Eroding access? The shift of local lending post-TCJA

ABSTRACT

We examine the effect of the 2017 Tax Cuts and Jobs Act (TCJA) on community bank lending practices through changes in organizational form. First, we corroborate prior literature and find that approximately 5% of community banks forgo their S-election to become C Corps post-TCJA. Second, we provide evidence on the determinants of the TCJA's effect on organizational form choice. Third, we utilize difference-in-differences models to study both the changes in net assets and the lending practices between the newly converted C Corp (i.e. switcher) banks and non-switchers. Consistent with avoiding double taxation, we find that switcher banks retain higher earnings and distribute fewer dividends. Finally, we find that switcher banks prioritize high-yield commercial loan products at the expense of agricultural personal lending. Overall, we find economically significant changes in both the net assets and lending practices of newly converted C Corp banks due to the TCJA.

Keywords: organizational structure, tax policy, community bank investment

JEL Classification: G21, G32, H21

I. INTRODUCTION

Community banks represent 97% of all U.S. banks and are vital to many local economies in the United States (FDIC 2020). They foster trust and engagement within their communities, leading to close ties with customers and local organizations. These close social ties allow community banks to familiarize themselves with potential future clientele. This familiarity enables them to provide financial services for certain types of customers—small businesses, farmers, first-time homebuyers—of whom large, national banks may be reluctant to serve. Additionally, because of their size (less than $10 billion in total assets), community banks can more rapidly adapt to survive and thrive during changing market conditions, or regulatory and tax policy changes.

We examine the effects of the 2017 Tax Cuts and Jobs Act (TCJA) on community banks. The hallmark of the TCJA was lowering the corporate income tax rate from 35% to 21%. Because of this drastic rate cut, we first confirm that a sizeable amount (approximately 5%) of community banks re-organize their structure from an S corporation (henceforth referred to as "S Corp) to a C corporation (henceforth referred to as "C Corp") in order take advantage of the lower corporate tax rate (Nguyen, Pacheco, Stone 2023). Moreover, distinct from Nguyen et al. 2023, we confirm that the phenomenon of switching organizational form holds when solely examining community banks rather than all banks.

We then perform a determinants test to better understand the specific factors that drive a community bank to forgo their S-election. Next, we examine the effects of switching to a C Corp on community bank net assets—more specifically, their retained earnings, common stock dividends and preferred stock dividends. Finally, we examine the effects of switching to a C

Corp on community bank investment—more specifically, their commercial and industrial (C&I), agricultural, and personal loans.

Our study should be of interest to both researchers and policy makers. Researchers have extensively studied the 2017 TCJA, the largest tax reform in the U.S. since 1986, analyzing its consequences for effective tax rates (Dobridge, Kennedy, Landefeld, Mortenson 2024), capital structure (Carrizosa, Gaertner, Lynch 2023), foreign and domestic earnings (Dyreng, Gaertner, Hoopes, and Vernon 2023), investment (Gallemore, Hollander, Jacob, and Zheng 2024), foreign investment (Markarian and Crawford 2024), the shifting of foreign-cash holdings (Gleason, Menzer, and Wilde 2024), fixed-asset investment (Bitzan, Hong, Huseynov 2023), executive compensation (De Simone, McClure, Stomberg 2022; Luna, Schuchard, Stanley 2023), and organizational form (Nguyen et al. 2023). However, to the best of our knowledge, none of these studies examine the effect of the TCJA on investment at the local economy level. The study most closely related to ours is Nguyen et al. (2023). The authors study the effect of the TCJA on banks forgoing their Subchapter S-election to become C Corps to take advantage of the new, lower corporate tax rate. Our study extends Nguyen et al. (2023) by examining the downstream effects of the TCJA-induced organizational form changes.

Additionally, because we are interested in investment at the local economy level and we are studying banks with publicly available Consolidated Reports of Condition and Income (henceforth referred to as "Call Reports"), we take advantage of the data and setting to implement a causal difference-in-differences research design. We first predict that community banks that re-organize to C Corps after the TCJA (“switchers”) will possess greater retained earnings and grant fewer common stock dividends compared to non-switchers. Secondly, we

predict that switcher community banks will re-invest their tax savings back into their communities, albeit with a focus on higher-yield loans.

To test our predictions, we start with 6,382 unique community banks during the period 2014-2020. Our sample spans from 2014-2020 to capture a few years both before and after the enactment of the TCJA. We first observe how many community banks forgo their S-elections and become C Corps post the TCJA (i.e., starting in Q1 2018). We find 372 unique community banks in our sample that forgo their S-election to become a C Corp post-TCJA. Next, to expand upon the determinants of a switcher banks, we conduct a stepwise regression of factors that contribute to post-TCJA switching from an S Corp to a C Corp. Among others, we find significant correlations between key bank-level details (i.e., size, deposits, performance, and securities) and critical bank capital measures (i.e., Tier 1 leverage ratio and common equity Tier 1 capital) and the likelihood of a community bank becoming a switcher post-TCJA.

For our first hypothesis, we utilize a difference-in-differences research design to investigate changes in net assets between switcher and non-switchers. We first examine retained earnings and common stock dividends. Although switcher banks theoretically save on tax expense by switching from an S Corp to a C Corp with a lower tax rate, one major consequence of re-organizing is double taxation (Scholes and Wolfson 1989).[1] From a theoretical perspective, C Corps are incentivized to minimize taxation by retaining additional earnings within the bank rather than distributing common stock dividends. Additionally, newly re-organized C Corps may prioritize raising capital for development and expansion over immediate dividend distributions.

[1] C Corps are first taxed as a stand-alone entity. Second, any dividends issued are taxed yet again at the individual shareholder level. Meanwhile, S Corps are only taxed once. Any profit or loss in an S Corp "flow down" to the shareholders and are taxed at the individual level.

