BANKING & FINANCE

S Corps: A Growing Trend in Small Bank Holding Company Formation

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The Internal Revenue Service's (IRS) 2013 data reveal that 72 percent of corporate tax returns are Subchapter S corporations (known as "S corps"), making them the most common type of corporate entity in the United States. S corps can also be banks and bank holding companies. So why do some banks make this choice?

Companies have options for the kind of business entity they choose to be for tax purposes. Typically, banks and bank holding companies are corporations, which provides limited liability protection——that is, the individual shareholder's personal assets are not legally liable for debts the corporation incurs. Profits are taxed first at the federal corporate level and then again at the individual shareholder level when dividends are paid.

If the corporation meets certain requirements to file with the IRS as an S corp, such double taxation can be avoided. An S corp passes through profits (or losses) to the shareholder's personal tax return, subject only to their individual income tax rates. Furthermore, S corp taxes are allocated based on pro rata shareholder's ownership. For example, a shareholder who owns 25 percent of an S corp's stock will be responsible for proportionally paying taxes on 25 percent of the S corp's earnings, even if distributions were not paid. To qualify as an S corp, the IRS requires that

- A company must be a domestic corporation.
- Shareholders must be individuals, certain qualifying trusts or estates, and U.S. citizens.
- Shareholders cannot be partnerships, corporations, or nonresident aliens.
- A company may have no more than 100 shareholders (spouses or families of shareholders may count as one individual shareholder).
- A company may have only one class of stock.

Additionally, a corporation is ineligible if it is:

- A bank or thrift institution that uses the reserve method of accounting for bad debts under section 585 of the Internal Revenue Code.
- An insurance company subject to tax under subchapter L of the U.S. Internal Revenue Code.
- A corporation that has elected to be treated as a possessions corporation under section 936 of the U.S. Internal Revenue Code.
- A domestic international sales corporation (DISC) or former DISC.

According to 2009 research conducted by the New York Fed, in 1997 more than 6 percent of all banks chose to become S corps. By the end of 2007, more than 32 percent of all banks were registered as S corps. As of June 30, 2017, the Federal Reserve System regulates 1,646 small bank holding companies that are S corps. (Table 1 shows the Federal Reserve Districts ranked by highest percentage of S corps with their respective asset concentration.) Nearly a decade after the New York Fed's initial research—and even with a high number of bank closures following the financial crisis—data indicates that S corps remain heavily concentrated in the Minneapolis, Atlanta, Chicago, Dallas, Kansas City, and St. Louis Federal Reserve Districts.

Table 1

Small Bank Holding Company S Corps Regulated by All Federal Reserve Banks

District	Total number of S corps	Total number of BHCs	Percent		Total S corp assets (thousands)	Total BHC assets (thousands)	Percent
FRB Minneapolis	295	440	67%		$ 71,180,353	$ 102,096,217	70%
FRB Dallas	241	404	60%		$ 65,355,647	$ 113,449,663	58%
FRB Kansas City	370	685	54%		$ 78,598,265	$ 142,555,139	55%
FRB Chicago	334	685	49%		$ 70,663,243	$ 169,474,481	42%
FRB St.Louis	185	450	41%		$ 43,762,770	$ 162,473,530	27%
FRB Atlanta	147	451	33%		$ 36,253,005	$ 132,643,728	27%
FRB San Francisco	26	131	20%		$ 7,351,098	$ 52,969,765	14%
FRB Cleveland	30	191	16%		$ 8,005,405	$ 51,205,256	16%
FRB Richmond	11	173	6%		$ 3,938,310	$ 59,691,928	7%
FRB Philadelphia	4	101	4%		$ 1,575,208	$ 40,712,798	4%
FRB Boston	2	95	2%		$ 419,925	$ 52,103,023	1%
FRB New York	1	79	1%		$ 351,535	$ 39,746,460	1%
Aggregate Total All FRBs	1,646	3,885	42%		$ 387,454,764	$ 1,119,121,988	35%

Note: Data are through the second quarter of 2017.
Source: Federal Reserve Banks data and author's calculations

Table 2 shows the concentration of S corps located in the Sixth District on a state level, and the map shows the state concentration of S corps that file the FR Y-9SP (Parent Company Only Financial Statements for Small Holding Companies) and their average assets. Additionally, the map shows the limited number of S corps who file the FR Y-9C. Average assets for each S corp vary by state, with the smallest reaching just under $200 million in assets. While S corps are limited to 100 shareholders, the amount of assets held by an institution has no limit. Still, the vast majority of the S corps—an estimated 97 percent—are regulated under the Fed's Small Bank Holding Company Policy Statement. The Board of Governors revised the policy statement in April 2015 to extend to more of these types of institutions, increasing the asset level from $500 million to $1 billion.

