Hovde

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Subchapter S Perspective

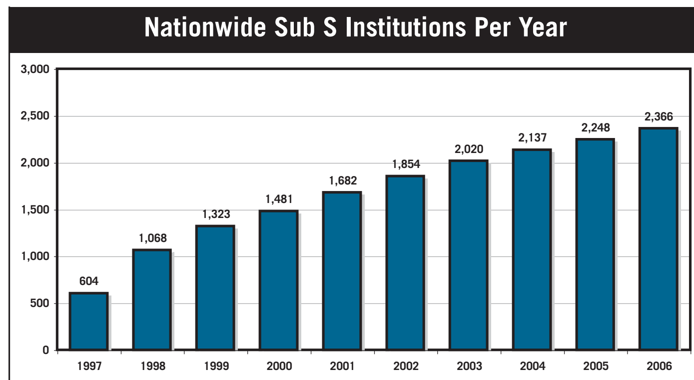
An Overview and Analysis of a Popular Ownership Structure

Introduction

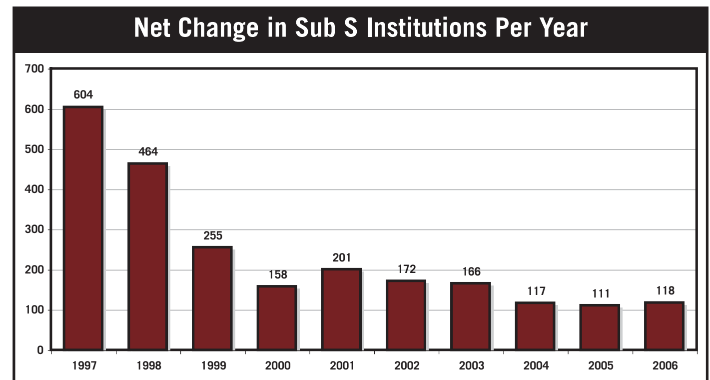
A growing phenomenon in the banking industry is the proliferation of Subchapter S institutions. According to the FDIC, as of March 31, 2006, roughly 27% of all reporting financial institutions were organized as S corporations. What is fueling the growing attraction to the Sub S form of ownership? In this Hovde *Industry Update*, we examine some trends affecting banks and thrifts electing Subchapter S, the benefits and limitations of a Sub S election, and why next year we may see a flurry of M&A activity involving S corporations.

History and Overview

The Subchapter S form of ownership became available to financial institutions upon passage of the Small Business Job Protection Act of 1996. The Act allowed banks and thrifts to operate as S corporations beginning in 1997. During that year, 604 financial institutions either converted to S corporations or began operations as S corporations. The following year an additional 464 banks elected S corporation status, and by March 31, 2006, 2,366 banks and thrifts were operating as S corporations.



Source: FDIC



Source: FDIC

Why are so many banks deciding to convert? The primary reason is that as Subchapter S corporations, corporate taxes on earnings are eliminated. Virtually the entire tax burden of the corporation is passed on to individual shareholders on a *pro rata* basis, resulting in higher after-tax rates of return for shareholders. S corporation earnings are taxed only once—at shareholders' respective tax rates—whereas a C corporation's earnings are taxed once at the corporate level and again at the shareholder level vis-à-vis dividends or capital gains. We will discuss this difference in greater detail in a later section.

Subchapter S was designed to benefit small business owners. As such, there is a limitation on the number of shareholders an S-Corp may have. Until the passage of the American Jobs Creation Act of 2004 (the 2004 Tax Act),

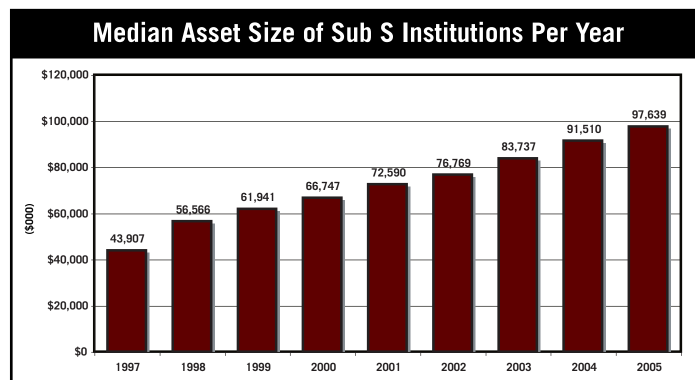
S corporations were limited to 75 shareholders. The 2004 Tax Act raised the maximum number of shareholders to 100. In addition, the Act made several changes that made it easier for companies to elect Sub S status, including the opportunity to treat family members as one shareholder and permission for certain IRAs to hold S corporation stock. Because a C-Corp can only make an S-Corp election effective at the start of a fiscal year, few banks could take advantage of the more relaxed qualifications until this year.

We have already seen 118 Sub S conversions in the first quarter of 2006, which is more than the totals from the previous two whole years (117 banks elected in 2004 and 111 elected in 2005).