Therefore, we predict and find that switcher banks will be more reluctant to issue dividends and therefore retain additional earnings within the bank. We find that the average switcher bank has 5.7% higher retained earnings compared to non-switchers. For more context, the average sample bank has approximately $30.7 million in retained earnings. Therefore, this increase of 5.7% translates into an approximate increase in retained earnings of $1.75 million per community bank.

Within our first hypothesis, we also study the effect of preferred stock dividends on switcher vs. non-switcher banks. However, because of the bond-like characteristics of some types of preferred stock (i.e., cumulative preferred stock where dividend payments are owed to investors rather than granted) we do not make a strong, directional prediction. We fail to find a statistically significant difference in the amount of preferred stock dividends when comparing switchers vs. non-switchers.

For our second hypothesis, we utilize a difference-in-differences research design to investigate the tax policy implications of the TCJA on community bank investments. Our proxies for investment are the major types of loans listed on the Call Reports—C&I loans, agricultural loans, and personal or individual loans. Our category for individual loans is comprised of multiple types of loans—credit card, credit plans, auto loans, and personal loans (including student loans). We predict that switcher community banks restructure their lending practices to invest more in C&I loans at the expense of agricultural and individual loans for a few reasons.

First, C&I loans are generally larger and thus more profitable than individual loans. For example, a small business will generally borrow more money than an individual person, while the overhead of the underwriting costs remains the same (Nichols 2024). Second, some individual loans (i.e., credit card loans) are unsecured, making them less attractive to banks.

Third, community banks face competitive pressures for agricultural loans from farm credit associations and agricultural cooperatives. This tends to drive down the profitability of agricultural loans, making them less attractive to community banks (Miller, Ifft, and Mashange 2024). Finally, C&I loans carry higher risk than individual loans because of industry-specific challenges. These higher risks translate into higher yields for community banks. Newly re-organized C Corp banks may be drawn to higher yield loans for a multitude of reasons including investor expectations, a shift in strategic focus, broader lending flexibility, increased competition (Donohoe, Lisowsky, and Mayberry 2019), and a lower cost of capital.

Our results for switcher community bank lending practices are in line with our predictions. First, we find that switcher community banks issue more C&I loans as a percentage of total assets compared to banks that do not switch by 6.1%.[2] In dollar terms, each switcher community bank issues roughly $2.6 million in additional C&I loans. Given that the typical small business loan can be as small as $10,000, this result is economically meaningful. Second, we find that switchers issue 1.1% fewer agricultural loans as a percentage of total assets or roughly $2.6 million fewer agricultural loans compared to non-switchers.[3] Finally, we find that switchers issue 6.5% fewer individual loans as a percentage of total assets or roughly $1 million fewer individual loans compared to non-switchers.[4]

Next, we perform two robustness tests. First, we verify the existence of parallel trends for each of the six dependent variables (i.e., retained earnings, common stock dividends, preferred stock dividends, C&I loans, agricultural loans, and individual loans) for both of our hypotheses in the pre-TCJA period. Second, our analysis so thus far assumes that switcher banks sought the

[2] 0.005 / 0.082 = 0.061
[3] -0.005 / 0.45 = -0.011
[4] -.002 / 0.031 = 0.065

lower corporate tax rate for C Corps under the TCJA. However, unprofitable banks may have entirely different incentives to convert to C Corp status compared to profitable banks. Therefore, we perform a triple difference-in-differences (DDD) analysis to add an additional layer of comparison. More specifically, we compare banks that switch and were profitable in 2017—the year prior to the enactment of the TCJA provisions—to those that switch and were not profitable. We find that our original inferences do not change across all six specifications from our two hypotheses.

Finally, as an additional analysis, we examine the riskiness of the loan portfolios held by switcher community banks vs. non-switchers. Because newly re-organized C-Corp community banks have fewer restrictions on the number and type of shareholders, they may be encouraged to pursue riskier loans to satisfy shareholder demands for higher returns. Additionally, to avoid double taxation, switcher banks may be tempted to reinvest their profits into higher yield products, affecting both the availability of credit for small businesses and overall credit risk.

Generally, longer loan maturities are positively correlated with credit risk, as they are subject to greater uncertainty and vulnerability to macroeconomic events, such as recessions, inflation, or interest rate fluctuations. Therefore, we utilize loan maturity distributions across banks to proxy for credit riskiness. However, contrary to our prediction, we find that on average, newly re-organized C Corp banks increase their short-term loans with maturities between 3 months and 3 years and decrease their long-term loans with maturities between 3 and 15 years. These results indicate a decrease in credit risk for switching banks.

Our study should be of interest to both researchers, tax policymakers, and bank regulators. For researchers, we contribute to two large streams of literature. We contribute to the banking literature by adding to our knowledge of community bank behavior. First, we confirm

that the findings of Nguyen et al. (2023)—on average community banks forgo their Subchapter S election post-TCJA—hold when solely examining community banks. We also contribute by studying the deterministic characteristics of switchers. Second, we contribute to the literature on community bank investment behavior particularly when faced with both a lower tax rate and new organizational form.

We also contribute to the taxation literature—particularly the literature on the consequences of the TCJA and the literature on taxes and investment. We add to the TCJA literature by studying the effects of the tax law on the financial services industry—an industry often overlooked in tax research due to the inherent differences in the regulatory and institutional system for the banking industry compared to non-financial firms. We also contribute to the literature on taxes and investment by studying the local economy effect of community banks rather than large, multinational companies.

Finally, our study should also be of interest to tax policymakers and bank regulators. For tax policymakers, our study sheds light on a new consequence of the TCJA—the allocation of community bank investment. For bank regulators, it is beneficial to understand the motivators for community bank lending, especially because community banks are vital for many of the small, local economies that make up the U.S. (FDIC 2020).

