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Annual Banking Workshop Tax Update

ON TRACK WITH YOUR AGENDA



Review of recent guidance, tax credits, BASEL III tax computations and state nexus matters

- Bad Debt Directive
- Tangible Property Regulations
- Federal Tax Credits
- Tax Return Due Date Changes
- BASEL III computations
- Transaction Issues
- State Tax Issues – Including Nexus

Allowance for Loan Losses and Charge-offs



- General Rules under IRC section 166
 - Deduction allowed on any debt that becomes worthless within taxable year
 - Large banks (>500M asset required to use this method)
- Reserve Method for small banks
 - Code section 585
 - Recapture rules

Methods of Determining Bad Debt Deductions



- There are 4 methods
 1. Facts and circumstances
 2. Specific order from a regulator
 3. In accordance with policy of regulator with written confirmation in next audit
 4. Reserve method for small banks

GAIN CONTROL WITH A CONFORMITY ELECTION



Stay in control of your tax charge-offs with a conformity election

- **Requirements**

1. Debt charged off in whole or part for regulatory purposes
2. Specific order of bank's supervisory authority, or
3. Corresponds to bank's classification as loss asset
4. Express determination letter required

- **Benefits**

Book/Tax charge-offs are consistent

Lower IRS audit risk and fewer procedures

GAIN CONTROL WITH A CONFORMITY ELECTION



Loss Asset is a debt classified as loss asset by bank that corresponds to a class that meets the standards in the Uniform Agreement on Classification of Assets and Securities Held by Banks.

- Election must be made on Form 3115
 1. Initial election is an automatic change
 2. Subsequent elections are not automatic
 3. Express determination letter required prior to election

GAIN ADVANTAGES WITH A CONFORMITY ELECTIONS



- **Non Accrual Interest**

1. GAAP: Bank stops accruing interest when loan placed on nonperforming status
2. Tax: accrual method taxpayers must take amounts into income when right to the income is fixed and determinable

Tax Rule:

- Interest income considered fixed as it is earned (Rev. Rul 72-100)

GAIN ADVANTAGES WITH A CONFORMITY ELECTION



- **Non Accrual Interest**

1. Doubt as to collectability: no need to accrue if no reasonable expectation of payment
 - Example: collateral securing loan is valued less than loan principal.
2. *Corn Exchange Bank (1930)*
 - Even though on accrual basis no tax unless income good and collectible
 - Injustice to taxpayer to insist on taxation

GAIN ADVANTAGES WITH A CONFORMITY ELECTION



- **Non Accrual Interest with Conformity**
 1. Must still accrue interest on NPL
 2. Interest deemed accrued and then immediately paid off
 3. Possible to claim deduction for previously accrued interest

GAIN ADVANTAGES WITH A CONFORMITY ELECTION



- Loans not subject to conformity
 1. Securitized loans
 2. Restructured loans with a gain/loss
 3. Loans under principal recovery
 4. In-substance foreclosures
 5. Purchase impaired loans under SOP 03-3
 6. Loans held by non-banks

GAIN ADVANTAGES WITH A CONFORMITY ELECTION



- **NPL Tax Collections**

1. IRS rules provide that payments on a loan are interest to the extent interest has accrued on the loan as of the date payment is due
2. GAAP typically applies payments to principal first
3. This can create a disparity between book/tax accounting

NPL EXAMPLE WITH PAYMENT APPLIED TO INTEREST



		GAAP						
		Beginning	Interest		Ending	Book		
		Balance	Accrued	Payments	Balance	Basis		
Non accrual interest		5,000	6,000		11,000	-		
Principal		100,000	-	(3,000)	97,000	97,000	Apply to principal	
					108,000	97,000		
		Tax						
		Beginning	Interest		Ending	Tax		
		Balance	Accrued	Payments	Balance	Basis		
Non accrual interest		5,000	6,000	(3,000)	8,000	-	Charge off	
Principal		100,000	-	-	100,000	100,000	Charge off of \$3,000	
					108,000	100,000		
	Charge off as partially worthless pursuant to Reg 1.166-2(d)(3)				Difference	(3,000)		
					Payment	3,000	Bad debt recovery	
						-	Net tax return impact	