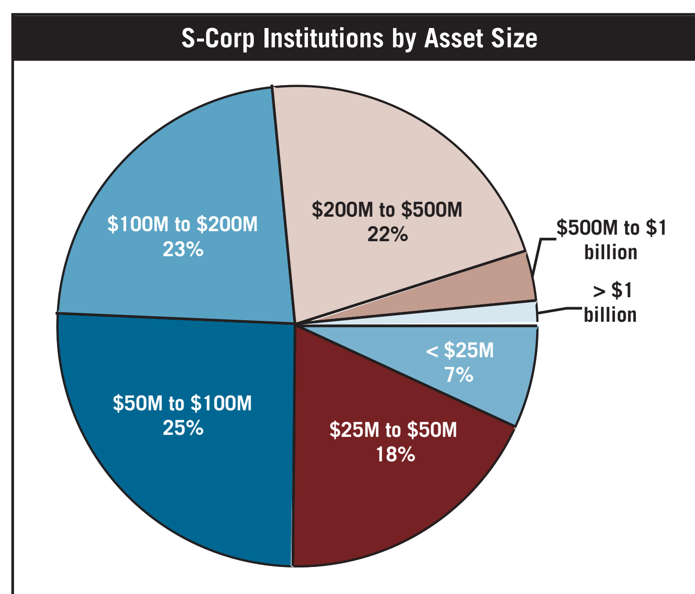
Ownership structure tends to be the overriding factor affecting whether a bank can and will elect Sub S status. On the one hand, it is relatively easy for a C-Corp bank with less than 100 shareholders to elect Sub S since it would fall within the current shareholder limitations (assuming it meets other requirements). A C-Corp bank with 200 shareholders, however, would have a more difficult time converting, since it would need to reduce its current number of shareholders to 100 or less, necessitating the elimination of ineligible or uninterested shareholders. This is usually accomplished by completing a reverse stock split or by buying out existing shareholders. A bank also may be able to reduce its number of shareholders by counting different family members as one shareholder, pursuant to the new S-Corp guidelines. A bank with 500 or more shareholders (i.e., a public company) interested in electing Sub S would need to complete a difficult (and often expensive) going-private transaction, whereby existing non-qualified shareholders for S-Corp purposes would be "squeezed out" of the company.

Since the loosened restrictions on shareholder limits and family members counting as one shareholder, we have seen many larger organizations attempt squeeze-out transactions to get below 100 shareholders. Oftentimes, this can lead to legal battles in which the shareholders being squeezed out of the company object to the price per share they are receiving. In such instances, companies have opted to tender for outstanding stock prior to effecting the squeeze-out, essentially making the transaction optional for shareholders. If the tender offer does not bring the company below 100 shareholders, it then will begin the squeeze-out process.

As banking assets in general have risen, and as larger banks have elected Sub S, the median asset size of Sub S institutions has predictably increased each year since 1997. The following chart details the year-over-year growth in the median asset size of Sub S institutions.



Source: FDIC



Source: SNL Financial

Despite the relaxed shareholder qualifications, the majority of banks that elect Sub S still have less than $100 million in assets, and only 5% of Sub S banks have over $500 million.

The largest Sub S thrift in the country is Midland Financial Company, headquartered in Oklahoma City, with over $10 billion in assets. The largest S-Corp bank in the country is City National Bancshares in Miami, Florida, with $2.9 billion in assets. Each of nineteen S-Corp banks and thrifts are larger than $1.5 billion in assets. The chart on the next page is a list of the fifteen largest S-Corp banks and thrifts in the country.

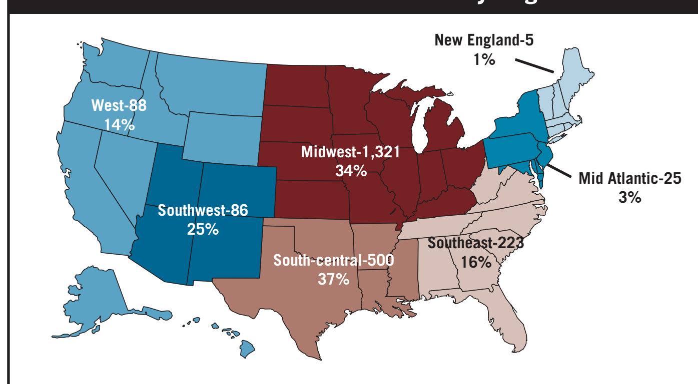
S corporation Nationwide Breakdown

Slower-growth banks with less of a need for retained earnings tend to elect Sub S more often than fast-growth institutions because excess capital can be distributed to shareholders without the double taxation