II. INSTITUTIONAL DETAILS AND PRIOR LITERATURE

2.1 Subchapter S Election

The hallmark of the TCJA for corporations is the considerable federal tax rate reduction from 35% to 21%. In contrast, for individual taxpayers in the highest tax bracket, the tax rate

only decreased from 39.6% to 37%. This rate differential is important when considering the organizational form of S Corps and C Corps.

To become an S Corp, a company must file an election—Form 2553—subject to approval—with the IRS within 75 days of its formation or before March 31st of the current tax year (IRS 2020). If a company choses to forgo their S-election and become a C Corp, every shareholder must consent to the change. Additionally, if company wishes to revert to an S Corp within five years of forgoing their election, they must obtain IRS approval before filing a new election (IRS 2020). Generally, while either organizational form can offer significant tax benefits depending on the circumstances, electing to become (or forgoing) an S Corp involves administrative burdens.

S Corps are flow-through entities, meaning that all the profits, losses, and any tax due "flows down" to their shareholders. For tax purposes, individual shareholders pay taxes from their share of any income generated at their own individual tax rate rather than the corporate tax rate. Additionally, S corporations have strict rules when it comes to who can be a shareholder. First, S corporations are limited to having only 100 shareholders. Second, these shareholders can only be individuals, estates or trusts, or a non-for-profit 501(c)(3) organizations (PwC 2021). Third, all shareholders must be U.S. citizens or residents. Lastly, S corporations must be incorporated in the United States and are only allowed to have one class of stock (PwC 2021).

In contrast, C Corps are subject to double taxation, meaning that they are taxed both at the entity level and any shareholders receiving dividends are also taxed on the income at their specific tax rate (PwC 2021). For the objective of this study, the main difference between S Corps and C Corps is that for S Corps any profit, loss, and subsequent tax flows down to the 100 or less shareholders for them to pay at their own individual tax rate while C Corps pay their tax

at an entity level. Because the tax rate changes so drastically between corporations and individuals due to the TCJA, the differential in which party is responsible for paying taxes between S Corps and C Corps is an important consideration when thinking about the incentives for changing organizational form.

2.2 Tax Cuts and Jobs Act of 2017

The TCJA is the largest tax reform the U.S. has undergone since 1986. Furthermore, for such sweeping legislation, the tax act was passed extremely quickly. Donald J. Trump, somewhat surprisingly, won the U.S. presidential election on November 8, 2016. While he did campaign on tax reform, tax legislation was not introduced to the U.S. House of Representatives nor widely talked about in the media until November 2, 2017. From there, the legislation was quickly passed and moved to the Senate where it also passed. The TCJA was officially signed into law on December 22, 2017 (Congress 2017). Because there were only 50 days between inception and being signed into law, and a lot of uncertainty during that time period, many firms may not have been able to act quickly enough to implement any tax saving strategies at the end of 2017.

As previously stated, the hallmark of the TCJA for corporations was the drastic corporate tax rate reduction from 35% to 21%. A considerably smaller rate reduction for individual taxpayers in the highest tax bracket was also enacted from 39.6% to 37%. On the surface, only observing these two facts, it appears to be most beneficial to organize as a C corporation post-TJCA. However, as a consolation for partnerships and S corporations who do not receive as large of tax benefits as C corporations, the TCJA included Section 199A. Section 199A allows individuals—partners in partnerships or shareholders in S corporations—to deduct up to 20% of the qualifying business income from their applicable pass-through income (IRS 2024). This

provision of the TCJA may give some S corporations pause when deciding whether to forgo their Subchapter S election.

2.3 Taxes and Investments

The connection between taxes and investment is fairly intuitive and has been explored to some extent in other contexts (e.g., Giroud and Rauh 2019). Holding all else constant, if an entity's tax bill is expected to be smaller than in previous years, then that entity will have more cash on hand. Depending on the company's needs, that surplus cash may either go towards retained earnings or building up cash reserves, go back to investors, or be re-invested into the company. In our setting with community banks, re-investment could also mean reinvesting both back into the business and into the community by issuing more loans to clientele.

Crawford and Markarian (2024) study the effect of the TCJA on investment by comparing U.S. firms with Canadian firms. They find U.S. firms increase investment after the TCJA relative to Canadian firms. Gallemore et al. (2024) study the same concept but include a moderator of firm-level tax policy uncertainty to add more nuance regarding the amount of investment following the TCJA. For domestic-oriented firms, they find firms with more tax policy uncertainty (i.e., for example uncertainty due to the how long the tax law is expected to stay in place) leads to lower levels of investment. Overall, the research in this area of taxes and investment—particularly regarding the TCJA—shows that lowering taxes increases investment, subject to moderating effects such as tax policy uncertainty.

2.4 Community Banks

Unlike prior studies on the TCJA and investment (i.e., Crawford and Markarian 2024; Gallemore et al. 2014) our study focuses on a unique setting to study taxes and investment after the TCJA—community banks. In terms of number of banks, community banks comprise of 97%

of all U.S. banks and are vital to many local economies in the United States (FDIC 2020). Because community banks foster close social ties within their communities, studying them can shed light on the effects of the TCJA on more local economies that collectively make up a large, but understudied portion of the U.S. Additionally, because of their size (less than $10 billion in total assets), community banks can more rapidly adapt to survive and thrive during rapidly changing political landscapes and tax policy changes.

III. HYPOTHESIS DEVELOPMENT

Based on prior studies that examine tax rate reductions and investment (i.e., Crawford and Markarian 2024; Giroud and Rauh 2019; Gallemore et al. 2014), it seems intuitive that faced with a drastic corporate tax rate reduction and a relatively small individual tax rate reduction, community banks organized as S Corps would re-organize to C Corps if feasible. Although switcher banks theoretically save on tax expense by switching from an S Corp to a C Corp with a lower tax rate, one major consequence of re-organizing is double taxation.[5] From a theoretical perspective, C Corps are incentivized to minimize taxation by retaining additional earnings within the bank rather than distributing common stock dividends.

