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ABA

Subchapter S

Registry

Lends Support

to Ag Banks

by Mark Baran

The ABA kicked off the 1998 year by establishing the ABA Subchapter S Registry for banks that have elected, or are considering electing, S corporation tax status. This exclusive, no-cost service, provides ABA members with concise, reliable and accurate information on a host of Subchapter S banking issues and activities. Subchapter S Registry membership has grown tremendously since its January inception, particularly among ABA-member ag banks. Currently, ag banks¹ make up more than 65 percent of Subchapter S Registry membership.

Since January 1997, Subchapter S banking has become a popular choice within the banking community. Such popularity is evidenced by the fact that 1,017 banks have elected Subchapter S as of March 31, 1998. Banks that have elected range from \$4 million to \$3.5 billion in asset size. Many more banks are expected to follow this trend that began in January 1997, when federal legislation allowed eligible banks not using the reserve method of accounting for bad debts to become S corporations. The Subchapter S banking phenomenon has shown no signs of slowing, and the ABA is prepared to deliver important information to member banks interested in preserving and maintaining their S status.

Ag bankers recognize the many benefits associated with choosing a pass-through method of taxation.

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¹ Ag banks are defined as commercial banks with assets less than \$500 million whose ratio of domestic farm loans to total domestic loans exceeds the unweighted average of this ratio at all FDIC-insured commercial banks. This ratio stood at 16.22 percent in 1997, 16.23 percent in 1996 and 16.62 percent in 1995.

Profitability of Subchapter S Corps and Non-Subchapter S Corps, First Quarter 1998 (\$ in billions)

	<u># of banks</u>	<u>Total Assets</u>	<u>Avg. ROA</u>	<u>Avg. ROE</u>
Banks with assets < \$100MM				
Subchapter S corps	798	\$36	1.74%	16.88%
Non-Subchapter S corps	4,945	228	1.12	10.12
Banks with assets \$100MM - \$1B				
Subchapter S corps	196	37	1.87	19.78
Non-Subchapter S corps	2,722	692	1.34	13.95

Source: FDIC

Naturally, the most notable and primary reason for electing is the realization of tax savings. However, there are many more benefits (and pitfalls) associated with S status. For example, recently released data reflects increased profitability by Subchapter S banks. During the first quarter 1998, Subchapter S banks clearly outperformed non-Subchapter S banks. (See chart above.)

Realization of these tax and performance benefits does not come without a price. Those institutions that have undergone the Subchapter S conversion process will attest to the many costs associated with electing Subchapter S. These costs include, but are not limited to, appraisal, accounting and legal fees for services necessary to ensure and maintain S corporation eligibility. Taxes may also be imposed for changing a bank's accounting method for bad debts.

Ongoing planning and expert advice with respect to the complex Subchapter S rules will also be necessary for S banks. Traps for the unwary exist in the tax laws that may impact investment decisions. For example, the passive income limitation rules impose a corporate-level tax on "ex-

cess passive income" and on built-in gains upon the sale of pre-conversion appreciated assets. Further, depending on the circumstances in an individual S corporation ag bank, there may be problems (or possibly benefits) associated with owning certain tax-exempt assets. Because Subchapter S ag banks conduct business in a unique and volatile lending environment, these special tax rules may have a greater impact. The amount of investment assets held by the S corporation ag bank may vary due to agricultural lending demand in a particular region. In these circumstances, special passive income and tax-exempt asset issues predictably arise.

There is a seemingly endless amount of Subchapter S information available to aid bankers personally and professionally. The body of laws and related materials governing Subchapter S corporations are immense, complex and often intimidating. Therefore, understanding this unique tax structure is critical, particularly for CEOs and major shareholders. For this reason, Subchapter S Registry members are provided the latest news, planning issues, and legislative and regulatory developments. The Sub-

chapter S Registry Report, which is a newsletter service prepared and distributed on a regular basis, is designed to respond to the special needs of Subchapter S banks. Additionally, a library of information is contained in the Subchapter S section in the *Members Only* section of ABA's website at www.aba.com. At this site, you will find bank-specific Subchapter S information, such as tax rules, articles, economic data, state law updates, upcoming peer group events and a discussion group site that allows bankers to post messages and communicate directly with banking peers. ABA member bankers may also register for the *Members Only* section at no

cost. Go to www.aba.com, click on *Members Only* and complete the registration form.

The ABA strives to meet the demands of its membership as an advocate and information resource. The Subchapter S Registry should be your primary resource for information that will enable you to maximize Subchapter S benefits and minimize tax exposure. Membership continues to grow at a rapid pace. If you have not already registered your bank for this exclusive service, we invite you to sign up today. To register for the Subchapter S Registry, call Mark Baran at (202) 663-5317 or e-mail him at mbaran@aba.com. jal