Top 15 Largest S corporations

Rank	Holding Company	City, ST	Bank Name(s)	Bank/ Thrift	12/31/05 Assets ($000)
1	Midland Financial Co.	Oklahoma City, OK	Midfirst Bank	Thrift	$10,245,657
2	Beal Financial Corp.	Plano, TX	Beal Bank SSB and Beal Savings Bank	Thrift	$4,354,397
3	Waterfield Mortgage Co.	Indianapolis, IN	Union Federal Bank of Indianapolis	Thrift	$2,906,099
4	City National Bancshares, Inc.	Miami, FL	City National Bank of Florida	Bank	$2,872,870
5	Amboy Bancorporation	New York, NY	Amboy National Bank	Bank	$2,662,454
6	La Jolla Bancorp, Inc.	La Jolla, CA	La Jolla Bank, FSB	Thrift	$2,665,630
7	Semperverde Holding Co.	Conshohocken, PA	Firstrust Savings Bank	Thrift	$2,146,026
8	Sturm Financial Group, Inc.	Denver, CO	Premier Bank and American National Bank	Bank	$2,069,187
9	Marquette Financial Companies	Minneapolis, MN	Marquette Financial Companies	Bank	$2,064,989
10	Luther Burbank Savings	Santa Rosa, CA	Luther Burbank Savings	Thrift	$2,016,515
11	Woodforest Financial Group, Inc.	The Woodlands, TX	Woodforest National Bank	Bank	$1,877,100
12	Amarillo National Bancorp, Inc.	Amarillo, TX	Amarillo National Bank	Bank	$1,909,042
13	Liberty Capital Inc.	Wilmington, OH	Liberty Savings Bank, FSB	Thrift	$1,848,973
14	Broadway Bancshares, Inc.	San Antonio, TX	Broadway Bank	Bank	$1,705,951
15	New South Bancshares, Inc.	Irondale, AL	New South Federal Savings Bank	Thrift	$1,725,426

Number of Sub S Institutions by Region



Source: FDIC

State Concentration of S-Corp Banks and Thrifts

State	Sub S Institutions	Total Institutions	% of S-Corp Institutions
MN	305	466	65.5%
ND	58	99	58.6%
WY	24	43	55.8%
OK	149	273	54.6%
IA	203	411	49.4%
NM	25	56	44.6%
KS	164	371	44.2%
SD	37	92	40.2%
TX	257	661	38.9%
NE	85	258	32.9%
MT	25	81	30.9%
IL	205	707	29.0%
MO	101	373	27.1%
CO	44	172	25.6%
FL	74	300	24.7%
LA	40	163	24.5%
WI	67	302	22.2%
TN	45	204	22.1%
MS	21	100	21.0%
AR	33	161	20.5%
KY	45	227	19.8%
GA	64	349	18.3%
AL	29	161	18.0%
RI	2	13	15.4%
UT	10	69	14.5%
Remaining 25 States	136	2703	5.0%
Total - Nationwide	**2248**	**8815**	**25.5%**

Source: FDIC

of dividends C-Corp shareholders incur. Evidence of this is the prevalence of Sub S institutions in the Midwest and South Central compared to other regions. Midwest and South Central banks are generally the slowest growing banks in the country. The median asset growth rate between 2000 and 2005 of all banks and thrifts in the Midwest and South Central U.S. was 5.0% and 6.0%, respectively, compared to 9.8% for the

West, 8.2% for the Northeast, 8.0% for the Southwest, 7.7% for the Mid-Atlantic, and 7.5% for the Southeast.

Thirty-seven percent of all banks in the South Central U.S. and 34% of all banks in the Midwest operate as Sub S banks. In contrast, Sub S banks in the New England and Mid-Atlantic regions represent only 1% and 3%, respectively, of the total banks in each region. Approximately 81% of all S corporations are located in the Midwest and South Central regions of the country. The concentration of S corporations is better illustrated on the second map in which each pin-point represents a Sub S institution in operation as of December 31, 2005.

Interestingly, Minnesota has the highest number of S-Corp banks and thrifts, with 305, and the highest percentage of S-Corp banks, with 65.5% of all banks and thrifts operating under the Sub S form of ownership. North Dakota, Wyoming and Oklahoma all have over 50% of banks organized as S-Corps. No banks or thrifts in Hawaii, Idaho, Maine, New Hampshire, or Vermont had converted or been organized as S corporations as of December 31, 2005.

The Difference to Shareholders

When comparing a C-Corp structure to an S-Corp structure, one should look at the differences in three major areas:

1. ***Tax treatment as an ongoing entity***

   S corporations are considered "pass-through" entities, whereby taxable income is passed through to shareholders based on their *pro rata* ownership percentage. The income (or loss) is not taxed at the corporate level, but rather appears on the shareholders' tax returns. Similar to a partnership structure, an S-Corp issues K-1s to each shareholder, allocating taxable (and permanently non-taxable income, such as municipal bond income) on a *pro rata* basis. To the extent that dividends do not exceed accumulated federally taxed income, they are not taxable. C corporations, on the other hand, pay tax on income at the corporate level and, then, their shareholders incur personal income taxes when dividends are paid. The current capital gains and dividends tax rate of 15% (which was recently extended through 2010, but still depends on the outcome of the 2008 presidential and congressional elections) has helped reduce the effect of the double taxation for C-Corp shareholders; however, those dividends still get taxed. Ongoing income would be taxed only once—at the shareholders' respective tax rates—if the company were organized as an S-Corp.

2. ***Tax treatment upon the sale of shares***

   The tax treatment for a selling S-Corp shareholder also differs significantly from that of a selling C-Corp shareholder. As income is passed through, the tax basis of each S-Corp shareholder is increased to the extent of its allocable income, and decreased by dividends or distributions. Put another way, all taxable income not paid out in dividends, together with all permanently tax exempt income, is added to the shareholder's tax basis. When the shares are eventually sold, an S-Corp shareholder's basis likely will be significantly higher than the original purchase price. And since a taxable capital gain is the difference between the sale price and the tax basis, the taxable gain will be far lower than in a comparable sale by a C-Corp shareholder, whose tax basis remains at the original cost.