Preferred stock dividends are somewhat more complex to predict theoretically than common stock dividends. Because S Corps are only allowed one class of stock, it may seem intuitive for switcher banks to have more preferred stock dividends. However, newly re-organized C Corp banks may be hesitant to immediately create a class of preferred stock. For example, some types of preferred stock (i.e. cumulative preferred stock) possess bond-like

[5] C Corps are first taxed as a stand-alone entity. Second, any dividends issued are taxed yet again at the individual shareholder level. Meanwhile, S Corps are only taxed once. Any profit or loss in an S Corp "flow down" to the shareholders and are taxed at the individual level.

characteristics requiring dividend payments to investors rather than leaving them to the manager's discretion. A switcher community bank may prefer to orient themselves and establish their position as a newly formed C-Corp before committing to guaranteed dividends. Therefore, we do not make a strong, directional prediction on the difference of preferred stock dividends between switchers and non-switchers. We state our first hypothesis below.

H1: Switcher community banks have higher retained earnings, lower common stock dividends, and no change in preferred stock dividends compared to non-switchers.

Next, we explore how switcher community banks allocate their excess cash due to a lower-than-expected tax bill. Chay, Chong, and Im (2023) study a similar phenomenon of firms with excess cash due to the 2003 dividend tax cuts. However, instead of discovering that firms increase their investments with the excess cash, they find that firms increase their investment efficiency by forgoing frivolous, managerial rent-seeking projects. In our setting, with the excess cash from choosing to re-organize into a form with a lower tax rate, switchers may choose higher-yield loans to invest in to increase their investment efficiency.

Additionally, because C Corp banks are not bound by the rigid rules of an S-election (i.e., they are allowed more than 100 investors, institutional investors and multiple classes of stock), the shift to a C Corp structure often brings changes in ownership, capital needs, and strategic priorities. These changes can affect a community banks lending practices—drawing C Corp banks to invest in higher-yield loans. For example, meeting new investor expectations may become more difficult due to differences in the number and type (i.e., institutional) of investors. These new shareholders may expect higher growth and returns. Therefore, switcher banks may find themselves shifting their strategic focus from serving the local community to maximizing shareholder value. As an additional incentive to maximize shareholder value and choose to invest

in higher-yield loans, this strategic shift and future increased profitability may also attract new investors in a subsequent period.

Additionally, due to the broader lending flexibility of becoming a C Corp, switcher banks may feel better positioned to incur riskier, higher-yield loans. Furthermore, the TCJA created a more favorable tax and ultimately business environment for all C Corps. Therefore, there may be increased competition in the lending sphere. To remain competitive, C Corp banks may prioritize higher-yield loans to achieve a more competitive return on equity. Finally, with access to a wider array of investors, switchers most likely experience a lower cost of capital. The reduction of this barrier may allow switchers to pursue higher-yield loans that their non-switcher counterparts would avoid.

In line with the incentives for wanting to invest in higher-yield loans (i.e., C&I loans), switcher community banks have several reasons to reduce their investment in agricultural loans and individual loans. First, C&I loans are generally larger and thus more profitable than individual loans. For example, a small business will generally borrow more money than an individual person, while the overhead of the underwriting costs remains the same (Nichols 2024). Second, some individual loans (i.e., credit card loans) are unsecured, making them less attractive to switchers. Third, community banks face competitive pressures for agricultural loans from farm credit associations and agricultural cooperatives. This tends to drive down the profitability of agricultural loans, making them less attractive to newly re-organized (Miller, Ifft, and Mashange 2024). We state our second hypothesis below.

H2: Switcher community banks issue more C&I loans, fewer agricultural loans, and fewer personal loans compared to non-switchers.

IV. RESEARCH DESIGN

4.1 Measuring Community Bank Net Assets

We measure bank net assets using retained earnings in quarter t. Retained earnings represent the accumulated net income the bank has earned over time. The ending retained earnings balance for each quarter is calculated by adding the beginning retained earnings balance to the bank's revenues and subtracting bank expenses and dividends paid out. In other words, the bank's quarterly net income is added to the beginning retained earnings balance, while dividends reduce it. As explained in prior sections, C Corp earnings are subject to double taxation when distributed as dividends. The first level of tax occurs at the corporate level, where the bank's income is taxed at applicable federal and/or state rates. Therefore, the bank's net income is already net of income tax expenses at the entity level. If the C Corp bank chooses to distribute a portion of its profits to shareholders in the form of dividends, its retained earnings will decrease. Shareholders receiving these dividends report them as personal income, which is taxed at individual income tax rates. This constitutes the second level of taxation at the personal level.

Community banks that switch to a C Corp structure should, *ceteris paribus*, have higher incremental retained earnings compared to other community banks. Unlike S Corp banks, which operate as pass-through entities, C Corp banks are not required to distribute earnings to shareholders. This allows them to retain more capital within the bank, thereby expanding their capacity to originate additional loans. We measure *RetainedEarnings* as the natural logarithm of the bank's retained earnings (RCON3632). To investigate whether higher retained earnings are facilitated by reduced dividend distributions, we examine the relationship between retained earnings and dividend payouts. Specifically, given the taxation implications of dividends to shareholders, we study whether the mechanism involves lower dividend payments. Community

banks typically issue both common and preferred stock dividends. Therefore, we include two separate dividend variables in our analysis: *Dividends_CS* for common stock dividends and *Dividends_PS* for preferred stock dividends.

4.2 Measuring Community Bank Lending

Community banks provide loans to stakeholders with diverse needs, and one of the most common types of lending sought by their customers is small business lending. According to the FDIC, community banks are more efficient than their larger counterparts at approving business loans. In its 2024 Small Business Lending Survey, the agency found that community banks can approve simple loans in as little as one business day (FDIC 2024a). Prior research also suggests that community banks help alleviate some of the challenges related to information asymmetry in rural lending, such as higher information opacity due to geographical distance (Berger and Udell 2002). Community banks play a crucial role in providing financing to companies that may struggle to obtain affordable loans from larger banks. These banks are known to rely on soft information—qualitative details about the customer based on their historical relationship—to make lending decisions (Craig et al. 2005).

