are transitory, existing only for a short time as the organization adjusts to the new ownership form. Many of the disadvantages will not apply to all organizations. Nonetheless, they may represent real costs to an organization and its shareholders and should be considered prior to deciding on the Subchapter S form of ownership.

Advantages of Electing Subchapter S Status

- Most federal and state corporate level income tax is eliminated, minimizing the double taxation experienced by non-Subchapter S shareholders.
- A Subchapter S shareholder's tax basis is increased by undistributed taxable income, thereby reducing capital gains on the ultimate sale of the Subchapter S's stock.
- Most losses, deductions and credits pass through to shareholders proportionately for use on their personal tax returns.
- Subchapter S Corporations are not subject to the corporate alternative minimum tax.

Disadvantages of Electing Subchapter S Status

- A corporate level "built-in-gains" tax applies to income and expense items attributable to periods in which the corporation existed as a non-Subchapter S. For example, the recapture of loan loss provisions that were recognized while the bank was a non-Subchapter S or the sale of an asset that was purchased before the bank became a Subchapter S.
- The built-in-gain item is subject to immediate double taxation. The net built-in-gain is recognized by the bank and is subject to corporate level income tax at the highest corporate tax rate. Then, the net built-in-gain, less the corporate level tax, is passed through and taxed at the personal tax rate of the Subchapter S shareholders. These items are treated as though the corporation was still a non-Subchapter S—except that they are taxed in the current year instead of the year the earnings are distributed.
- Net operating losses, excess capital losses, and non-Subchapter S credits do not carry forward to the Subchapter S.
- A Subchapter S bank can not use the reserve method for accounting for loan losses. Therefore, any bad debt reserve must be recaptured into taxable income and will be subject to the built-in-gains tax.
- A corporate level tax is imposed on net passive investment income, if the organization has non-Subchapter S corporate earnings and profits and excess passive investment income.
- Three successive years with excess passive investment income and corporate earnings and profits results in the termination of Subchapter S status.
- Subchapter S Corporations must generally use a December 31 tax year-end.
- Subchapter S Corporations and their shareholders are not allowed a dividends-received deduction.
- Shareholders who own in excess of 2 percent of the Subchapter S's stock lose certain nontaxable fringe benefits such as health insurance premiums and group term life insurance premiums.
- The organization continually needs to comply with shareholder eligibility requirements to preserve Subchapter S status.
- Loans from qualified retirement plans to Subchapter S Corporations may result in plan disqualification.
- Insufficient basis or the application of the at-risk of passive loss limitation rules may limit deductions for losses passing through to shareholders.
- Shareholders are taxable on their respective pro-rata share of Subchapter S income and gain, regardless of whether the Subchapter S makes distributions.
- Subchapter S Corporations can claim deductions for interest and salaries to Subchapter S shareholders only on a cash basis (not accrual).
- Shareholders' personal tax filings may become more complex since they will be required to report their proportionate share of the bank's earnings on both estimated and annual tax returns. Additionally, the bank will need to provide shareholders with the information to complete their tax returns.

APPENDIX 2

Performance Comparison
Subchapter S Banks and Non-Subchapter S Banks

Kansas City Federal Reserve Bank District States

	Non Sub-S		All Sub-S *	
	1999	% Change 1996 – 1999	1999	% Change 1996—1999
Number of Banks	1,023		356	
Asset/Liability Mix				
Asset Size ($ millions)	77.45	38.21	73.80	24.00
Loans to Assets (%)	62.32	9.10	61.51	9.10
State & Municipal Securities (%)	6.28	2.78	4.83	-14.81
Noncore Liabilities (%)	17.26	36.55	16.62	34.47
Asset Quality				
Noncurrent Assets (%)	1.02	-19.68	1.13	-4.23
Coverage Ratio (%)	167.02	11.16	135.96	-9.38
Net Loan Losses (%)	0.24	-7.69	0.23	9.52
Earnings and Dividends				
Net Interest Income (%)	4.08	-2.86	4.21	-3.66
Personnel Expense (%)	1.76	1.73	1.64	-1.80
Efficiency Ratio (%)	63.54	2.67	60.17	2.63
Pre-tax Net Income (%)	1.63	-7.39	1.81	-9.95
Income Taxes (%)	0.52	-5.45	0.07	-89.06
Return on Avg Assets ** (%)	1.11	-8.26	1.23	-10.87
Stated Dividend Payout (%)	46.32	-0.32	78.80	30.38
Adjusted Divd Payout (%)	46.32	-0.32	70.05	15.48
Capital Adequacy				
Total Capital (%)	10.12	-5.13	9.50	-9.00
PCA Rating	1.03	0.98	1.04	2.97
% "Well Capitalized"	97.26	-1.29	96.07	-2.57
Examination Results				
CAMELS Composite Rating	1.61	0.00	1.42	-0.70
CAMELS Management Rating	1.69	-3.98	1.55	-4.94