3. ***Franchise value at the time of sale***

   In general, an S-Corp bank is worth more than a C-Corp bank, assuming all other characteristics of the institution are equal. This is because, in most cases, it will be advantageous for a purchaser of an S-Corp to treat its acquisition as an "asset purchase" for tax purposes, allowing it to writeoff over 15 years the premium paid over tax book value. At a tax rate of 35% and a discount rate of 8%, the present value of that tax benefit to a purchaser of a bank with a $10 million book value sold at two times book would be an additional $2 million and, at three times book, an additional $4 million. In comparison, it will almost never make sense to structure a C-Corp acquisition as an asset sale. Of course, things are never quite as simple as they look, and, in the case of an S-Corp acquisition, there is something called a "built-in gains tax" which may come into play and lessen the advantage.

Let's get more specific: As for ongoing earnings, due to the reduced 15% dividend tax rate, the maximum federal tax rate that could apply to earnings of a C-Corp is 44.8%, assuming all of the corporation's after-tax net earnings are distributed through dividends (see diagram).

Shareholders of S-Corps are only subject to personal tax rates on the company's earnings. In the following example, we examine the difference in after-tax earnings between C-Corps and S-Corps. We assume

Total Top Federal Tax Rates Applied to Earnings of a C-Corp	
Federal corporate tax rate on earnings	35.0%
Tax on dividends - assuming full payout of remaining earnings - 15% x (100% - 35%)	9.8%
Top federal tax rate applied	44.8%

two identical banks—one C-Corp and one S-Corp—each with $10 million in capital. Both banks earn $2 million pre-tax and pay $1 million in dividends to shareholders. We assume a corporate tax rate of 35% and an individual tax rate of 35%.

After-Tax Earnings: C-Corp vs. S-Corp

Assumptions:
(a) Beginning capital for both banks is $10 million
(b) Both banks earn $2 million pre-tax
(c) Both banks pay dividend of $1 million
(d) C-Corp tax rate of 35%
(e) Individual shareholder tax rate of 35%
(f) Capital Gains / Dividends tax rate of 15%
(g) Sub S bank pays out additional dividends equal to the C-Corp's income taxes

(all $ amounts are shown in 000s)

		C-Corp	S-Corp
1	Beginning Capital	10,000	10,000
2	Pre-Tax Earnings	2,000	2,000
3	Corporate Taxes	700	0
4	After-tax Earnings[1]	1,300	2,000
5	Dividends / Distributions	1,000	1,000
6	Sub S Distribution Equal to C-Corp's Income Tax Expense	0	700
7	Ending Capital[2]	10,300	10,300
8	Shareholder Taxes on Bank Earnings	0	700
9	Shareholder Taxes on Bank Dividends / Distributions	150	0
10	Total Taxes - Bank and Shareholder[3]	850	700
11	**Shareholder After-Tax Cash[4]**	**850**	**1,000**

Notes:
[1] Line(2)-(3)
[2] Line(1)+(4)-(5)-(6)
[3] Line(3)+(8)+(9)
[4] Line(5)+(6)-(8)-(9)

After taxes, the C-Corp bank has net income of $1.3 million and pays a dividend of $1 million to its shareholders, resulting in $300 thousand added to capital. The S-Corp bank has after-tax earnings of $2 million (because it incurs no corporate tax on earnings) and pays a dividend of $1 million. We also have assumed that the S-Corp bank would distribute an additional $700 thousand to shareholders to cover the individual shareholders' tax liability on the bank's earnings, resulting in $300 thousand added to capital—the same as with the C-Corp. Shareholders of the C-Corp do not pay individual taxes on the bank's earnings; however, they do pay $150 thousand in taxes on the $1 million of dividends, utilizing a 15% dividend tax rate. The S-Corp's earnings are taxed only at the shareholder level. Utilizing a 35% tax rate, the total S-Corp tax burden is simply $700 thousand ($2 million multiplied by 35%). The C-Corp total tax burden is $850 thousand ($700 thousand in corporate taxes plus $150 thousand in dividend taxes). The net benefit to S-Corp shareholders is an additional $150 thousand of after-tax cash flow. *An important caveat, however, is the advantage of an S-Corp structure, relative to ongoing after-tax cash flow, will be greater for a slower growing institution paying out a high portion of its earnings, as compared to a faster growing peer, which must retain a higher portion of its earnings to support its growth.*

If the 15% capital gains and dividend tax rate disappears, either through new legislation in 2008 or if it does not get extended after 2010, the benefits of being an S-Corp will increase dramatically. In our previous example, if instead of paying 15% on dividends, the C-Corp shareholder had to pay the same 35% personal tax rate on dividends as the S-Corp shareholder paid on earnings, the total tax burden to the C-Corp shareholder would be $1.1 million ($700 thousand in corporate taxes plus $350 thousand in dividend taxes). The net benefit to S-Corp shareholders would be $350 thousand in after-tax cash flow.