Small business loans can be used for working capital, the acquisition of long-term assets, or business expansion. To capture small business lending, we measure *C&I* as commercial and industrial loans scaled by total assets. We also examine agricultural lending, given the importance of farm loans to community banks. Previous literature finds that community banks provide around 77% of agricultural loans and more than 50% of small business loans (Lux and Greene 2015). Many farms are also considered small businesses, so we investigate the effect of the TCJA on community bank agricultural lending.[6] Our variable *Agriculture* captures

[6] The Small Business Administration (SBA) uses four key characteristics to determine whether a business qualifies as a small business: 1) it is independently owned and operated, 2) it is organized for profit, 3) it

agricultural loans scaled by total assets. Together, these two measures capture a significant portion of community bank loan portfolios.

To further study the impact of the TCJA on lending, we examine statistical differences between switcher and non-switcher banks' loans to individuals. Community banks provide loans for personal financing, such as vehicle purchases, student loans, medical bills, and home improvements. Given the multifaceted nature of this type of lending, we employ a comprehensive measure, *Individual*, that captures all types of individual loans delineated on the Call Report. These include credit loans, revolving credit plans, automobile loans, and consumer loans (including student loans), scaled by total assets. Appendix A provides detailed variable definitions.

4.3 Research Design

We base our analysis on the determinants of the decision to relinquish S Corp status in favor of C Corp status in the post-period. Our variable *Switcher* is carefully coded to restrict observations to community banks that made an S Corp election in the pre-TCJA period and then became a C Corp following the enactment of the TCJA. Our initial analysis uses a stepwise logistic regression model, incorporating a series of variables from prior literature. This model offers several benefits for our setting. First, it reduces overfitting by iteratively removing insignificant predictors. Second, it improves the interpretability of our findings. Finally, it provides efficient analysis using our large dataset. All independent variables in our analysis are lagged by one quarter. Our stepwise procedure results in the model retaining key bank-level details such as size (*BankSize*), deposits (*Deposits*), performance (*ROA*), and securities

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does not dominate its industry on a national level, and 4) it meets specific size criteria. Link: https://www.sba.gov/federal-contracting/contracting-guide/size-standards#:~:text=General%20requirements,the%20U.S.%20or%20its%20territories

(*Securities*). We also find that critical bank capital measures, such as the Tier 1 leverage ratio (*Tier1Leverage*) and common equity Tier 1 capital (*CET-1*), are significant determinants of the decision to switch corporate forms.

$$\begin{aligned} Switcher_{i,t} = {} & \alpha_i + EmployeeSalaries_{i,,t-1} + NumberEmployees_{i,t-1} \\ & + Tier1Leverage_{i,t-1} + CreditCard_{i,t-1} + Agriculture_{i,t-1} \\ & + C\&I_{i,t-1} + CET-1_{i,t-1} + Banksize_{i,t-1} + Deposits_{i,t-1} + ROA_{i,t-1} \\ & + Securities_{i,t-1} + \varepsilon_{i,t} \end{aligned} \quad (1)$$

To study the effect of the TCJA on the bank's net assets and lending patterns, we estimate the following difference-in-differences model using OLS:

$$Outcome_{i,t} = \alpha_i + \gamma_t + \beta_1 Switcher_i * Post_t + \beta_2 Switcher_i + \beta_3 Post_t + \delta_{i,t-1} + \varepsilon_{i,t} \quad (2)$$

where *i* and *t* denote banks and quarters, respectively.

As defined in the previous section, *Outcome* is either *RetainedEarnings*, *Dividends_CS*, or *Dividends_PS* for tests of Hypothesis 1, or *C&I*, *Agriculture*, or *Individual* for tests of Hypothesis 2. *Post* is a binary variable equal to one for quarters after the enactment of the TCJA, and zero otherwise. *Switcher* is a binary variable that equals one if the bank was registered as an S Corp during the pre-TCJA period and became a C Corp during the post-period; otherwise, *Switcher* equals zero. In specifications that include bank and quarter fixed effects, the coefficients on *Switcher* (β_2) and *Post* (β_3) are subsumed by the fixed effects. β_1 is the coefficient of interest in this study, representing the interaction between the variables *Switcher* and *Post*. β_1 serves as the difference-in-differences estimator, capturing the change in profit management and lending following the switch from S Corp to C Corp. A negative coefficient for β_1 indicates a decrease in lending, while a positive coefficient suggests an increase in lending.

Following prior literature, we impose a strict combination of fixed effects to minimize the risk of confounding factors influencing our results (Breuer and DeHaan, 2024). Specifically, we

include bank-level and quarter fixed effects. In our specifications, α_i represents bank-level fixed effects, and γ_t represents quarter fixed effects. Our identification strategy exploits the decision by community banks to forego S Corp status in the post-period, given that they consistently made the S Corp election in the pre-TCJA period for all observed quarters. Our tests assume that the *Switcher* banks would have developed similarly to non-*Switcher* banks if they had not become C Corps. To control for bank-level factors that might influence lending activity or credit risk, we include a vector of control variables, including bank size (*BankSize*), total deposits scaled by total assets (*Deposits*), profitability (*ROA*), and the sum of held-to-maturity and available-for-sale securities scaled by total assets (*Securities*). We define all variables in Appendix A.

4.4 Data and Sample

We obtain data for community banks from regulatory Call Reports, which are mandatory quarterly filings required by bank regulators. These filings contain data on balance sheets, income statements, loan performance, asset quality, capital adequacy, liquidity, and off-balance sheet activities (FFIEC 2024). We use the Wharton Research Data Services (WRDS) Bank Regulatory Database to retrieve all relevant Call Report datapoints. Our sample period spans from 2014 to 2020, with sixteen pre-TCJA quarters and twelve post-TCJA quarters.