CONFORMITY ELECTION AND OTTI – TAX IMPLICATIONS



- **Bad debt on worthless debt securities**
 1. GAAP may require a write down; partially to the P/L and partially through OCI
 2. Tax: general rule worthless securities under IRC 165
 3. Bank Tax: debt obligations under IRC 166 as a bad debt
 4. Significance: IRC 166 permits partial worthlessness without disposal. IRC 165 only applies to total worthlessness

CONFORMITY ELECTION AND OTTI – TAX IMPLICATIONS



- **Tax Loss**

1. Demonstrated worthlessness such as default on security, bankruptcy, mounting financial losses, lack of collateral, etc.
2. Conformity election may apply to worthless debt securities (IRC 582(a))
3. OTTI is covered by the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts – a requirement of the conformity election

IRS released the notice in May 2013 asking for comments from practitioners and taxpayers regarding the conformity election

1. Whether changes in bank regulatory standards and processes since adoption of the regs require amendment to the regs
2. Whether the regs are consistent with the principles of code section 166

- **Other Than Temporary Impairment**
 1. Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks
 - a) Referred to in the regulations
 - b) 2004 agreement rescinds the 1991 agreement
 2. Guidance changed the regulatory reporting
 - a) May result in tax deductions not intended by the original regulations

- IRS objectives:
 1. Reduce burden in determining worthlessness by IRS and Bank
 2. Provide efficient method to resolve conflict when determining bad debt deduction
 3. Manage IRS resources until further guidance is issued

- Who can use the Directive?
 1. Applies to all banks not using the 585 method
 2. Applies to some bank subsidiaries – conformity election does not
 3. May apply to 585 banks with respect to debt securities, not loans

- **Applicable Financial Statement**
 1. Financial statement required to be filed with the SEC
 2. Financial Statement required to be provided to a bank regulator
 3. Is a call report an AFS?

- **Bank Subsidiary**

1. Not a bank
2. Conducts business a bank may conduct
3. Member of the same affiliated group
4. Under supervision of the Bank's regulator

- Eligible Debt

1. Any debt whether originated or acquired
2. Reported in the AFS
3. Subject to bad debt deduction rules
4. Not a security under tax rules and not MTM
5. Within scope of ASC 450 or ASC 310-40

- Eligible Debt Security
 1. Any debt security
 2. Reported in the AFS
 3. Subject to bad debt deduction rules
 4. Not a security under tax rules and not MTM
 5. Within scope of ASC 320

- Application – facts and circumstance method
 1. IRS will not challenge a Bank or Bank Subsidiary's bad debt deduction
 2. Deduction based on credit related impairment of charge-offs
 3. Must be recorded in AFS
 4. IRS will not challenge inclusion of selling costs as long as reported in AFS

- Deduction limitation
 1. Post tax deduction basis cannot be less than
 2. Post charge-off book basis, adjusted for non credit related charge-offs
 3. Must be recorded in AFS

- Application – conclusive presumption
 1. Differences from Facts and Circumstances method
 2. May deduct non credit related charge-off if pursuant to written order
 3. Certification statement is required by bank
 4. Written order does not need to be produced

- Application – conformity method
 1. Do not challenge deduction under conformity method with a proper election
 2. Do not challenge even if EDL is not obtained

- **Implementation**

1. Applies on an entity-by-entity basis
2. Pending further guidance once applied must continue to follow the Directive
3. Could be a first year adjustment in some circumstances
4. Can be applied beginning in 2010 or thereafter, but no later than year beginning in 2014

- **Certification**
 1. If claiming a bad debt deduction under the Directive must sign a certification statement
 2. Must be signed by person authorized to sign tax return
 3. Does not need to be attached to the return
 4. Certification for each year is required

- Other considerations
 1. Non accrual interest
 2. Amended call reports
 3. AFS – Holdco FR Y-9 form to fed reserve
 4. State regulator included
 5. Uncertain Tax Position

- Capitalize v. Deduct for income tax
 1. Book v. tax can be different
 2. Improvement/betterment v. repair
 3. De minimus capitalization policy
 4. Effective for years beginning after 1/1/14
 5. Form(s) 3115 with 2014 return
 6. Elections for book/tax conformity, De minimus safe harbor, capitalization election reviewed annually
 7. Partial dispositions

- As of January 1, 2015 no bonus depreciation and 179 limits reduced
 1. Bonus depreciation not applicable
 2. Section 179 limit
 - a) \$25,000
 - b) Spending Cap of \$250,000
 3. Will these rules be extended by Congress?
 4. Impact to planning?