A Step-up in Tax Basis

As previously mentioned, the tax basis of each S-Corp shareholder is increased on a *pro rata* basis by taxable (and permanently non-taxable) income, and decreased by dividends or distributions. A C-Corp shareholder's tax basis remains at the original cost. To illustrate the potential advantage this poses to S-Corp shareholders, let us use the same two banks as in our previous scenario; however, in this analysis, we will assume that a C-Corp and an S-Corp bank were formed ten years ago, each having capital of $7 million and all of their original shareholders. Each year they have pre-tax income of $2 million and pay dividends of $1 million. Additionally, the S-Corp bank pays a distribution of $700 thousand (equal to the C-Corp's corporate tax

Shareholder Tax Basis: C-Corp vs. S-Corp

Assumptions:

(a) Original shareholder tax basis for both banks is $7 million
(b) Beginning capital for both banks is $7 million
(c) Both banks earn $2 million pre-tax
(d) Both banks pay dividend of $1 million
(e) C-Corp tax rate of 35%
(f) Individual shareholder tax rate of 35%
(g) Capital Gains / Dividends tax rate of 15%
(h) Sub S bank pays out additional dividends equal to the C-Corp's income taxes

(all $ amounts are shown in 000s)

		C-Corp	S-Corp
1	Original Shareholder Tax Basis / Beginning Capital	7,000	7,000
2	Pre-Tax Earnings	2,000	2,000
3	Corporate Taxes	700	0
4	After-tax Earnings[1]	1,300	2,000
5	Dividends / Distributions	1,000	1,000
6	Sub S Distribution Equal to C-Corp's Income Tax Expense	0	700
7	Retained Earnings Per Year[2]	300	300
8	*In operation for ten years (times 10)*	3,000	3,000
9	Ending Capital After ten years[3]	10,000	10,000
10	Change in Shareholder Tax Basis Per Year	0	300
11	*In operation for ten years (times 10)*	0	3,000
12	**Ending Shareholder Tax Basis[4]**	**7,000**	**10,000**

Notes:
[1]Line(2)-(3)
[2]Line(4)-(5)-(6)
[3]Line(1)+(8)
[4]For S-Corp Line(1)+(11)

liability) to cover the individual shareholders' tax burden on the bank's earnings. The result is $300 thousand added to the capital of both banks every year. However, in the case of the S-Corp, $300 thousand also will be added to the shareholders' tax basis each year. After 10 years, capital at each bank has increased to $10 million (the original $7 million plus 10 years of $300 thousand of retained earnings).

Now assume both banks decide to sell and they receive the same premium. Shareholders of the C-Corp will pay capital gains taxes on the premium above $7 million, whereas shareholders of the S-Corp will pay capital gains taxes on the premium above $10 million. As retained earnings are added to capital over time, an S-Corp shareholder's ending tax basis can be significantly higher than its original cost basis, resulting in huge tax savings—in this case, at the current capital gains tax rate of 15%, a savings of at least $450 thousand—no matter what the ultimate sale price. *The caveat here is the opposite of the one described earlier regarding the current taxation of ongoing income. The step-up in tax basis has greater value for the shareholders of a faster growing institution, which must retain a larger portion of its earnings to support its growth. Indeed, one might say that the S-Corp structure will "pay you now, or pay you later."*

For simplicity's sake, we will not go into all the complexities relating to tax exempt municipal income, but it is too important a subject to ignore altogether. First, most tax practitioners believe that the 20% TEFRA disallowance of interest expense incurred to carry municipal securities does not apply to de novo S-Corps or to former C-Corps three years after electing S-Corp status. Second, as we mentioned earlier, while tax-exempt income is not added to the pool of retained earnings available to be distributed to shareholders as a tax-free dividend (the pool is known as the Accumulated Adjustments Account on the Federal Tax Return, or "AAA"), tax-free municipal income is added to another pool of retained earnings, known as the "Other Adjustments Account" and does get added to the S-Corp shareholder's tax basis in the same manner as taxable income. Savvy S-Corp bankers, whether operating in a slow- or fast-growing institution, can optimize their tax-free income at a level which approximates the amount of earnings needed to be retained to support internal growth. By "sheltering" retained earnings, a bank avoids the prospect of "phantom" income—that is, income which passes through to the shareholders as taxable income, without sufficient cash distributions to cover the taxes. Obviously, this is particularly important for fast-growing, profitable institutions which need to retain a significant percentage of earnings to maintain capital adequacy.

Who is Eligible?

Despite the significant advantages outlined here, many institutions will never qualify to become S-Corps. We have already mentioned that the maximum number of shareholders an S-Corp may have is 100. The 2004 Tax Act raised the shareholder limit to 100 from 75. In addition, the 2004 Tax Act allowed family members for six generations (i.e., a common ancestor and his or her lineal descendants, including spouses and former spouses) to be counted as one shareholder. This provision made electing Sub S easier for financial

institutions. Many banks are family-run businesses in which several family members may be shareholders. By counting all family members as one shareholder, it opens the door for banks that otherwise would have been ineligible to make an S-Corp election.

