the sub S bank report

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From the President

Dear Sub S Bankers and Friends,

As I began preparing for the 25th Annual Subchapter S Bank Association Conference, I asked my friend and law school classmate Senator John Cornyn what is the most important thing we (as Sub S Bank owners) can do to maintain the status quo for S corporations. His answer was to let Senators Manchin and Sinema know the importance of the issues for Sub S Banks.

Of course we and many other constituencies had been working very diligently to do so since the Biden Administration and new Congress took office in January 2021 with significant plans to raise taxes, eliminate the benefit of being a Sub S or pass thru entity and create numerous other regulatory burdens on banks.

Fortunately we seem to have gotten past most of those risks and largely as a result of those two Democratic Senators though clearly the American public's opinion has influenced this direction significantly.

I was with Senator Cornyn recently at a Republican National Senatorial Committee breakfast he was hosting Senators Rick Scott (Fla.) and Tom Tillis (NC). They believe the status quo with respect to tax laws will remain and that their Democratic Colleagues Sinema and Manchin will continue to hold the line. In addition, they believe that the closer we get to the mid-terms, the less likely it is that the Democratic Congress will move forward with these type plans for fear of individual district and State backlash.

Despite this outlook, we strongly urge the Sub S Bank community to take every opportunity to speak to your Congressional representatives and remind them of the importance of making permanent Section 199A which provides the pass through benefits for S corps and other flow through business entities.

Very truly yours,

Patrick J. Kennedy, Jr.
April 4, 2022, San Antonio, Texas.

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FIGHT FOR S CORP FAIRNESS IN ECIP CONTINUES

The Association has continued to press for equality of treatment for S corp banks who qualified for the Emergency Capital Infusion Program as either a minority depository institution (MDI) or a community development financial institution (CDFI). Of the 101 ECIP recipients, 34 of those were S corps. Of the 34 S corps, 28 were qualified by the Treasury Department as CDFI's and the other 6 qualified as MDI banks, thrifts, credit unions and CDFIs who were awarded the nearly $9 billion of "emergency capital" under the legislation enacted in December 2020, (see Michael Finley's article in our May 2020 Sub S Bank Report HERE). approximately 34 are believed to have been taxed under Subchapter S.

In March 2021, the Federal Reserve requested comment from the industry on the application of its existing regulations and policies for bank holding companies with a particular view to those who were eligible to participate in the ECIP. The Association filed a comment letter in response strongly encouraging the Board of Governors to permit Banks to treat the Subordinated Debt instruments as Tier 1 capital and not to treat them as debt under the small bank holding company policy.

We have participated in numerous conference calls with affected Sub S bankers and the leadership of the Community Development Bank Association (CDBA) whose capable Washington DC staff has done a great job working with US Treasury on these issues. We have contacted numerous Federal Reserve officials including the Chairman of the Board of Governors, his General Counsel, and other senior staff about the issue. Despite all these efforts including the request for comments which we presume were overwhelmingly in favor of treating Sub S Banks on a par with C Corp banks participating in the ECIP, neither the Board of Governors nor senior Board staff has responded with any official relief or statement. As a result, we are aware of some Sub S banks who terminated their election as a result of this inaction. While we have no insight yet, it is also possible that a number of ECIP awardees may have limited their participation in the program as a result of this inaction.

We recently learned that some of the Reserve Banks were issuing waivers of the rules on a case-by-case basis; however, this result has not produced a comprehensive solution and has hindered Congressional intent behind this legislation which was designed to increase lending and capital access in low to moderate income communities.

The Association continues to work on this issue and as recently as last week joined in another letter to the US Treasury seeking relief and continuing to encourage a comprehensive and uniform solution from the Fed. That letter can be found HERE.

See recent letters below:

- March 1, 2022, letter can be found HERE.
- December 29, 2021, letter can be found HERE.

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Subchapter S Bank Report – 1st Quarter 2022

The Association held its 24th Annual Conference in person on October 21-22 in San Antonio last year. The usual impressive array of speakers during the 2 day conference warrants some significant attention and as such we are dedicating this 1st Quarter issue to summarizing the presentations by our outstanding speakers and panelists.

Each of the summaries contains a link to the Speaker's full presentation outline which in most cases contain good detail.

