
TAXATION FOR BANKS

Partnership/LLC Taxation for Banks: What are the benefits?

Historically, financial institutions have had minimal flexibility in determining their tax entity type. Until 1997, when banks were allowed to elect S corporation status, the only option was to be taxed as a C corporation. Current tax laws do not permit banks to organize and operate as an LLC. However, a provision in the “Communities First Act” (H.R. 1697), introduced to Congress in May 2011, contains a provision that would, if passed by Congress and signed into law by the President, allow banks to utilize the LLC structure, and thus have the option to be taxed as a partnership. The following broad overview is intended to highlight some of the differences between S corporations (prior to any proposed S corporation reform, as is also contained in the “Communities First Act” bill) and partnerships, from a tax perspective, should banks be given the opportunity to operate as an LLC.

When an entity operates as an LLC, the entity is allowed flexibility in determining its taxation structure. An LLC can elect to file its tax return as a C corporation, S corporation, partnership or sole proprietorship (if there is only one owner). This article will primarily focus on the difference between S corporations and LLCs electing to file partnership returns.

Some Advantages

S corporations and partnerships both require all items of income, deductions, gains and losses pass-through to investors annually on Schedule K-1s. S corporations are allowed only one class of stock and must allocate income to shareholders based on their respective percentages of ownership. Partnerships do not have limits on the classes of equity, and are able to make special allocations of distributable items to its owners who are not proportionate to ownership. Thus, allocations of income, gains, losses, etc., are much more flexible in a partnership than an S corporation.

Cash distributions, in both types of entities, are tax-free to the extent of basis, with some exceptions for S corporations that were formerly taxed as C corporations, which may produce taxable dividends if certain thresholds are exceeded. If appreciated property is distributed, partnerships generally provide more favorable tax results than corporations.

The Internal Revenue Code limits the type and number of investors in S corporations, whereas a partnership can have any number or type of investors (e.g., a partnership can have eligible IRA, C corporation and foreign owners, whereas an S corporation generally cannot). For banks looking to raise capital, the LLC structure opens the door to new equity that previously may not have been available.

In addition, a partnership provides a mechanism that allows a new investor to reap tax benefits from a purchase price which exceeds the tax basis of the proportion of the partnership’s assets that the partner purchased. For example, if a new investor paid \$1 million for a 25 percent share of a partnership, and the asset bases for 25 percent of the partnership’s assets were only \$750,000, that partner would be able to depreciate and receive tax deductions for the excess \$250,000; this is referred to as a “Section 754 election.” Basically, it matches the basis of a partnership’s assets to the “outside” partnership interest basis of the investor. This tax favorable mechanism is not available for investors of S corporations.

Certain banks may have shareholders with low or no stock basis. If shareholders are allocated losses on their K-1s, the shareholders may not be able to deduct the losses due to their lack of basis. S corporation shareholders can increase their basis by making personal loans to the corporation or injecting more capital, but cannot

include entity-level debt when computing their stock basis. Partnership owners can include entity-level debt when computing their basis for purposes of determining deductibility of K-1 losses, thus enhancing the ability of a partnership's owners to deduct pass-through losses.

Some Drawbacks

S corporation banks with less than \$50 million of average annual gross receipts are allowed to prepare their tax returns using the cash basis method of accounting. For partnerships with a business activity, such as banking, there generally is not a limitation on the use of the cash method in regard to the gross receipts of the business ... unless one of the partners in the business is a C corporation. In that case, use of the cash method is limited to average annual gross receipts of only \$5 million or less. Thus, the existence of a C corporation partner would significantly hamper the ability to use the cash basis method of tax accounting for a partnership.

Active owners in S corporations are paid W-2 wages and pay their shares of FICA and Medicare taxes on the wages they earn. If there are profits in excess of the W-2 wages paid, all of the shareholders pay income taxes on their distributable share of such excess. Active owners in LLCs are paid "guaranteed payments," rather than a salary, and are not issued W-2s. The active owner in the LLC/owner is treated as being self-employed. It is the LLC member's responsibility to remit both the employer and employee share of FICA and Medicare taxes on these guaranteed payments. Also for active LLC members, the K-1 earnings in excess of guaranteed payments passed through are subject to FICA and Medicare taxes in addition to income taxes. A passive member's LLC earnings are only subject to income taxes, not FICA and Medicare taxes.

Also, if an existing C or S corporation should decide to convert to an LLC structure and be taxed as a partnership, this would generally be treated as a taxable liquidation of the corporation. This means, a valuation of the business would be needed, and any resultant goodwill/premium would be taxed upon liquidation of the entity, and any

appreciation on assets would likewise be taxed as if all assets of the corporation had been sold in a taxable sale transaction. However, the "Communities First Act" contains a provision that would provide relief from the taxability of this deemed corporation liquidation.

The bill proposes that the deemed liquidation would not be taxable, but as an alternative, the partnership bank would be subject to the S corporation built-in gains tax rules going forward. Thus, any inherent gain on assets at the liquidation date would be taxed as a built-in gain at a later date when the asset is sold.

Should Congress pass the provision allowing eligible banks to be taxed as partnerships, a bank will have many factors to consider in determining whether this would be the optimal taxation structure. The restrictive limits on S corporations, such as the number and type of shareholders and single class of stock limitation, may cause some banks to consider the partnership tax structure.

Eide Bailly will continue to monitor the progress of this legislation and keep you informed of any opportunities it may present.

CONTACT

Please contact your Eide Bailly advisor to discuss how your organization might benefit from the new legislation.