Not all shareholders of C corporations are eligible shareholders of S corporations. For example, partnerships and C corporations are not able to hold the stock of an S corporation, and only certain trusts are valid shareholders.

The following are examples of acceptable shareholders of S corporation stock:

- Any individual, except a nonresident alien;
- Guarantor trusts;
- Testamentary trusts;
- Qualified Subchapter S trusts;
- Electing small business trusts;
- Certain IRAs/Roth IRAs (only to the extent the stock held by the IRA or Roth IRA was acquired on or before October 22, 2004 and the IRA beneficiary is an eligible shareholder);
- Certain other trusts;
- Certain tax-exempt organizations; and
- Employee stock ownership plans.

One S-Corp is not allowed to own another S-Corp. If a holding company is organized as an S corporation and it owns 100% of another corporation (i.e., a bank), the holding company will treat its subsidiary as a Qualified Subchapter S Subsidiary (QSub). In such instances, all the assets and liabilities of the QSub are treated as the holding company's rather than as a separate corporation for income tax purposes. If a bank is not 100% owned by an S corporation, it will be treated as a C corporation.

S corporations may only have one class of stock. As such, if a C-Corp is interested in making a Sub S election, it may have a difficult time if it has several classes of stock. For example, preferred stock is not an eligible form of stock. Certain arrangements can be made to allow other forms of stock, including voting and non-voting common stock, "Phantom Stock," stock appreciation rights, and certain forms of options and warrants; however, it can be difficult to structure such arrangements under Sub S guidelines. Trust Preferred Securities do not pose a problem for S-Corps, as they are considered debt and not capital, for tax purposes.

Built-in Gains Tax

To understand better the S-Corp merger and acquisition landscape, one must be acquainted with the concept of "built-in gains." When a C-Corp bank decides to convert to an S-Corp, it will generally have a valuation of its corporate assets performed as of the date of the Sub S election. The purpose of this valuation is to identify those assets that have built-in gains. A built-in gain is the difference between the fair market value of an asset and its tax basis on the effective date of the election to be an S-Corp.

An S corporation is subject to a 35% "built-in gains tax," usually referred to as the "BIG tax," whenever any asset which had an unrealized gain at the S-Corp election date is sold during the ten years following the effective date of the S-Corp election. The BIG tax is paid only on the lesser of the unrealized gain at the effective date of the S-Corp election or the actual gain realized. Incremental value appreciation after the election date is not taxed. The tax is paid by the S corporation, which passes a deduction for the tax through to the shareholders.

A bank is exposed to the BIG tax only during its recognition period. The recognition period lasts for ten years beginning on the effective date of the S-Corp election. In 2007, the first class of banks that converted to S-Corps in 1997 will pass their ten-year anniversaries. Experts predict a spike in M&A activity involving S corporations beginning in 2007, at which time double taxation disappears for the 1997 class of S-Corps.

De novo institutions that begin as S-Corps have no built-in gains. These institutions can be acquired in an "asset sale" or sell individual corporate assets without triggering a BIG tax. As such, more de novo institutions have been organized as S-Corps in recent years—a trend that is unlikely to abate, given the potential BIG tax liability if the change is made later.

Most practitioners advising banks considering an S-Corp election recommend that the bank obtain a valuation of its corporate assets as of the effective date of the S-Corp election. It is particularly important to obtain a valuation of the bank's intangible assets (i.e. core deposit value, goodwill, and other intangibles) and real estate. These are the assets most likely to result in a BIG tax if the bank is sold before the tenth anniversary. If a valuation is not completed at the time of conversion, a retroactive valuation may be needed in the future—a more difficult and expensive exercise.

The S-Corp M&A Landscape

For economic reasons, a buyer of an S-Corp generally would prefer to structure a transaction either as an asset purchase, or as a stock purchase, where a Section 338(h)(10) election is utilized (effectively treating a stock purchase as an asset purchase for tax purposes) rather than a straight stock purchase. Utilizing an asset purchase, the buyer is able to amortize the premium paid against its future taxable income over a 15-year period, resulting in a significant tax benefit. A stock purchase does not offer this tax benefit unless a Section 338(h)(10) election is used. However, it rarely would make sense for a C corporation to sell itself in an asset sale, as the entire premium above its tax book value would be subject to the full corporate tax rate—and that is before its shareholders incur capital gains taxes on the proceeds received. For a selling S corporation, determining whether or not to allow itself to be acquired as an asset sale prior to its ten-year anniversary is a function of weighing the buyer's additional tax benefit against the seller's additional BIG tax burden.

Let us assume that a bank with $30 million of net book value made an S-Corp election effective as of January 1, 2001, at which time it was determined that the fair market value of the bank was $50 million. The net built-in gain of the bank would be $20 million. If the bank were to sell in an asset sale prior to its ten-year mark, the resulting BIG tax would be $7.0 million (see diagram).