Our initial sample size is 177,506, which includes data from Q4 2013 to create lagged variables for Q1 2014. The number of observations for our actual sample period is 163,675. We exclude banks that do not meet the size definition of a community bank (under $10 billion in assets), which reduces the number of observations to 159,351. We further restrict our sample to banks that have sufficient datapoints for all control variables, including the bank's Tier 1 leverage ratio. This leverage ratio measures the bank's financial strength by comparing its Tier 1 capital to its total assets and is consistently reported across all community banks, regardless of

whether they elect the Community Bank Leverage Ratio (CBLR) framework (Lu 2024). After removing observations without Tier 1 leverage data, our final sample consists of 133,211 bank-quarter observations. Table 1 summarizes our sample selection.

4.5 Descriptive Statistics

Table 2 (Panel A) presents the descriptive statistics for the full sample of community banks. The average amount of C&I lending as a proportion of total assets is 8.3%, agricultural 4.5%, and individual 3.1%. The average bank holds 20.4% of its assets in the form of securities (HTM and AFS). The average Tier 1 leverage ratio is 12.6%, which exceeds the applicable capital minimum requirements for community banks. In Panels B and C, we bifurcate our sample into *Switcher* = 1 and *Switcher* = 0, respectively. We note differences exist along several dimensions between the bank-quarter observations belonging to switching banks (130,029) and those belonging to non-switching banks (3,182), including our control variables. 4.5% (288) of sampled financial institutions (6,382) switched from S Corp to C Corp status following TCJA enactment.

Panel D of Table 2 presents a breakdown of the maturity of all loans, excluding residential mortgage loans. The maturity periods range from less than three months to over fifteen years. 10.5% of the loan portfolios of sampled community banks are set to mature within three months of the Call Report date, 6.7% within one year, 9.6% within three years, 9.8% within five years, 7.1% within fifteen years, and a relatively small 2.5% are set to mature in more than fifteen years. The distribution of maturity dates is generally balanced across the varying time periods. Given that maturity periods are interconnected with credit, interest, prepayment, and other industry-specific risks, the even distribution of loan maturities provides some reassurance that our sample reflects a representative set of loans.

V. MAIN RESULTS

5.1 The Determinants of Bank Formation Switching

Table 3 presents the results from Equation (1) for the determinants of the *Switcher* treatment variable. We employ a stepwise regression method to identify the likely predictors of a community bank switching from S Corp status in the pre-TCJA period to the C Corp status in the Post period. With *Switcher* as the dependent variable, we use backward elimination to iteratively remove all statistically insignificant variables. The procedure is an iterative process as it continues until no more variables can be removed. We use this method due to the large number of observations in our sample. Several results are notable. First, the pair of variables relating to bank payroll costs, *NumberEmployees* and *EmployeeSalaries*, are significant but have signs opposite to that of each other. One plausible explanation for this result is that banks facing higher compliance costs, as proxied for by employee salaries, are less likely to undergo the transition from being an S Corp to a C Corp. Meanwhile, the presence of more employees, which implies higher human resources, is a positive predictor of transitioning. This result can speak to the difficulty of transitioning between the two business forms.

Another pair of variables with coefficients that have opposite signs are the *CET-1* and *Tier1Leverage* variables. Common equity Tier 1 capital is considered the highest-quality capital held by a bank. Components of CET-1 include common stock, retained earnings, and accumulated other comprehensive income (AOCI). The commonality among these components is they enable the bank to immediately absorb losses. Compared to CET-1, other types of capital that make up Tier 1 Capital have lower loss-absorbing capacity. Examples of non-CET-1 Tier 1 capital are non-cumulative preferred stock, subordinated debt, and instruments that allow the deferral of interest payments or dividends. The results of Table 3 suggest that banks with the

highest quality of capital are more likely to become C Corps post-TCJA, compared to those with comparably lower quality capital.

Banks that are more likely to switch are those that tend to be smaller, have more deposits as a percentage of their total assets, and generally are more profitable. These characteristics are evidenced by the negative coefficient on *BankSize*, and the positive coefficients on *Deposits* and *ROA*. Furthermore, banks with a greater proportion of C&I (*C&I*) and agricultural (*Agriculture*) loans are more likely to switch corporate form, whereas those with higher *Individual* lending tend to be less likely to switch.

5.2 The Effect of the TCJA on Community Bank Net Assets

Given the incentives in the post-TCJA period for switcher banks to retain higher profits, as opposed to passing them through dividends, we predict that these banks will have relatively higher retained earnings compared to non-switcher banks. To test this hypothesis, we estimate Equation (2) with three related dependent variables. Table 4 presents the results for retained earnings (Panel A), common stock dividends (Panel B), and preferred stock dividends (Panel C). Across Columns 1 through 3 in each panel, we gradually increase the strictness of the specifications (Armstrong et al. 2022). In Column 1, we do not include any control variables or fixed effects. This column provides a baseline result that captures the direct relationship between the difference-in-differences estimator and the dependent variable. We add control variables in Column 2, followed by both control variables and fixed effects in Column 3. Thus, the final column represents the most stringent regression specification. This pattern persists across all three panels, and we carry it forward to Table 5.

In Panel A, with *RetainedEarnings* as the dependent variable, the coefficient of interest (*Switcher*×*Post*) is positive and statistically significant in all columns, suggesting that switcher

banks retain more earnings in the post-TCJA period. The coefficient estimate of 0.057 indicates that the average switcher bank has 5.7% higher retained earnings. In untabulated results, the average sample bank has approximately $30.7 million in retained earnings. Therefore, this increase of 5.7% translates into an approximate increase of $1.75 million per community bank.

