



# OCC ADVISORY LETTER

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Comptroller of the Currency  
Administrator of National Banks

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Subject: Buy-Sell Agreements between  
Subchapter S Corporations and  
National Bank Directors

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**TO:** Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel

## PURPOSE

This advisory letter is intended to refer national banks, especially community national banks, that seek to qualify as Subchapter S corporations for federal tax purposes to an Internal Revenue Service ruling that may be relevant to them.

## BACKGROUND

The Internal Revenue Service (IRS) issued a private letter ruling that may be of interest to national banks and bank holding companies that seek to qualify, or continue to qualify, as Subchapter S corporations for federal tax law purposes.<sup>1</sup> The IRS private letter ruling responds to an inquiry from a bank holding company about an agreement between the holding company and the directors of its subsidiary bank (the Directors Agreement).<sup>2</sup> The IRS Letter discusses how the Directors Agreement may have affected the ability of the bank holding company to qualify as a Subchapter S corporation. In particular, the IRS Letter discusses how the Directors Agreement may have resulted in the bank holding company having more than one class of stock, which under federal tax law would have disqualified the holding company from being treated as a Subchapter S corporation.

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<sup>1</sup> A Subchapter S corporation generally is treated as a “conduit” for tax purposes. The net income or loss of a Subchapter S corporation is passed through to the corporation’s individual shareholders, who include it in their individual tax returns. Subchapter S status results in corporate earnings being taxed only once, rather than being taxed twice like the earnings of other corporations, which are taxed once at the corporate level and then taxed again at the shareholder level when the earnings are distributed as dividends. *See* 26 USC 1361 *et seq.*

<sup>2</sup> Priv. Ltr. Rul. 2002-17-048 (Jan. 24, 2002)(the IRS Letter). The IRS Letter is available on the IRS Internet Website at <http://www.irs.gov/pub/irs-wd/0217048.pdf>.

## DISCUSSION

The IRS Letter is of particular interest to community national banks and their holding companies. These entities often seek Subchapter S status and could have buy-sell agreements similar to the Directors Agreement. Under 12 USC 72, directors of national banks must own “qualifying” shares. This statutory qualifying share requirement is designed to ensure that national bank directors will have sufficient interest in their bank to induce them to be vigilant in protecting the bank’s interests.

Under section 72, a national bank director generally must own a qualifying equity interest of \$1,000 in the stock of a national bank or its holding company. In an interpretive ruling, the OCC has stated that the qualifying equity interest may include common or preferred stock that has an aggregate par value of \$1,000, an aggregate shareholders’ equity of \$1,000, or an aggregate fair market value of \$1,000. The value of the qualifying interest is determined as of the date purchased or the date on which a person became a director, whichever value is greater.<sup>3</sup> The OCC also has endorsed legislation that would amend section 72 to enable the OCC to allow a national bank director to satisfy the qualifying share requirement by holding a subordinated debt instrument that would not be treated as a separate class of stock for Subchapter S purposes.<sup>4</sup>

Under Subchapter S, a small business corporation can have no more than 75 shareholders.<sup>5</sup> In order to limit the total number of shareholders to no more than 75, qualifying shares sometimes are subject to buy-sell agreements that require a director to sell back the shares on specified terms upon ceasing to be a director. These agreements sometimes also provide that all dividends and other distributions from qualifying shares received by the director will be returned. These agreements and similar arrangements involving qualifying shares may, depending on their specific terms, affect the ability of a national bank or its holding company to qualify as a Subchapter S corporation. National banks and their holding companies that have elected Subchapter S treatment, therefore, should review their qualifying share arrangements for compliance with all applicable IRS requirements.

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<sup>3</sup> See 12 CFR 7.2005.

<sup>4</sup> See Financial Services Regulatory Relief Act of 2002, H.R. 3951, 107<sup>th</sup> Cong. 101.

<sup>5</sup> 26 CFR 1.1361-1(b)(1)(i).

## General Description of Relevant IRS Regulations

Under Subchapter S of the IRS Code,<sup>6</sup> a corporation may have only one class of stock outstanding.<sup>7</sup> A Subchapter S corporation is treated as having only one class of stock outstanding if all the shares confer identical rights to distribution and liquidation proceeds.<sup>8</sup> A bona fide buy-sell agreement is generally disregarded for purposes of determining whether a corporation's outstanding shares confer identical rights to distribution and liquidation proceeds. However, the buy-sell agreement is not disregarded if, among other things, the agreement establishes a purchase price that, at the time the agreement is entered into, significantly deviates from the fair market value of the stock. As indicated in the IRS Letter, buy-sell agreements "that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a purchase price that is significantly in excess or below the fair market value."<sup>9</sup>

## Facts of the IRS Letter

As indicated above, the IRS Letter involved a bank holding company that sold shares of its stock to the directors of its subsidiary bank subject to a buy-sell agreement.<sup>10</sup> The Directors Agreement provided that each director of the national bank would sell his or her shares back to the holding company for the same price for which the director had purchased the shares upon the director ceasing to hold the office of director. The Directors Agreement also provided that each director would assign to the holding company all dividends and other distributions on the shares. Sometime after putting in place the Directors Agreement, the holding company became concerned that the terms of the agreement may have inadvertently resulted in the creation of a second class of stock that would disqualify the holding company for Subchapter S treatment. The holding company, therefore, amended the Directors Agreement to: (1) provide that the bank holding company would repurchase the shares at their fair market value and (2) eliminate the requirement that the directors assign dividends and distributions back to the bank holding company. The IRS Letter indicates that the amended Directors Agreement did not create a second class of stock.

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<sup>6</sup> 26 USC 1361 *et seq.*

<sup>7</sup> 26 USC 1361(b)(1)(D).

<sup>8</sup> 26 CFR 1.1361-1(l)(1).

<sup>9</sup> IRS Letter (citing 26 CFR 1.1361-1(l)(2)(iii)).

<sup>10</sup> The IRS Letter also is relevant to situations involving a national bank that does not have a holding company. Such a bank could also seek to qualify for Subchapter S treatment and have a qualifying share arrangement similar to the one described in the IRS Letter.

## CONCLUSION

As a private letter ruling, the IRS Letter is expressly nonprecedential and nonbinding upon the IRS.<sup>11</sup> National banks should recognize, however, that its reasoning could be applicable to their situations. Accordingly, a national bank that has a qualifying share arrangement similar to the one described in the IRS Letter may wish to consult competent tax counsel to ensure that the arrangement fully complies with all applicable federal tax requirements.

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<sup>11</sup> See 26 USC 6110(j)(3).