*—excludes banks that converted after 1999.
**—adjusted for assumed corporate tax rate for Subchapter S banks.

Description of Table Structure

The table provides a comparison of the average performance of Subchapter S banks with the average performance of non-Subchapter S banks. The Subchapter S group includes banks that converted in 1997, 1998 or 1999. The non-Subchapter S group includes banks that had not converted through June 2000. Banks that converted in the first half of 2000 are excluded from both groups.

There are five sections to the table: Asset/Liability Mix, Asset Quality, Earnings and Dividends, Capital Adequacy, and Examination Results. For each performance measure, the table includes the value for 1999 and the percentage change in the value since 1996. The year 1996 was chosen since it was the last year in which banks could not elect Subchapter S status.

The table includes all banks in the states encompassing the Kansas City Federal Reserve District that were chartered prior to 1993 and have assets of under $1 billion or are in bank holding companies with consolidated assets of less than $1 billion. For each variable, the key consideration is whether there has been a change in the Subchapter S banks' average value, relative to that of the non-Subchapter S banks.

Description of Variables

State & municipal securities

Securities issued by states and political subdivisions in the U.S. as a percentage of total assets.

Noncore liabilities

Federal Funds purchased and securities sold under agreements to repurchase + total domestic time deposits of $100,000 or more + foreign deposits + demand notes issued to the U.S. Treasury + other borrowed money—Federal Funds sold and securities purchased under agreements to resell as a percentage of total assets.

Noncurrent assets

Total loans past due 90 days or more and still accruing + total nonaccrual loans + other real estate owned as a percentage of total loans.

Coverage ratio

Allowance for loan and lease losses as a percentage of noncurrent assets.

Net interest income

Total interest income – total interest expense as a percentage of average assets for the year.

Personnel expense

Salaries and employee benefits as a percentage of average assets for the year.

Efficiency ratio

Noninterest expense as a percentage of net interest income + noninterest income.

Pre-tax net income

Income (loss) before income taxes and extraordinary items and other adjustments as a percentage of average assets for the year.

Income taxes

Applicable income taxes as a percentage of average assets for the year.

Return on avg assets

Net income (loss) after taxes as a percentage of average assets for the year. For Subchapter S banks, net income is reduced by imputed income taxes (see below).

Stated dividend payout

Cash Dividends declared on common stock + cash dividends declared on preferred stock as a percentage of net income.

Adjusted divd payout

Reported cash dividends + imputed income taxes as a percentage of net income – imputed income taxes. Note: only relevant for Subchapter S banks; for non-Subchapter S banks the Stated Dividend Payout and the Adjusted Divd Payout will be the same.

Total capital

Total equity capital + subordinated notes and debentures as a percentage of total assets.

PCA rating

A numerical rating of capital adequacy used by banking regulators, ranging from 1 to 5 where 1="well capitalized," 2="adequately capitalized," 3="under capitalized," 4="significantly undercapitalized" and 5="critically undercapitalized." See Section 208.33 of the Federal Reserve Board's Regulation H, Subpart B, for a further explanation.

% "Well Capitalized"

The percentage of banks with a PCA rating of 1 (see above).

CAMELS composite rating

A numerical rating of overall bank condition assigned as part of the bank examination process. Ratings range from 1 (best) to 5 (worst).

CAMELS management rating

A numerical rating of management expertise assigned as part of the bank examination process. Ratings range from 1 (best) to 5 (worst).