The policy statement allows these small bank holding companies (BHCs) to operate with higher leverage levels than larger organizations would be permitted to have. The policy statement also grants these small BHCs an exemption from the Federal Reserve Board's policy on consolidated risk-based capital.

Small BHCs operating under the policy statement have significantly fewer regulatory reporting requirements than larger organizations, with a supervisory approach tailored for each company based on a variety of factors, including legal entity and regulatory structure. Specifically, FR Y-9SP filers (for holding companies with total consolidated assets of $1 billion or less) file the report semiannually rather than quarterly, and it requires significantly less detail.

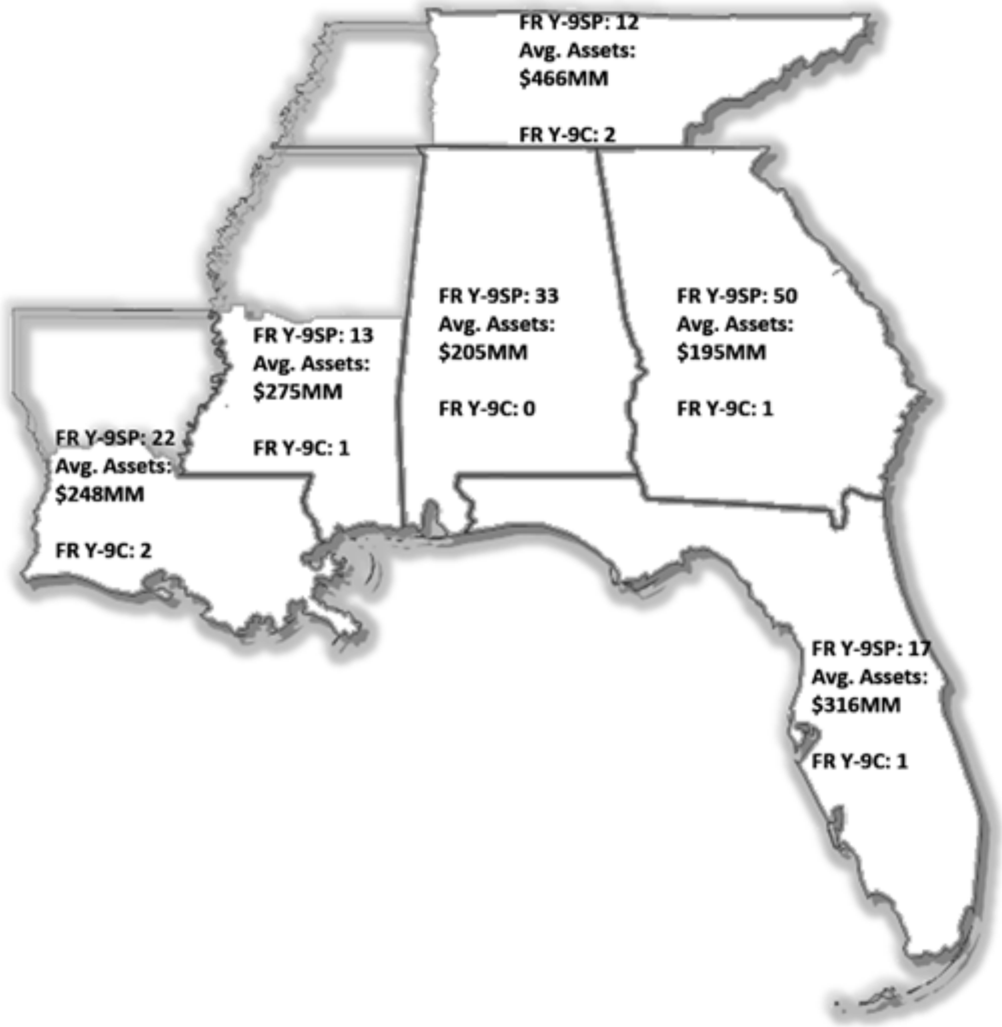
Table 2

Small Bank Holding Company S Corps Regulated by the Atlanta Fed

State	Total number of S corps	Total number of BHCs	Percent		Total S corp assets (thousands)	Total BHCs assets (thousands)	Percent
GA	50	132	38%		$ 9,650,789	$ 35,124,119	27%
AL	33	102	32%		$ 6,594,104	$ 24,932,659	26%
LA	22	48	46%		$ 5,465,833	$ 14,417,703	38%
FL	17	71	24%		$ 5,365,144	$ 24,244,802	22%
TN	12	71	17%		$ 5,601,453	$ 25,928,947	22%
MS	13	27	48%		$ 3,575,682	$ 7,995,498	45%
Totals	147	451	33%		$ 36,253,005	$ 132,643,728	27%

Note: Data are through the second quarter of 2017. A portion of Louisiana is regulated by the Federal Reserve Bank of Dallas. Portions of Tennessee and Mississippi are regulated by the Federal Reserve Bank of St. Louis.

Source: Federal Reserve Banks data and author's calculations



Legislation affecting S corps is heating up

Recent legislative proposals to introduce new policies and amend tax laws have propelled S corps into the news, and the proposals' potential effects under debate. Rep. Kenny Marchant (R-TX) introduced H.R. 2339 (the Capital Access for Small Business Banks Act) to the House of Representatives on May 3, 2017. The legislation would amend the Internal Revenue Code to allow banks or BHCs that are S corps to increase the allowable number of shareholders from 100 to 500 and allow the banks or BHCs to issue preferred stock. The bill applies to all taxable years after December 31, 2017.

Increasing the allowable shareholders from 100 to 500 would allow S corps to raise additional capital and potentially facilitate ease of mergers or acquisitions with other financial institutions while maintaining S corp status. Additionally, Senator Mike Crapo (R-ID) of the Senate Committee on Banking, Housing, and Urban Affairs introduced S.2155 on November 16, 2017, which (among other things) amends the Small Bank Holding Company Policy Statement consolidated asset threshold from $1 billion to $3 billion for BHCs that