1. Low Income Housing:

- a) Claimed over 10 years (prorate in year 1)
- b) Compliance period is 11 years
- c) Accounting changes – expense pro rata based on tax benefits

2. Historic Credit:

- a) 20% credit if certified and 10% if not
- b) Credit claimed in year placed in service
- c) Basis reduction
- d) Five year holding period

1. Solar Credit:

- a) Credit is 30% of qualified expenditures including certain labor
- b) Can be used against AMT.
- c) Credit rate falls to 10% in 2017.
- d) Basis reduction by 50% of credit claimed

2. New Market Tax Credit:

- a) Investment or loan to low-income communities
- b) Capital must stay in low-income community 7 yrs
- c) Credit is 39% claimed over 7 years
- d) Not used against AMT
- e) Transactions are often leveraged with a loan to maximize returns

- Due date change for tax years beginning after 12/31/2015
 1. Partnership/S Corp due 15th day of 3rd month (March 15 for Dec year end)
 2. C Corporation now 15th day of 4th month (April 15th)
 - a) June y/e still due 9/15 until 12/31/2025
 - b) Extension calendar years 5 months
 - c) Extension June years 7 months
 - d) All others 6 months

REGULATORY CAPITAL – OLD RULE



- The amount of DTAs recognized as good assets for regulatory capital are:
- Net with DTLs: allowed to extent netted with DTLs
- Net DTAs are allowed if they can be carried back against previously paid taxes
- Remaining allowed if they can be absorbed against projected tax liability estimated for 12 months from reporting date.

REGULATORY CAPITAL – BASEL III SUMMARY



- Deferred taxes are categorized differently
- Separate DTA/DTLs from certain separately reported items such as goodwill and MSRs.
- AOCI opt out election – excluded related DTA/DTLs
- Segregate remaining DTAs by:
 1. Sourced from NOLS and Credits, and
 2. DTAs sourced from temporary differences

REGULATORY CAPITAL – BASEL III SUMMARY



- DTLs allocated to DTAs – typically allocation to NOLS/Credits is more advantageous. Allocation method should be consistent
- Deduct DTAs from NOLS and Credits from CET1
- Remaining net DTA tested for:
 - Hypothetical carryback, then
 - 10% of CET1
- Amount that exceeds 10% of CET1 is deducted
- Consider phase-in 40% in 2015, 60% in 2016, 80% in 2017

REGULATORY CAPITAL – BASEL III SUMMARY



- Net DTA and MSRs deducted from CET1 to extent they exceed 15% of CET1
- DTAs offset by carryback – 100% risk weighting
- Remaining Net DTA subject to 250% risk weighting starting in 2018. Need to plan for this in 2016/17 so there is not a surprise come Q1 in 2018.

Transaction Costs – Complete or Partial Purchase/Sale



- Must capitalize amounts paid to facilitate certain transactions.
 1. Acquisition of assets that are a trade/business
 2. Ownership interest if, immediately after, taxpayer is related
 3. Acquisition of ownership interest in taxpayer
 4. Restructuring, recapitalization or reorganization
 5. Tax free transfer under 351/721
 6. Formation of disregarded entity
 7. Capital raising
 8. Stock issuance
 9. Borrowing
 10. Writing an option

Meaning of Facilitate – What Does it Encompass



- Amount paid in the process of investigating or pursuing the transaction
 - Based on all the facts and circumstances
 - Fact that amount would/would not have been paid but for the transaction is important but not determinative
- There are special rules for certain costs
 - We will not discuss all special rules. There are 8 special rules – highlight a few on next slide.