24th Annual Conference 2021

Succession and Estate Planning Strategies for the Sub S Shareholder

Dub Sutherland of Kennedy Sutherland provided an excellent presentation on Management and Board Succession Planning. He pointed to the significant cost to companies which failed to provide successful CEO succession planning and provided specific strategies to assure successful selection and transitions. He noted the importance of an engaged Board and Shareholder group, an early talent identification program and the need for a formal talent development plan which incorporates on the job training, coaching/mentoring and access to formal outsourced leadership programs. He provided a specific list of sub S specific tools to facilitate the development and retention of top management and board talent including compensation and long term value creation tools.

Aaron Hawthorn of RSM next provided a review of common estate and gift planning tools for the Subchapter S shareholder including gift strategies, generation skipping tax planning, and the use of grantor retained annuity trusts. He also surveyed the Administrations tax proposal changes and the significantly negative impact they could have on Sub S shareholders. While these now seem to be in our rear view mirror, reviewing these are a stark reminder of the Democrat Party proposals that will likely never go away. Some of these have reappeared in the President's recently announced budget.

See link to these presentations.

Information Technology Planning for Financial Institutions with Focus on Cyber Risiliency

Sundeep Bablani of CLA provided an excellent review of the risk financial institutions and their customers face with Cyber Security and Data compromise risk. He reviewed the importance of establishing a governance framework (which was also the detailed focus of the last speaker of the Conference whose presentation is linked here. Sundeep provided a detailed review of suggested Operational planning, Regulatory Issues and Concerns, Ransomware response and the importance of managing Cyber Risk and the important difference it can make in the preservation of shareholder value. See his full presentation here.

See Sundeep's full presentation here.

SkopeSM Overview Sub S Presentation

Doug Hogan of Full Skope did a great job articulating the benefits and use case of Full Skope's SkopeSM shareholder management product. The demo portion of the presentation was especially helpful to me in terms of visualizing the simple data import process. I was also pleased to see that the software allows for automated ACH payments in terms of processing shareholder distributions. Doug had complete command of the various product offerings and handled participant questions with ease and a pinch of humor to boot. Following this presentation I was curious to hear more about Full Skope's other product offerings such as its loan origination system.

See full presentation here.

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Investment Strategies for Sub S Banks

I learned so much listening to the trio of Randy Rouse (Retired Broadway Bank CIO), Elisabeth Vogel (Raymond James), and Dan Stimpson (Vining Sparks) discussing the latest in banking trends and investment strategies for Sub S Banks. Of particular value to me was the analysis Elisabeth presented demonstrating the cumulative income benefit to purchasing bonds now as opposed to waiting until rates increase before investing. Vining Sparks echoed that same sentiment during Dan's presentation as well. What an eye opener! It was truly a pleasure to be a fly on the wall as these three seasoned experts shared their insights into not only what's happening in the industry and financial markets but how best to strategically invest going forward.

See full presentation here.

Active Portfolio Management

Greg Roll of Vining Sparks provided an informative presentation on active loan portfolio management in a post-pandemic market. He reviewed the impact of the 2020 pandemic, including the current trends in loan growth, delinquencies, and margins. Greg gave an excellent overview of banks' strategies to protect their margins and create optimal returns. He focused on market expectations and provided an in-depth review of loan trading strategies to enhance portfolio performance.

His presentation contained detailed information on loan trading rates and yields for various types of lending including auto loans, RVs, mortgages, HELOCs and Lease pools. He described the benefits of selling loans and buying loans. He noted that there is significant demand from buyers and not enough supply.

See his full presentation here.

Intro to Data Governance and the Board's Role in Oversight

Jody Westby, CEO of Global Cyber Risk LLC provided an exceptional and eye-opening introduction to cyber threats, drivers of cyber risks, and the role management and executives of financial institutions play in the mitigation and management of such risks, beginning with the development of an internal governance framework. Jody went on to provide a sample governance structure that mapped out the important channels of communication between a financial institution's Board of Directors, executives, and upper management down to the institution's specialized officers. The presentation concluded with Jody's top 12 must-haves for financial institutions exercising proper cyber governance.

See Jody's full presentation here.

