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LEGAL ALERT

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Strategic Planning: Uncertainty Over the Bank Shares Tax Should Have You Thinking About Converting to a Pennsylvania State-Chartered Savings Bank

As you continue to engage in strategic planning over the course of this year, one of the issues that most concerns state- and federally-chartered commercial banks is the ongoing debate in Pennsylvania government over the future of the Bank and Trust Company Shares Tax (the "Shares Tax"). If you are a member of the Pennsylvania Bankers Association or the Pennsylvania Association of Community Bankers, you are receiving communications and calls to action on a frequent basis regarding Governor Wolf's proposal to raise the Shares Tax rate from 0.89% of the book value of total bank equity capital to 1.25% of the book value of total bank equity capital retroactive to January 1, 2014. Obviously, such an increase in the Shares Tax rate would have a significant effect on your bottom line.

You may have a bank competitor down the street or in the next town that does not seem to be too worried about the Shares Tax issue. The reason may be that the bank competitor is already a savings bank and is not subject to the Shares Tax.

We have been analyzing this issue over several months and have reached the following conclusion: **now more than ever, it makes sense for commercial banks - whether Pennsylvania state-chartered banks or national banks - to consider converting to the Pennsylvania stock savings bank charter regulated by the Pennsylvania Department of Banking and Securities (the "Department")**.

This conclusion is based upon the following factors:

- It is highly unlikely that there will be favorable changes to the Shares Tax in the near future.
- A conversion to a savings bank charter will allow a bank to become taxed under the Mutual Thrift Institutions Tax (the "Thrift Tax"), which will cause a significant reduction in a bank's Pennsylvania corporate tax liabilities going forward.
- Changes to the Banking Code of 1965 (the "Banking Code") that became effective in December of 2012 (the "2012 Amendments") have made the savings bank charter equal to and possibly better than the bank charter in terms of powers.
- There is no discernable "downside" to converting to a savings bank from a business model and operations perspective.

<u>The "New" Pennsylvania Savings Bank Charter</u>

Although three years have elapsed since enactment of the 2012 Amendments, the changes to the Pennsylvania savings bank charter are still relatively "new" in the eyes of most. Many people still are not aware that, with the 2012 Amendments, **the Pennsylvania savings bank charter now has exactly the same lending powers as the Pennsylvania bank charter**.

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Section 506 of the Banking Code, which is the lending provision for savings banks, states that:

> A savings bank may *lend money, extend credit and discount or purchase evidences of indebtedness and agreements for the payment of money pursuant to section 303 of this act* and acquire and lease personal property pursuant to a binding arrangement for the leasing of such property to a customer upon terms requiring payment to the savings bank, during the minimum period of the lease, of rentals which in the aggregate will exceed the total expenditures by the savings bank for or in connection with the acquisition, ownership, maintenance and protection of the property.

7 P.S. § 506 (emphasis added). Section 303 of the Banking Code was completely rewritten as part of the 2012 Amendments to simplify the lending restrictions for banks, including by eliminating interest rate and fee caps and providing a "super-most-favored-lender" provision which allows Pennsylvania banks to lend money "at any interest, finance charge, rate or terms permitted for any other financial institution or any other lender regulated by any State or Federal supervisory authority on the specified class of loan." *See* 7 P.S. § 303(b)(i). Thus, **Pennsylvania state-chartered banks and savings banks can now lend money on terms available to any bank or non-bank lender in the country** that is subject to state or federal regulation, without the need for a parity application under Section 201(c) of the Banking Code.

In addition to this virtually unlimited consumer and commercial lending ability, a savings bank has:

- The same loans-to-one-borrower limitations that a state-chartered commercial bank operates under, pursuant to Section 516 of the Banking Code, which mirrors Section 306 of the Banking Code applicable to banks;

- Expanded investment authority under Section 504 of the Banking Code as compared to the provisions currently available to state-chartered commercial banks under Sections 307 and 311 of the Banking Code;

- All of the general powers under the Banking Code currently available to state-chartered commercial banks, such as corporate governance, bank premises investments, branching, mergers and acquisitions and parity authority; and

- No requirement to have the word "savings" in its corporate name, as the 2012 Amendments removed that requirement for savings banks.

If there were a particular bank power that is not specifically available to a savings bank under the Banking Code that a bank would wish to have going forward,[1] a bank could either file a parity notice under Section 201(c) of the Banking Code at the time of conversion to a savings bank in order to obtain all miscellaneous powers available to a national bank or simply file a parity notice as the need arises.