- Employee compensation, overhead and de minimis costs do not facilitate a transaction
- Employee Comp: salary, bonus and commission. Annual payments to a director are EE Comp.
- Special meeting fees are not EE Comp and may facilitate transaction
- Overhead: does not facilitate
- De minimis costs only if total costs are $< \$5,000$
- Can elect to capitalize some or all per transaction

- The Regs provide a bright line test to determine whether a cost facilitates the transaction
- Only if amount relates to activities performed on or after:
 - Date on which letter of intent, exclusivity agreement or similar document is executed by acquirer and target
 - Date on which material terms are authorized or approved by Board of Directors. If no Board, by appropriate governing body. If none, date acquirer and target execute binding written contract reflecting terms

Bright Line Test – Certain Costs Excepted from Rule



- Certain costs must be capitalized even if paid or incurred before bright line test is satisfied
- Appraisal, formal written evaluation or fairness opinion
- Structuring the transaction, including negotiating and obtaining tax advice on the structure
- Preparing and reviewing documents that effectuate the transaction (e.g. Purchase & Sale Agreement)
- Obtaining regulator approval including filings
- Obtaining shareholder approval (proxy costs, solicitation costs, etc)
- Conveying property such as transfer taxes and title registration

Success Based Fees – Must they be Capitalized?



- Amounts paid, contingent upon a successful closing is an amount paid to facilitate – must capitalize

Exceptions to the rule

- Document amounts allocable to other activities such as strategic planning
- Documentation must include
 - Activities performed
 - Amount of fee or time allocable to each activity performed
 - Date activity performed, if deemed important
 - Name, address, phone number of service provider

Success Based Fees – Safe Harbor Deduction



- Revenue Procedure 2011-29 provides a safe harbor in lieu of maintaining documentation
- Election can be made to deduct 70% of success based fee without maintaining documentation. Remaining 30% is capitalized.
- Election must be made with the tax return
 - Statement attached to return in year fee incurred or paid. Election is irrevocable.
 - Stating electing safe harbor, identifying transaction stating success based fee amounts deducted and capitalized

- Rule applies to Corporation and Executive
- Corporation loses some deductions
- Executive pays a 20% surcharge
- Applies to officer, shareholder or highly compensation (top 1% of comp)
- Amounts in excess of a formulaic computation are “Excess Parachute Payments”
- Excess Parachute Payments are not deductible by the corporation and subject to a 20% excise tax paid by the recipient

- Computation of Excess Parachute Payment
 1. Determine base amount which is average salary over previous 5 year period.
 2. Compare 3 times the parachute payment to the base amount.
 3. Parachute payment is a change of control payment
 4. If amount exceeds 3 times the base there is an excess parachute payment.
 5. The excess is the transaction contingent payment less the base amount.

- Limitations related to acquired tax attributes – NOLs, Losses, Credit Carryovers
 1. Annual limitation of the amount of carryovers based on value of target immediately before ownership change
 2. Value times IRS long term tax exempt rate.
 3. May use the highest rate of current and prior two months

Net Built In Losses under Section 382



- The amount of loss recognized in a hypothetical sale of assets immediately before transaction
 1. Threshold amount: Lower of 15% of FMV or \$10 Million
 2. Recognized losses are only limited for 5 years beginning with acquisition date
 3. Recognized losses on loans are limited by 12 months. IRS Notice 2003-65.

- Nexus: means a general connection or presence in a state. Subjecting taxpayer to state and local taxes
 1. Historically: property and/or payroll within a state
 2. Economic Nexus: physical presence not required. Such as Capital One Bank (MA tax case).
 3. Community banks have increasing exposure to state taxation because of physical presence or economic nexus.

1. Connecticut

- a) Mandatory combined reporting
- b) Use of NOLs/Credits have been changed (50% limit)
- c) Extended 20% corporate surcharge for 2016/2017.

2. New York

- a) Major reform. State taxation regime on banks was repealed.
- b) File same returns as other corporation but with special bank only deductions and apportionment

3. Rhode Island has combined reporting for 2015 but does not include bank.

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Specializing in:

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