- are not engaged in significant nonbanking activities directly or through a nonbank subsidiary,
- do not conduct significant off-balance sheet activities directly or through a nonbank subsidiary, or
- do not carry a material amount of debt or equity securities outstanding registered with the Securities and Exchange Commission.

As of January 30, 2018, the committee has conducted hearings on the bill, which currently remains within the Senate.

President Trump signed the Tax Cuts and Jobs Act into law on December 22, 2017, marking the most significant changes to the U.S. tax code in decades. Income earned from pass-through businesses (S corps, sole proprietorships, partnerships, and LLCs)—previously subject to individual tax brackets that could reach 39.6 percent——is now subject to individual tax brackets that peak at 37 percent after a 20 percent deduction is applied. This proposal would provide strong incentives to businesses to form or convert to pass-through businesses, but it might reduce IRS collections. This topic is evolving every day as studies consider the impact on taxpayers' disposable income and IRS collections.

Impact on Federal Reserve reports Impact on Federal Reserve reports

Should some bills in Congress become law, financial institutions regulated by the Federal Reserve would face new questions about their companies' strategies, goals, or directions. If H.R. 2339 becomes law, S corps that raise enough capital to raise their asset size over $1 billion would have to switch from filing the FR Y-9SP to its equivalent for larger institutions, Consolidated Financial Statements for Holding Companies, the FR Y-9C. Changing from FR Y-9SP to FR Y–9C brings increased reporting responsibilities and compliance costs, something smaller financial institutions would like to reduce.

Outlook

In many Federal Reserve Districts, S corps make up a significant number of small BHCs. With several proposed changes on the horizon, supervisors will continue to monitor any shifts in how BHCs choose to structure themselves for regulatory or tax purposes.

David Kahn
Senior financial statistics analyst in the Atlanta Fed's Financial Statistics and Structure Analysis department

Recommended reading

Discussion of the effects of new tax plan
https://www.thebalance.com/trump-s-tax-plan-how-it-affects-you-4113968

Subchapter S Bank Association website
http://www.subsbanks.org/news

S-Corporation Association of American website
http://s-corp.org/our-history/

IRS information about S corporations
https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations

Analysis of reform of U.S. tax laws
https://www.congress.gov/bill/115th-congress/house-bill/1