BIG Tax Example	
Net Book Value at 12/31/00	$30,000,000
Fair Market Value at 12/31/00	$50,000,000
Built in Gains	$20,000,000
BIG tax (35%)	**$7,000,000**

Subsequent Sale Prior to Ten-Year Anniversary	
Net Book Value at 12/31/05	$40,000,000
Acquisition Price at 12/31/05	$100,000,000
Net Premium above Book Value	$60,000,000
Present Value Tax Benefit of Amortizing Premium over 15 Years[1]	**$11,983,270**

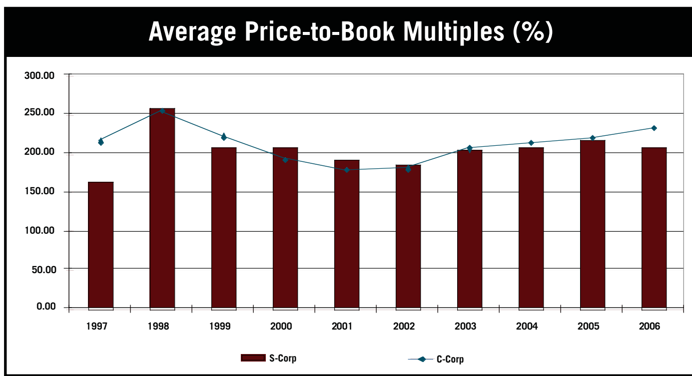
[1]Assumes 8% discount rate and 35% tax rate

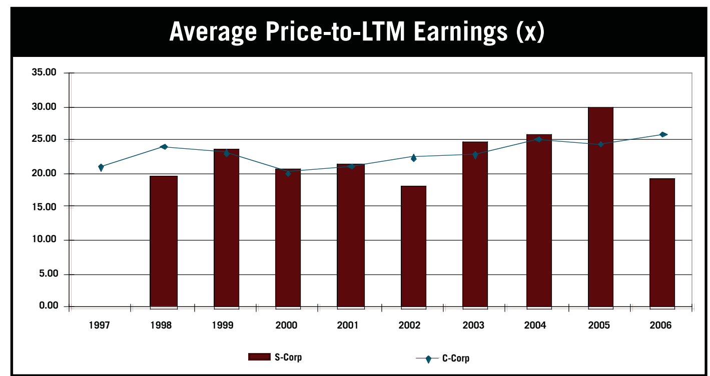
Using the example above, assume the bank sold in 2006 for 2.5x book value when its book value was $40 million. The $100 million purchase price would result in a $60 million premium. If the buyer structured the purchase using a Section 338(h)(10) election, the $60 million premium would be amortized over the next 15 years and result in a tax benefit to the buyer of approximately $12 million (assuming an 8% discount rate and a 35% tax rate). This benefit is significantly more than the S-Corp's BIG tax liability of $7 million ($20 million x 35%). A savvy seller will want a piece of that benefit, and the buyer likely will oblige. However, while the buyer may increase the purchase price on paper, the seller would most likely then be obligated to pay the BIG tax. Negotiating who receives the tax benefit and who absorbs the tax liability ultimately becomes a balancing act between the buyer and seller.

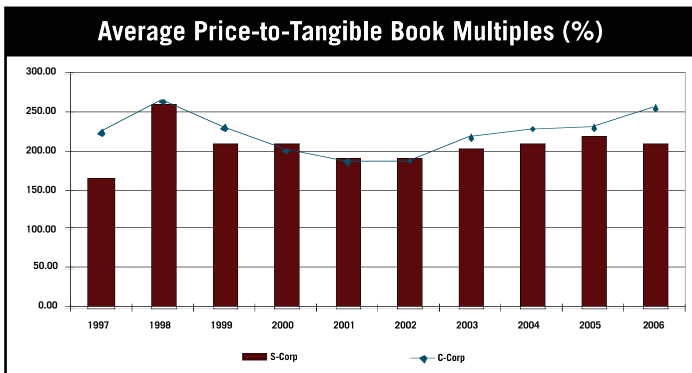
An S-Corp's ten-year anniversary is significant because, while the seller's BIG tax is eliminated, the buyer's tax benefit remains. Selling S corporation shareholders should be expected to share in the buyer's tax benefits, resulting in higher nominal deal values. For this reason, it is easy to see why many experts predict pricing multiples of S-Corp transactions to exceed those of C-Corps in 2007 and beyond, as more S-Corps pass the ten-year mark.

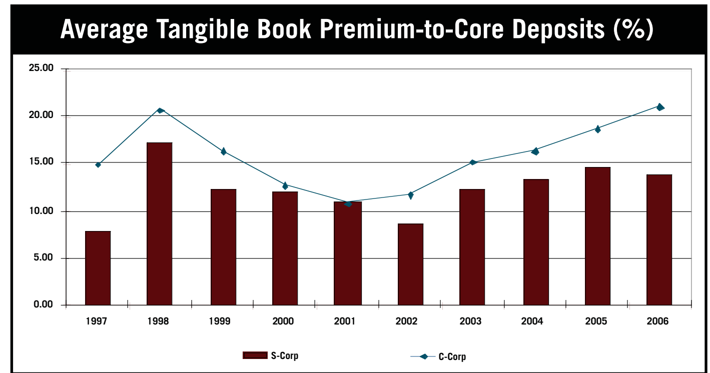
As illustrated in the previous example, however, it often can make financial sense to structure the sale of an S-Corp as an asset sale before the ten-year mark, provided the present value of the tax benefits to the buyer outweighs the BIG tax liability to the seller. For tax purposes, the optimal time to sell during the ten-year waiting period can be conceptualized as a continuum. The further away from the Sub S election date, the more likely the tax benefits will outweigh the BIG tax liability. On the other hand, the further away from the election date, the closer the S-Corp is to the ten-year mark when the BIG tax is eliminated altogether.

