While most banks and their directors are generally aware of the tax benefits of an S election, there are some potential disadvantages. One disadvantage is the potential for S elections to encounter additional volatility to the equity account and lower capital ratios relative to C corporations when losses are incurred (all else equal).

When banks are profitable, the impact of the tax election on equity for S and C corporation banks is relatively muted as both pay out a portion of earnings to cover taxes either in the form of a direct payment of the federal tax liability as a C corporation or in the form of a cash distribution to shareholders to cover their portion of the tax liability as an S corporation. However, S corporations are typically limited relative to C corporations in their ability to recognize certain tax benefits when losses occur. The equity accounts of most C corporations benefit from the ability to recognize tax loss carrybacks and deferred tax assets following the occurrence of losses, which serve to soften the direct impact of the loss on capital. S corporations are generally precluded from any tax benefit after the recognition of losses and the resulting loss is directly deducted from equity. A few nasty quirks of book and tax income can make the situation even worse for shareholders and the S corporation bank.

To help illustrate the point further, consider the following example which details how losses realized as an S corporation can flow directly through to equity without the tax benefit recognized by a C corporation. As detailed below, the capital account of the S corporation was impacted more adversely following the recognition of losses than the C corporation (all else equal).

<table>
<thead>
<tr>
<th>Bank Perspective</th>
<th>C Corp</th>
<th>S Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Troubled Bank</td>
<td>Troubled Bank</td>
</tr>
<tr>
<td>Pre-Tax Loss</td>
<td>(4,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Est. Tax Benefit</td>
<td>35.0%</td>
<td>1,400</td>
</tr>
<tr>
<td>Net Income (Loss)</td>
<td>(2,600)</td>
<td>na</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Impact on Equity</th>
<th>C Corp</th>
<th>S Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Equity Capital</td>
<td>8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Net Income (Loss)</td>
<td>(2,600)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Ending Equity</td>
<td>5,400</td>
<td>4,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Equity/Asset Ratio</td>
<td>5.4%</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

FIGURE ONE

In a recent survey of bank transaction activity nationwide conducted by Mercer Capital, we noticed some evidence of this disadvantage surfacing among S corporation banks. Of transactions (whole bank sales) involving target banks with assets between $100 million and $1 billion announced
since June 30, 2008, the majority of S corporation banks sold were distressed, defined as either having non-performing assets as a percentage of assets greater than 3.0% (three out of four transactions involving S corporation targets) or reporting a loss in the most recent year-to-date period (two out of four transactions involving S corporation targets). This trend is illustrated more fully in the chart below and is notable especially when compared to transaction activity of C corporations over this period.

We found some additional evidence that S corporation banks may be experiencing the detrimental impact of additional capital volatility in a review of bank failures. Of 8 total S corporation bank failures since 1998, five have occurred since January 1, 2008, with three occurring since December 1, 2008.

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While it is too early to tell whether this evidence of increased transaction activity and failures among distressed S corporations is purely a coincidence or early indications of an emerging trend of capital volatility for S corporation banks, this analysis prompted a number of questions:

» Should a conversion to a C corporation be considered by an S corporation prior to recognizing losses?
» Should a conversion to a C corporation be considered even if no immediate losses are expected as a matter of conservatism?
» Should the exploration of acquisition possibilities by S corporations be accelerated prior to recognizing losses so that a C corporation buyer could recognize any tax benefits potentially unavailable to the S corporation or its shareholders?
» Should S corporations be managed more conservatively than C corporations given the added potential for volatility in the capital account?
» Should an increase in merger and recapitalization activity, bank failures, or conversion back to C corporations among troubled S corporation banks be expected for the remainder of 2009 and beyond?
» Do the shareholder limitations of S corporations limit their ability to raise capital, thereby forcing a distressed S corporation bank to pursue merger partners when substantial losses arise?

If your bank is dealing with any of these issues, feel free to give us a call to discuss the situation confidentially.