Next, we examine whether dividends contribute to the result in the previous panel. In Panel B, we regress Equation (2) with the dependent variable as common stock dividends (*Dividends_CS*). The coefficient on the difference-in-differences estimator (-0.787) is negative and statistically significant for common stock dividends, implying that switcher banks drastically reduce their dividend payouts after changing their business formation. This result further supports the previous finding of higher retained earnings. Given that we control for net income through the *ROA* variable, our results suggest that the reduction in dividends indeed has an incremental effect on raising retained earnings.

In Panel C, where the dependent variable is preferred stock dividends (*Dividends_PS*), the coefficient estimate on β_1 is negative but insignificant. This result indicates that, given the bond-like features of preferred stock, community banks that switched business formations were unable to modify the terms of dividend payments to preferred shareholders. Thus, there was no change in preferred stock dividend payments. Comparing the magnitudes of the results in Panels B and C, we find that the coefficient estimate of (-0.787) in Panel B substantially outweighs the (-0.002) in Panel C. Taken together, we find that payments on common stock dividends decline in the post-TCJA period, which contributes to higher retained earnings. These results are consistent with our hypotheses.

5.3 The Effect of the TCJA on Small Business Lending

Table 5, Panel A presents the regression results from Equation (2) with *C&I* as the dependent variable. In all three columns of Panel A, the coefficient on β_1 is positive and significant. The results suggest that banks that switch their business formation are more likely to increase their small business loans following the TCJA. The coefficient of 0.005 implies an increase of 0.5% in C&I loans scaled by total assets, or a 6.02% increase relative to the sample mean. In dollar terms, the average bank in our sample holds $526,867,700 in total assets. Our empirical result from Column 3 translates into roughly $2.6 million in additional C&I loans per bank. Given that the typical small business loan can be as small as $10,000, this result is economically meaningful.

We continue to analyze the impact of TCJA-induced formation switching by studying other forms of community bank loans in Panels B and C, which present our analysis of Equation (2) with *Agriculture* and *Individual* loans as the dependent variables, respectively. The coefficient estimate on *Switcher×Post* is negative and significant in all columns for both variables. As *Agriculture* represents agricultural loans scaled by total assets, the estimate of -0.005 in Column 3 implies that, relative to non-switcher banks, switcher banks decrease their agricultural lending as a percentage of total assets by 0.5%. The average community bank in our sample allocates 4.5% of their loans to agricultural lending. This 0.5% decline represents a 2.25% decrease in agricultural lending overall, or $2.6 million in fewer agricultural loans per bank. In Panel C, the coefficient estimates on *Switcher×Post* are negative and significant across all three specifications. These results suggest switcher banks have lower individual loans by approximately $1.5 million per bank. Taken together, our results in Table 5 indicate that treatment banks increase small business loans at the expense of agricultural and individual loans.

VI. ADDITIONAL ANALYSIS AND ROBUSTNESS TESTS

6.1 Parallel Trends and the Incremental Effect of Bank Profitability in 2017

A critical assumption of any difference-in-differences research design is the validity of the parallel trends assumption (Roberts and Whited 2013). To test this assumption, we use the post-estimation tool *ptrends* in Stata, which examines whether linear trends in the dependent variables are parallel during the pre-TCJA period. The null hypothesis for each test is that the linear trends are parallel. For all six main dependent variables, we fail to reject the null hypothesis in every case, supporting the validity of our difference-in-differences design. To further ensure that the observed post-treatment differences between switcher and non-switcher banks are attributable to the TCJA, we introduce an additional layer of comparison between profitable and unprofitable banks.

Our analysis thus far assumes that switcher banks sought the lower corporate tax rate for C Corps under the TCJA. However, unprofitable banks may have entirely different incentives to convert to C Corp status compared to profitable banks. While we control for several bank-level characteristics and employ robust fixed effects, confounding trends may still exist, particularly those specific to profitable banks. To address this, we perform a triple difference-in-differences (DDD) analysis to add an additional layer of comparison. Specifically, we compare banks that switch and were profitable in 2017—the year prior to the enactment of the TCJA provisions—to those that switch and were not profitable.

We introduce a new variable, $Profitable_{17_i}$, a binary indicator that takes the value of one if the bank had a positive average income (loss) before income taxes between Q1 and Q4 of

2017, and zero otherwise.[7] This approach allows us to better isolate the treatment effect and control for potential biases that may persist in our difference-in-differences design (Olden and Moen 2022). Furthermore, the triple differences estimator accounts for additional layers of confounding trends, including those not captured in a standard difference-in-differences specification (Olden and Moen 2022). We estimate the following specification:

$$Outcome_{i,t} = \alpha_i + \gamma_t + \beta_1 Switcher_i * Post_t * Profitable_{17_i} + \beta_2 Switcher_i * Post_t + \beta_3 Switcher_i * Profitable_{17_i} + \beta_4 Post_t * Profitable_{17_i} + \beta_5 Switcher_i + \beta_6 Post_t + \beta_7 Profitable_{17_i} + \delta_{i,t-1} + \varepsilon_{i,t} \quad (3)$$

As in Equation (2), $Outcome_{i,t}$in Equation 3 represents one of the six main dependent variables analyzed in Tables 4 and 5. The coefficient β1 serves as the triple difference estimator and captures the treatment effect. This estimator controls for lower-order interactions and baseline differences, isolating the impact of the TCJA on banks that converted to C Corp status in the post-TCJA period. Additionally, it accounts for trends specific to profitable banks, adding an extra layer of control.

Table 6 presents the results of our triple differences analysis. Columns 1 through 3 examine the dependent variables retained earnings, common stock dividends, and preferred stock dividends, as reported in Table 4. Columns 4 through 6 focus on the dependent variables for commercial, agricultural, and individual loans, consistent with Table 5. Across all six columns, the results are qualitatively consistent with those in their respective tables, supporting the robustness of our findings.