Since January 1, 1997, there have been 230 announced M&A transactions in which the selling company was an S corporation. During that same time, 2,660 C-Corp transactions have been announced. When we examine the average pricing multiples paid for banks and thrifts since 1997, there is no discernable difference in the premiums paid for C-Corps versus S-Corps (see charts). If anything, C-Corps have been sold for slightly higher premiums over the years. This may be misleading, however, since the stereotypical S-Corp bank is a smaller, family-owned bank in a rural marketplace. Generally speaking, small, rural banks sell for lower multiples than larger banks in metropolitan markets. Also, it is likely that a number of the announced S-Corp transactions were not structured as asset sales due to the potential for BIG taxes to the seller. It generally does not make sense to structure an S-Corp transaction as an asset sale soon after it converts because the BIG









Source: SNL Financial

tax liability likely will still be large. In such instances, the S-Corp transaction should be structured as a standard stock sale and would not warrant any additional premium paid by the buyer, since the buyer would not be able to amortize the premium as it would in an asset sale.

In 2007, we anticipate several of the S-Corps that converted in 1997 to consider selling, since their built-in gains tax liability will have been eliminated. In theory, in the next year we should notice a considerable difference in the premiums paid for certain S-Corps, as compared to comparable C-Corps. Transactions involving S-Corps that have passed their ten-year anniversary should almost always be structured as asset sales, because buyers will be able to amortize the premium paid over 15 years, resulting in a significant tax benefit, and sellers will not incur any BIG taxes.

Also a potential catalyst for heightened M&A activity next year could be the simple fact that pricing is at its highest level since 1998. For the 127 bank and thrift transactions announced in the first half of 2006, the average price-to-tangible book multiple was 2.5x and the average price-to-last twelve months earnings multiple was 25.4x. S-Corps crossing the ten-year mark in 2007, and currently contemplating a sale transaction can take advantage of the hot 2006 M&A environment with the intention of closing the transaction after January 1, 2007.

The Future of Sub S

Since the 2004 Tax Act loosened restrictions on banks converting to Sub S, we anticipate many more banks will either convert to S-Corps or be organized as S-Corps. In the first quarter of 2006 alone, there were 118 banks and thrifts that converted or began operations as S corporations.

While the 15% capital gains tax rate and dividend rate has lessened the relative advantage of S-Corps over C-Corps (by reducing the double taxation disadvantage of C-Corps), 15% is likely as low as it ever will be, and the advantage of S over C is as narrow as it likely ever will be. The elections in 2008 could be pivotal for maintaining the 15% rate. While Congress has extended the 15% rate through 2010, Congress could repeal it in 2008 if an election changes the party in control. Regardless of whether it is in 2008 or 2010, if the 15% tax rate disappears, the relative advantage of S-Corps will be significantly greater, and we could expect more S corporation conversions leading up to those years.

We anticipate the median asset size of S-Corp banks to continue to increase, as larger institutions begin to convert. In recent months, we have spoken with several institutions with $500 million+ in assets that are contemplating a conversion. While a conversion of that size institution may require a "squeeze-out" valuation to be performed and includes the risk of

potential litigation by disgruntled shareholders, many C-Corp Board members understand the potential after-tax benefit to shareholders that an S-Corp presents, and are willing to take the steps necessary to convert.

We also expect a growing number of S-Corp conversions in the Northeast and the West, where S-Corps historically have been scarce. The Midwest currently has the highest concentration: as of March 31, 2006, there were 3,944 banks and thrifts operating in the Midwest, of which 1,321 were S-Corps. As we noted previously, most S-Corps are smaller, family-owned banks operating in rural markets. Fewer banks fit that description in the heavily concentrated Northeast, where there are far fewer financial institutions relative to the region's population. However, we anticipate that S-Corps will become more popular in those regions, now that the qualifications for Sub S have been loosened.

Conclusion

The Subchapter S form of ownership has been a very valuable option for shareholders of banks and thrifts for nearly ten years. In 2007, the first class of banks that converted to Sub S will pass their ten-year anniversary and the potential for built-in-gains taxes will disappear. We anticipate next year's M&A market will heat up as many of these institutions contemplate a sale. If the transaction is structured properly, an S-Corp bank could command significantly more dollars than its C-Corp counterpart.

Hovde Financial has advised on more than 250 bank and thrift transactions since 1987, including several S-Corp transactions in recent years. We are quite familiar with the transaction structures that make financial sense for C-Corp and S-Corp banks and thrifts alike. If you would find it helpful to discuss in greater detail the factors affecting S-Corps or the current M&A environment in general, we would welcome the opportunity to meet with you. Please feel free to contact us in Washington, DC at 202.775.8109, in Chicago at 847.991.6622, in Los Angeles at 310.535.9200, or in Palm Beach at 561.279.7199.

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