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Volume 10, Number 1 May 2003

New Tax Law Favors the Mutual Holding Company Structure

Last week Congress passed the Jobs and Growth Tax Act which President Bush signed into law on May 28, 2003. The Act provides significant benefits for investors generally and, specifically, investors in financial institutions, which historically have been more aggressive dividend payers than other sectors. Mutual holding companies, which are uniquely positioned to pay attractive dividends, should benefit significantly from the new tax law. In summary, the Act:

- reduces the tax rate on cash dividends to 15%. This rate cut applies retroactively to dividends paid during 2003 and will remain in effect through 2008. Beginning in 2009, if not extended, the dividend tax rate would revert to the individual investor's marginal tax rate, which currently is as high as 38.6%.

- reduces the tax rate on long-term capital gains to 15% from 20%. This tax rate reduction applies to investments sold on or after May 6, 2003. If not extended, this tax rate would revert to 20% in 2009.

Impact of the Act on Dividend–Paying Companies

Among the clear winners from this new tax legislation are dividend-paying companies, particularly companies that can pay sizeable dividends on a sustained basis. Investors who have favored capital gains over dividends, because of the lower tax rate on capital gains, will now be more neutral toward dividend income. In practical terms, this means that investors in community bank stocks may be more satisfied with the returns they receive from solid quarterly dividends. Companies that can pay attractive and sustained dividends also should be favored by investors even in a weaker stock market.

Dividend-paying stocks also will become a more attractive investment alternative when compared to bonds and other interest-bearing investments, which will continue to be taxed at an investor's marginal tax rate. For investors in the highest tax bracket, the tax rate on dividends *will be less than half* the tax rate on interest-bearing investments like bonds, certificates of deposits and savings accounts.

Impact on Mutual Holding Companies

Among dividend-paying stocks, mutual holding companies are uniquely structured to pay high and sustained dividends because a mutual holding company is only required to pay dividends on shares held by public stockholders. Simply put, since a cash dividend typically would be paid only on public shares, a mutual holding company can pay *more than twice* the amount of dividends to its stockholders as a typical dividend-paying company *for the same total cash outlay*. The new tax law puts a premium on the kind of dividend-paying capacity that mutual holding companies enjoy.

Well-capitalized mutual institutions often express reservations about forming a mutual holding company and selling common stock because of the additional capital that would be raised. The new tax law provides a very practical use for excess capital that has generally eluded mutual savings institutions, and is far preferable to making special interest distributions to depositors. Those special distributions are taxed at ordinary income rates and raise a variety of practical issues.

For example, assume ABC Savings Bank has: $25.0 million of capital; $200 million of assets; and $2.0 million of annual earnings. If it forms a mutual holding company and sells 47% of its stock to employees, management and customers for $15.0 million (1.5 million shares at $10.00 per share), it would have pro forma capital of approximately $39.4 million after taking into account transaction expenses and stock benefit plans. ABC Savings Bank reasonably could pay annual dividends of at least $1.33 per share, or its entire pre-offering earnings, even assuming no growth in earnings from the additional capital raised.

One of the frequent reservations expressed by mutual institutions about converting to public-company status is the pressure from stockholders to deliver capital gains. The new tax law should result in less pressure on dividend-paying companies to produce capital gains if they are able to pay significant cash dividends. The mutual holding company structure is ideal for this purpose.

Luse Gorman Pomerenk & Schick is the nation's leading law firm in mutual holding company and conversion transactions. If you would like to discuss the impact of the new tax law on the mutual holding company structure, please feel free to contact any of the following partners of the firm:

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