“... it is too early to tell whether this evidence of increased transaction activity and failures among distressed S corporations is purely a coincidence or early indications of an emerging trend of capital volatility for S corporation banks.”
Valuation issues intersect with a bank’s affairs more often than you may imagine, and they are likely to arise during your tenure as a director or manager. These valuation issues might include merger and acquisition activity, an employee stock ownership plan, capital planning, litigation, or financial planning, among others. Mercer Capital has been working with financial institutions for over 25 years and has provided valuation and other financial consulting services to thousands of clients. We find that most of our clients have the same basic questions about these important valuation issues. This handbook is written to address many of these questions and to provide useful information for bank directors and managers when valuation needs emerge.

SECTION ONE: INTRODUCTION TO VALUATION
Chapter 1: The Valuation Process
Chapter 2: Core Valuation Concepts
Chapter 3: Financial Management & Performance Measurement

SECTION TWO: COMPENSATION & EMPLOYEE BENEFIT PLANS
Chapter 4: Employee Benefit Plans
Chapter 5: Stock Options, Restricted Stock, & Stock Appreciation Rights

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Chapter 6: Estate & Gift Tax Issues
Chapter 7: Raising Capital
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Chapter 12: Sub-Chapter S Conversions

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Chapter 14: Fair Value Accounting In Business Combinations
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Chapter 16: A Primer on Litigation
Chapter 17: Statutory Fair Value
Chapter 18: Divorce of a Key Shareholder

SECTION SEVEN: CONCLUSION
Addendum: The Capital Purchase Program (CPP)
Addendum: IRS Provides New Tax Incentive for Banks

THE BANK DIRECTOR’S VALUATION HANDBOOK
What Every Director Must Know About Valuation

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Addendum: The Capital Purchase Program (CPP)
Addendum: IRS Provides New Tax Incentive for Banks
The Troubled Asset Relief Program (“TARP”) became law on October 3, 2008, and was intended to address solvency concerns among banks. However, as market conditions continued to deteriorate, the implementation of the TARP changed. Realizing that repurchasing assets was unlikely to restore confidence in banks’ solvency, the Treasury’s priority shifted from repurchasing illiquid assets to direct investments in financial institutions. Over the weekend of October 10, 2008, the Treasury held meetings with the heads of the largest U.S. financial institutions, which led to the issuance of $125 billion of preferred stock by these institutions to the federal government. The government then announced that all U.S. financial institutions could apply for the program on similar terms. Thus, the Capital Purchase Program (“CPP”) was born.

The CPP has the potential to change the banking landscape for years to come. This handbook covers a number of topics related to the CPP, including the activity to date in the program, the advantages and disadvantages of participating, accounting issues raised, and the actual cost of the preferred stock after factoring in the warrants. While this handbook covers issues applicable to all banks, we specifically directed our analysis to privately held banks for several reasons. First, while many analyses of the CPP have been prepared, we have found little guidance intended for privately held banks. Second, participation in the CPP by privately held banks creates issues that are not faced by publicly traded banks, and we address these issues in this handbook.

Contents

INTRODUCTION

OVERVIEW OF THE CAPITAL PURCHASE PROGRAM
   Terms of Capital Purchases in Public Financial Institutions
   Modified Terms for Private Financial Institutions
   Applying for CPP Funds

ACTIVITY TO DATE

ISSUES FOR PRIVATELY HELD BANKS
   Advantage #1 – Dividend Rate
   Advantage #2 – Accessibility
   Advantage #3 – Offensive and Defensive Applications
   Disadvantage #2 – Restrictions on Use and “Legislative/Regulatory Risk”
   Disadvantage #3 – Restrictions on Dividends and Compensation
   Disadvantage #4 – S Corporation Issues
   Mixed Advantage/Disadvantage – Community Reaction

VALUATION ISSUES

ACCOUNTING ISSUES

EFFECTIVE COST OF CAPITAL FOR PRIVATE BANKS
Tagging a text with the label “classic” should not be done carelessly. But 50 years after its initial release, few would disagree that Revenue Ruling 59-60 deserves the title. Written in the spare, unadorned style of a government publication, the Ruling is a compact storehouse of enduring practical wisdom for business appraisers and the users of appraisal reports.