S Corporation – Employee Stock Ownership Plan (ESOP)

Alex Mounts of Krieg Devault, a long time participant in the Subchapter S Bank Association Conferences provided another excellent overview of the use of an ESOP in a subchapter S entity. An ESOP provides all employees a stake in the business but also provides a means of controlling not only the voting, but also the disposition of those shares. Alex explained the use of an ESOP as a succession planning vehicle for gradual transfer of ownership to the next generation or an outright purchase of the entire outstanding stock of a company by the ESOP. He noted that it can easily be combined with existing 401(k) plans, and underscored the fact that the ESOP's share of S corp income is not subject to tax and therefore accumulates tax free over time, creating an extremely valuable tool to build employee wealth in an S Corp. Alex also noted that an ESOP can instill a pride of ownership culture in an employee base, increasing their commitment and enthusiasm for the business, thereby increasing the value of the company as a result of that cultural shift and the inherent significant tax benefits.

Additionally, Alex presented an in-depth review of the characteristics of an ESOP and how to create a well-designed program. He explained how that there are a handful of key players in a plan and dispelled myths about the level of control that these players would have and myths about the effect an ESOP would have on a company. For example, the ESOP trustee would become involved in running the bank or that an ESOP would affect compensation rates and stock values. He provided an exceptional analysis on why these myths have no validity, and how a well-structured ESOP has many benefits not only from an employer perspective but also from an employee perspective.

See full presentation here.

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Tax Guidance for Sub S Community Banks

Mel Schwarz and Paul Sirek of Eide Bailly, LLP and Steve Cunningham of BKD, LLP gave a wonderful presentation full of helpful tax guidance for Sub S banks. They spent considerable time discussing the status of the Reconciliation Bill proposed by the House, new tax proposals contained in the Reconciliation Bill, and 2022 projected tax rates based of those proposals. They also discussed ways in which banks, and individuals who could be affected by estate tax changes, can begin planning in order to be better prepared in the event the Reconciliation Bill becomes law and provided a comparison highlighting the tax benefits of being an S Corp both under present law and the Reconciliation Bill's proposals. Fortunately, none of this has come to pass.

In addition to their discussion of new tax legislation, they discussed a number of other bank tax related topics including how banks should treat their loan costs, bond market discounts, strategies with regard to bad debts, fixed asset cost recover considerations, deductions for employer contributions to ESOPs and retirement plans. Each of these can be viewed in detail in their presentation which can be accessed through the below link.

See full presentation here.

Sub S Bank Hot Topics

Kevin F. Powers and Kathy Herbig of Crowe LLP delivered an outstanding expert panel discussion on hot topics pertaining to Subchapter S banks. Among other things, they provided insights as to how the Build Back Better Act's proposed changes would affect S Corps and C Corps, including (a) capping the overall 20% deduction from qualified business income under IRS rules at $500,000 for joint filers, which would apply to all such income generated by S Corps, and (b) the increase of the maximum tax rate to 26.5% for C Corps.

They also discussed important considerations when converting from an S Corp to a C Corp, and highlighted some of the current trends in the mergers and acquisitions landscape. For example, "F" reorganization transactions were more common for acquisition of non-bank S Corp targets, with the S Corp target becoming a single member limited liability company of a newly formed S Corp in the "F" reorganization. They further noted that many states have adopted pass-through entity tax legislation, and that election of pass-through entity taxation may require elections at both the entity and owner level, depending on the state.

A link to their presentation can be viewed here.

Use of Qualified/Nonqualified Plans for Sub S Banks

Ken Derks of NFP, a long time contributor to many years of Annual SubS Bank Association COnferences gave an informative presentation on compensation challenges that can occur amongst Sub-S Banks offering qualified or non-qualified plans. At the outset of his presentation, Mr. Derks supplied a graph outlining the most prevalent compensation challenges that these banks incurred in 2021, including recruiting and retaining sufficient personnel. Mr. Derks further provided attendees with information on the significant cost of losing a top producing loan officer or a key employee, as opposed to the relatively minimal efforts needed by the bank to retain those employees. The presentation further advised banks on the need to diversify their bank officers, such that multiple generations can be represented in the organization and the bank can receive sufficient perspective on the financial environment.