Imputed income taxes

For Subchapter S banks only, an income tax is imputed based on the average income tax rate for the non-Subchapter S banks and the pre-tax net income of the Subchapter S bank. For instance, if the average income tax rate for the non-Subchapter S banks in 1999 was 32% and a Subchapter S bank had earnings of $10 million, its imputed income tax would be $3.2 million.

ENDNOTES

1 "Subchapter S" refers to the section in the Federal tax code relevant for this form of ownership. Subchapter S organizations are often called "Sub-S" or "S-Corps." Non-Subchapter S organizations are often referred to as "C-Corps," again, due to the relevant section of the tax code. We will use the terms "Subchapter S" and "non-Subchapter S" throughout this paper.

2 The states included are Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming. Although the District includes only parts of Missouri and New Mexico, banks in the entire states are included.

3 Since election must occur at the beginning of the year, except for newly formed banks, there should be few, if any, additional Subchapter S banks by year-end 2000.

4 For additional information on the effect of these restrictions on Subchapter S eligibility see "Banking Taxation, Implications of Proposed Revisions Governing S-Corporations on Community Banks," GAO, June 2000, and "Subchapter S Survey," American Bankers Association, December 1999.

5 The FDIC estimates that, as of December 1999, about 40 percent of Subchapter S banks had 3 or fewer shareholders, per GAO, op.cit.

6 The year 1993 was chosen since this guarantees that all banks in the study were at least three years old as of January 1, 1997, the first date that banks were allowed to convert to Subchapter S status. "Less than three years old" is an often-used definition of new, or "de-novo," banks.

7 Nearly 80 percent of all U.S. banks, including most small banks, are owned by bank holding companies. A "banking organization" is comprised of the parent holding company and its banking and nonbanking subsidiaries. If a bank is part of a banking organization, the bank cannot convert to Subchapter S unless the entire organization does so.

8 Nationwide, 95 percent of Subchapter S banks have assets of under $250 million.

9 Regulatory capital designations range from a best of "well capitalized" to a worst of "critically undercapitalized." Being "well" capitalized is often a criterion for granting banking organizations certain powers, such as becoming a financial holding company or issuing brokered deposits.

10 The higher asset growth of non-Subchapter S banks could, at least partially, be the result of acquisitions, since banks contemplating acquiring other banks, especially with an exchange of stock, would be less likely to convert to Subchapter S status.

11 The holding company structure itself offers tax benefits to organizations with significant expenses at the parent level. In small bank holding companies, the largest of these expenses is usually interest expense on debt. Therefore, companies with high debt expense may have less need of the additional tax advantages offered by Subchapter S.

[12] Each year, bank holding companies are required to file a report with the Federal Reserve System (the F.R. Y-6) that lists the amount of shares held by each shareholder with at least a five-percent ownership interest in the holding company. Using this report, the average number of shareholders holding at least a five-percent interest and the total percentage of stock held by this group can be calculated for each company.

[13] There is no legal requirement that banks do this. Shareholders may have sources other than bank dividends from which to pay their increased personal taxes.

[14] The decision of whether to accept additional risk is not unambiguous. By reducing taxes, after-tax earnings are increased at any income/risk level. Thus, a bank could actually choose to reduce risk and still raise after-tax earnings above the pre-Subchapter S level.

[15] Multiple responses were possible for most questions.

[16] First-year taxes could also have increased since some "built-in-gains" must be recognized for tax purposes in the year of conversion (see Side Box 2 for additional details).

[17] Since Subchapter S banks' earnings are not reduced by income taxes, their net income to average assets ratios are not directly comparable to those of non-Subchapter S banks. The Federal Financial Institutions Examination Council has recognized this problem and adjusts the net income ratio of Subchapter S banks for an implied corporate income tax in their Uniform Bank Performance Reports.

[18] The alternative minimum tax may impose income taxes on income sources that are usually tax exempt.

[19] There were only seven responses to this question, since it was added to the survey late in the process.

[20] There are very specific rules governing how shareholders are counted. A husband and wife, including their estates, are counted as one shareholder even if shares are owned individually. Tax-exempt entities and qualified plans are generally considered one shareholder, but each beneficiary of an electing small business trust is considered one shareholder. Each owner of a grantor trust is also considered one shareholder for purposes of the 75-shareholder count.

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