Our purpose in writing this book is twofold: first, to offer a guided tour through the Ruling, pointing out some of the most prominent features of the landscape (and providing the occasional warning about rough terrain); second, to pull back the curtain a bit, granting a non-technical view of how appraisers (at least this group) attempt to translate the guidance found in the Ruling into actual valuation engagements.

Published in January 2009, this 120+ page book is written for attorneys and other users of business appraisal reports. Order your copy today.

Chapter List

Chapter 1  A Summary of Revenue Ruling 59-60 from a Business Appraiser’s Perspective
Chapter 2  Fair Market Value Versus The Real World
Chapter 3  What Revenue Ruling 59-60 Means for Operating Companies
Chapter 4  Revenue Ruling 59-60’s Application to Asset-Holding Entities
Chapter 5  The Growing Influence of Intangible Assets
Chapter 6  Selecting a Business Appraiser
Chapter 7  Landmark Tax Court Cases
Appendix A  Revenue Ruling 59-60
Appendix B  Court Case Bibliography
Appendix C  The National Economy in 1959
We are responding to requests to put this 1992 book back into print and we are publishing it as an e-book.

Valuing Financial Institutions

An e-booklet that adds to the S Corp vs. C Corp debate.

Embedded Capital Gains

A closer look at the Embedded Capital Gains issue.

Rate & Flow: An Alternative Approach to Determining Active/Passive Appreciation in Marital Dissolutions

In this e-book, we present an alternative model for determining active / passive appreciation in a marital dissolution.

QMDM Fact Sheet

The latest information about the QMDM in a pdf format.

Visit our website at www.mercercapital.com for more information or to download an e-book.

Understand the Value of Your Local Exchange Carrier

Over the past decade, the telecommunications industry has been characterized both by rapid innovation and obsolescence. Whether through selling, acquiring, divesting, or any other major strategic change, it is important to realize the value of your telecommunications company as it stands today.

Understand the Value of Your Electrical Distributorship

Electrical equipment wholesalers operate in a highly fragmented industry, consisting largely of family-owned business with a few locations within a relatively close proximity. This article provides insight into the situational (when and why) and analytical (how) aspects of valuing electrical distributors.

Understand the Value of Your Start-Up Business

Valuation for start-up enterprises can be a tricky proposition. Regardless of industry, start-ups generally share a common set of operational characteristics and valuation needs that are distinct from mature firms. This article discusses the different valuation considerations relevant to start-up companies.

Understand the Value of Your Independent Trust Company

Due to their variance in size, there is no one-size-fits-all definition of an independent trust company, and recognition of the particular attributes of independent trust companies is significant to understanding their value.

Understand the Value of Your Brick Business

This article provides an informative overview regarding the valuation of businesses operating in the brick industry, including a discussion of value as it relates generally to both manufacturers and wholesalers, as understanding how brick businesses are valued may help you understand how to grow the value of your business.

Understand the Value of Your Insurance Brokerage

For the past several years, insurance brokerages have been in a period of consolidation, and the current soft market is expected to persist for at least the near term. As such, it is an opportune time for business owners to have an idea of what their brokerage business is worth.

Understand the Value of Your Physician Practice

The event that triggers ownership transfer can be categorized as either voluntary or involuntary. It is important for physicians to consider the universe of ownership transfer possibilities, because sooner or later, you will be involved.

Understand the Value of Your Wholesale Distributorship of Malt Beverage Products

The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. It is critical that value be determined and articulated in a credible fashion.
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- » Valuation for Corporate Income Tax Issues
- » Valuation for ESOPs
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- » Valuation of Employee Options
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