<u>A Pennsylvania State-Chartered Savings Bank is Not Required to be a Qualified Thrift Lender Under Federal Law</u>

Federal savings associations are required to be a "qualified thrift lender" under federal law, which requires that at least 65% of the federal savings association's investments must be in qualified thrift investments, which are essentially residential mortgages and small business loans.[2] **A Pennsylvania state-chartered savings bank would not be required to be a qualified thrift lender under federal law, unless the savings bank is under a holding company that has elected to become a savings and loan holding company** rather than a bank holding company. [3]

Furthermore, unlike the restrictions on federal savings associations, [4] **a Pennsylvania state-chartered savings bank has no restrictions on the amount of commercial lending it may do**, other than loans-to-one-borrower limitations.

[2] 12 U.S.C. § 1467a(m).

[3] 12 U.S.C. §§ 1467a(1)(A) and 1467a(l).

[4] Generally, federal savings associations are limited to making commercial loans in aggregate amounts of up to 20% of total assets, provided that amounts in excess of 10% of total assets may only be used for small business loans. 12 U.S.C. § 1464 (c)(2)(A).

No Change to Assessments Payable to the Department

In terms of the semiannual assessment payable to the Department, savings banks are assessed by the Department on the same scale as commercial banks, so **a bank converting to a savings bank would pay the same semiannual assessment to the Department**. *See* 10 Pa. Code § 5.2. For a national bank, conversion to a Pennsylvania state-chartered savings bank would result in an approximate 50% reduction in annual assessments as compared to what a national bank pays to the Office of the Comptroller of the Currency ("OCC").

Savings Banks are Subject to the Thrift Tax

The Shares Tax and the Thrift Tax are the only Pennsylvania corporate taxes that are applicable to banks and savings banks. As mentioned above, **a savings bank is subject to the Thrift Tax, not the Shares Tax, which can yield significant savings in a bank's Pennsylvania corporate taxes**.

The Thrift Tax applies to "[e]very: (1) savings bank without capital stock; (2) building and loan association; (3) savings and loan association; and (4) *savings institution having capital stock*." 72 P.S. § 8501 (emphasis added). As a "savings institution having capital stock," a commercial bank as a converted stock savings bank would be subject to the Thrift Tax. The Thrift Tax applies a rate of 11.5% to the net earnings or income received or accrued from all sources during the tax year.[5] Income earned from United States obligations or Pennsylvania state and local obligations is excluded from the computation of net earnings on income. Additionally, no deduction is permitted for the amount of interest expense related to tax-exempt income. Apportionment of income to Pennsylvania is permitted through payroll, receipts, and deposits factors, and institutions subject to the Thrift Tax are permitted to carry forward net operating losses for a maximum of three years.

[5] 72 P.S. § 8502(a).

Even under the current Shares Tax rate of 0.89% of the book value of total bank equity capital, as a bank grows, the disparity between a bank's Shares Tax liability and Thrift Tax liability will only continue to grow. Should the Shares Tax be increased to 1.25% of the book value of total bank equity capital as proposed by Governor Wolf's budget submission, the disparity would become drastic.

The Pennsylvania Department of Revenue issued a statutorily-mandated report regarding the Shares Tax in January 2015 that, among other things, identified the incongruity between banks paying the Shares Tax and stock savings banks paying the Thrift Tax and recommended fixing the issue by requiring stock savings banks to pay the Shares Tax. However, Governor Wolf's budget proposal, and discussions in the General Assembly surrounding the Shares Tax issue to date, do not include this "fix." Given the historical propensity of the General Assembly to only address amendments to Pennsylvania's tax laws during budget season, it does not appear that this "fix" will occur anytime soon, if at all. **Even if such a "fix" is enacted, a bank converting to a savings bank may benefit from several years of reduced taxation under the Thrift Tax with no change in business model or operations**.

Federal Charters Do Not Offer the Same Benefits as the Pennsylvania Savings Bank Charter

Among the charter types available to a bank, **the Pennsylvania savings bank charter is clearly superior to the federal savings association and national bank charters** because a Pennsylvania savings bank can exercise all of the powers of either federal charter via parity while paying approximately half of the annual assessment that a federal charter pays to the OCC. Additionally, while the federal savings association charter also has the advantage of being subject to the Thrift Tax, the federal savings association charter is subject to the lending restrictions addressed above that may hinder a bank's ability to engage in commercial lending. A national bank charter offers no tax advantage and costs almost twice as much as a Pennsylvania savings bank charter in terms of the annual assessment to the OCC.

Conclusion

With the 2012 Amendments, and the unlikelihood of favorable changes to the Shares Tax in the near future, the Pennsylvania savings bank charter is an option that warrants consideration by the Board of Directors of any commercial bank as part of the strategic planning process. Conversion to a savings bank will increase the investment powers for a bank, while not adversely affecting the bank's lending activities, business model or operations. A conversion to a savings bank charter will also allow a commercial bank to become taxed under the Thrift Tax, which will cause a significant reduction in a bank's Pennsylvania corporate tax liabilities going forward.

Need More Information?

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