Allison Kaylor of NFP provided attendees with key considerations in establishing their benefit plans, such that their plans can serve the best interest of the plan participant, as well as the bank, and ensure that the fiduciary responsibilities of the bank are fulfilled. Next, Ms. Kaylor's presentation addressed specific plan components and analyzed the advantages and disadvantages of offering these provisions to their banking organization.

See link to these presentations.

A New Approach for Growth

Jeffery Kendall, Chairman and CEO of Nymbus gave a presentation on an innovative approach to the world of banking which incorporates advanced banking software and technology into the traditional structure of a community bank. The presentation outlined the benefits that the use of Nymbus by these banks can produce, as well as the challenges that all financial technology companies face in the industry. Mr. Kendall provided attendees with a new perspective on how the banking industry can operate and thrive in today's market. Mr. Kendall then engaged in a conversation with Royce Itschner, President and Chief Operating Officer of

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TransPecos Banks, which has been working with Nymbus for nearly 4 years. With Nymbus and its own affiliate Full Skope, LLC, the Bank launched its BankMD(c), its digital brand focused on the credit needs of doctors. Mr. Itschner and Kendall discuss the recent conversion of TransPecos' entire core banking system to Nymbus, which may be one of the first banks in the United States to make a complete (hard) conversion to the new 3rd generation cloud based core banking systems.

See link to these presentations.

First De Novo Subchapter S thrives

by Patrick J. Kennedy, Jr.

"*Without Chairman Dr. James Bolen attending the Subchapter S Conference and myself the subsequent year we probably would not have had the confidence to choose the Subchapter S bank charter business plan. It was the right decision for our shareholders, executive management, and employees. Including an ESOP component also created a long term compensation benefit for all our employees.*"

— David Dotherow, CEO, Winter Park National Bank

We recently had a visit with our friends in Winter Park Florida just outside of Orlando who chartered the first de novo subchapter S bank in August 2017 — which also was the first new national bank that was chartered since 2008. They had finished their 4th year of existence in a great position and were very optimistic about continuing their success. We met their Chairman and principal shareholder Dr. James Bolen and his wife at the Subchapter S Bank Conference in September 2016 and he related how he was considering chartering another de novo bank in the Orlando area but this time he did not want to build it up and sell it. Rather he was interested in creating a long term investment for his family and those of the other organizers and shareholders with whom they had previously had three other successful area de novo banks.

We discussed our efforts in Washington to encourage the FDIC to lift its implicit ban on de novo institutions which had been in place since 2008. We also discussed the opportunities of chartering the new bank as an S corp from the beginning. Later that year we met with Dr. Bolen and some of the key players with whom he had worked previously. Importantly David Dotherow, President and CEO was among the group and this introduction led to a series of meetings over the next few months in which we helped strategize and plan the details of the new bank.

The prep work included a meeting in Washington DC at the FDIC and OCC during which Dr. Bolen, David Dotherow and other key players were able to meet with the Director of Supervision at the FDIC and other senior staff and come away with the conviction that a de nova bank was again possible and that it could be organized as an S corp from the beginning.

As of December 31, 2022, Winter Park National Bank reported total assets just over $797 million, total capital of roughly $45.7 million against the original capital raise of $38.5 million and net income of $7.8 million.

As a Subchapter S Bank, we were able to take advantage of the unique benefits an S corp election provides for an ESOP. Winter Park National may be the first ever de novo bank that had an ESOP as one of its initial shareholders. This permitted each employee the opportunity to roll over existing retirement funds into the new ESOP and use those funds as initial capital for the new bank. The opportunity was available to all employees on a one time basis and most took the opportunity to invest. Now that the Bank has been paying dividends on its stock the ESOP accumulates cash tax free, providing a significant benefit for employee-participants.

Kennedy Sutherland LLP served as counsel to Winter Park in its chartering process and organization and is very proud of the Bank's accomplishments!

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SAVE THE DATE FOR THE
2022 ANNUAL CONFERENCE!

Join us for the only conference built exclusively for S Corp banks with S corp professionals who will share their experiences & knowledge on not just the "what" and the "why," but the "how."

REGISTER

Date: **October 20-21, 2022**
Location: **The Westin Riverwalk in San Antonio**

For More Information:
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