[7] Datapoint RIAD4301 effectively achieves this purpose, as it is defined on the Call Report as "Income (loss) before applicable income taxes and discontinued operations".

6.2 The Effect of the TCJA on Bank Credit Risk

Switching from S Corp to C Corp status can significantly influence a bank's risk-taking behavior. For example, while S Corp banks are limited to 100 shareholders, C Corp banks face no such restrictions. Moreover, unlike their S Corp counterparts, C Corp banks can issue multiple classes of stock, including both preferred and common stock. These features may encourage C Corp banks to pursue riskier loans to satisfy shareholder demands for higher returns. Additionally, some community banks may choose to terminate their S Corp status to reap the benefits of the TCJA's lower corporate tax rate. Consequently, switcher banks may experience reduced tax liabilities and higher retained earnings. To avoid double taxation, C Corp banks are incentivized to reinvest their profits into higher yield products, affecting both the availability of credit for small businesses and overall credit risk.

The FDIC defines credit risk as arising "from the potential that a borrower or counterparty will not repay a debt obligation. Loans and certain types of off-balance sheet items, such as letters of credit, lines of credit, and unfunded loan commitments, are the largest source of credit risk for most institutions" (2024b). To proxy for credit risk, we analyze the maturity periods of total loans, excluding home mortgage loans, at the bank level. The Call Report categorizes loans by maturity intervals: less than three months (*LoansLess3Mos*), three to twelve months (*LoansLess1Year*), one to three years (*LoansLess3Years*), three to five years (*LoansLess5Years*), five to fifteen years (*LoansLess15Years*), and greater than fifteen years (*LoansOver15Years*). For consistency, we scale the loan amounts for each maturity period by total assets. Generally, longer loan maturities are positively correlated with credit risk, as they are subject to greater uncertainty and vulnerability to macroeconomic events, such as recessions, inflation, or interest rate fluctuations.

To assess whether newly converted C Corp banks exhibit higher levels of credit risk, we analyze loan maturity distributions across banks. Because credit risk and maturity are positively correlated, loans with longer maturities are associated with increased uncertainty and higher perceived risk. Using the Call Report's pre-categorized maturity data, we estimate Equation (2) separately for each maturity period. Table 7 presents the results for the six intervals. In Columns 2 and 3, where the dependent variables are *LoansLess1Year* and *LoansLess3Years*, the coefficients on *Switcher×Post* are positive and statistically significant. These findings indicate that treatment community banks increase their short-term loans. Conversely, for longer maturities between three and fifteen years (Columns 4 and 5), the coefficients on *Switcher×Post* are negative and statistically significant, with stronger significance than in Columns 2 and 3. This suggests a marked decrease in loans with maturities greater than three years.

Columns 1 and 6 yield mixed results. In Column 1, where *LoansLess3Mos* is the dependent variable, the coefficient on *Switcher×Post* is negative and statistically significant, while in Column 6, the results are insignificant. Given the quarterly submission frequency of Call Reports, the findings in Column 1 are more challenging to interpret. Overall, the results in Table 6 reveal that switcher banks tend to increase short-term loans with maturities between three months and three years, while decreasing loans with maturities between three and fifteen years. Contrary to our hypothesis that conversion would increase risk, these findings suggest a decrease in credit risk.

VII. CONCLUSION

The TCJA marked an epochal shift in U.S. tax policy. When enacted, it represented the most significant reform to the nation's tax system in thirty years (Bird-Pollan 2019). However, the law's impact on businesses has primarily been studied from the perspective of large

corporations. The U.S. economy and small businesses, however, are indivisible: 99% of all businesses are considered small businesses (Office of Advocacy 2023). Community banks are critical in supplying credit to small businesses, farms, and individual customers, all of whom are key drivers of local economies (FDIC 2020). Moreover, small businesses employ nearly half of the U.S. workforce (Bernanke 2010).

Given that the current accounting literature has largely focused on the law's impact on large corporations, our study provides valuable evidence about its impact on a different but equally significant sector of the U.S. economy. Notably, we show that after the enactment of the TCJA, 4.5% of community banks terminated their S Corp status with the IRS in favor of becoming C Corps. We hypothesize that, and provide evidence for, the primary incentive for this switch was the TCJA's 21% corporate income tax rate. We estimate that switcher banks significantly increase their retained earnings while simultaneously lower common stock dividends.

We also examine the economic consequences of community bank business formation shifting. Our results are both statistically and economically significant. We find that the TCJA's enactment is associated with an average increase of $2.6 million in small business loans for each treatment financial institution. Given that the typical small business loan can be as small as $10,000, our results are economically meaningful. In contrast, we find that treated banks reduced the amount of farm and individual loans in the post-TCJA period. Consistent with theoretical predictions, our results suggest that newly converted C Corp banks prioritize high-yield commercial loan products at the expense of other types of lending.

Our paper adds to the literature on the effectiveness of tax policy, and more specifically, the effectiveness of the TCJA (Wilde and Wilson 2018). To the best of our knowledge, this is the

first paper to focus on the TCJA's impact on community banks. The extant literature has focused on large, multinational corporations (Hanlon et al. 2019; De Simone et al. 2022; Dyreng et al. 2023), whereas limited evidence exists on the law's impact on smaller entities. Our study extends the TCJA literature by providing empirical evidence on the community bank effects of the TCJA. Furthermore, our study contributes to the evolving literature examining the implications of regulatory changes on banks. Many banking studies focus on regulatory changes that directly impact financial institutions. However, one challenge in these studies is that banks are expected to anticipate upcoming regulatory changes and take actions that affect the outcome variables (Beatty and Liao 2014). Our study contributes to the banking literature by examining a law that ostensibly had no direct provisions for the banking sector, thus reducing the likelihood that banks would have anticipated a TCJA effect.

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