Year End Tax Update for Community Banks

November 3, 2015

WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

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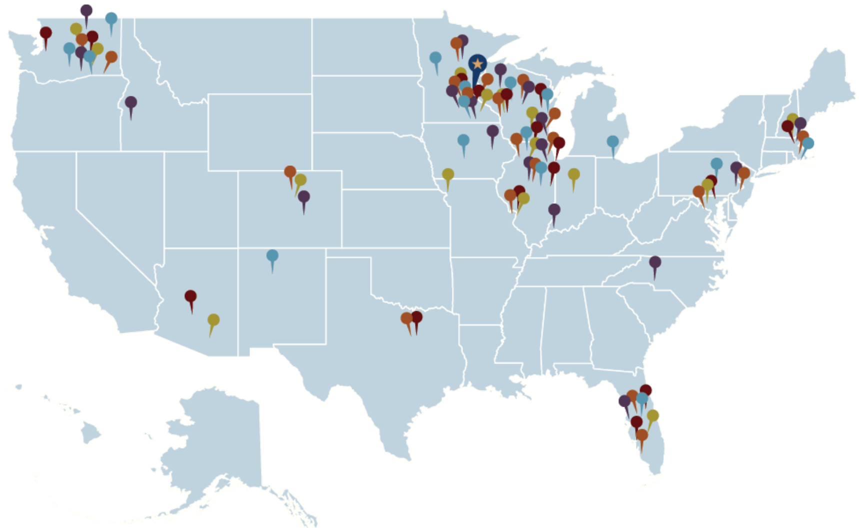

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Speaker Introductions

- John Matthiesen, Principal – Chicagoland
- Rod MacLachlan, Principal – Toledo, OH
- Brad Mattson, Principal – Minneapolis, MN
- Tim Malecha, Principal – Minneapolis, MN
- Amanda Garnett, Manager – Downstate Illinois and Missouri

Learning Objectives

- At the end of this session, you will be able to:
  - Identify tax changes affecting banks at 2015 year end
  - Evaluate the tax regulations and IRS pronouncements impacting your bank

Tax Bad Debts

John Matthiesen

History

- In 1986 IRC Section 585 was changed to restrict the use of the reserve method.

- Only C Corp banks that have <500 million in assets can use the reserve method.

Why the Change

- Concern reserve method allowed a deduction before losses actually occurred.
- Reserve method would allow a deduction larger than the actual present value of the losses.
- Concern many large banks were taking advantage of the reserve method to significantly reduce their Federal tax liability.

History – Cont'd

- In 1997 commercial banks became eligible to elect S-corporation status.
- A requirement for the S-election was termination of the reserve method for tax purposes.
- The controversy between IRS and banks has not changed
  - What is the amount of the loss?
  - When did it occur?

1991 The Conformity Election

- No challenge to deduction if one of the following is met:
  - Bad debt deduction is equal to charge off in applicable financial statement
  - Bad debt equal to change if pursuant to specific rider or written confirmation from bank regulators.
  - The bank has properly elected the conformity election.

2014 IRS Industry Directive to Agents

- Do not challenge bad debt deductions if the deduction does not reduce the tax basis below the financial statement basis.
- Do not require proof of a specific regulatory order.
- If conformity election had been made do not require an express determination letter.

2015 Activity

- FAA20153501F – IRS Field Service Advice
  - Taxpayer who failed to record a charge off was not allowed a tax deduction.
  - Partial worthlessness calculation and documentation was not enough to claim tax deduction.

2015 Take-Aways

- Identify loans that have potential losses.
- Tax deduction requires a charge off recorded on financial statement.
- Conformity election not required.
- In most cases if tax deduction matches financial statement deduction the deduction will not be challenged.

Bank Owned Life Insurance

Rod MacLachlan

What is Bank Owned Life Insurance?

- BOLI consists of life insurance policies placed on the bank's executives and /or board of directors
- An upfront single premium payment is made to purchase the life insurance
- The value of the policy grows tax deferred
- The death benefit is tax free when ultimately received

Why Bank Owned Life Insurance?

- BOLI is used to fund employee benefit expenses and can produce a higher after-tax return than many other typical bank investments
- Very popular with banks – as of 6/30/15, 58.85% of banks reported owning BOLI, averaging 12.67% of Tier 1 capital

Regulatory Guidelines

- Must comply with “The Interagency Statement on the Purchase and Risk Management of Life Insurance” (OCC-2004-56a)
- Must purchase to assist with employee compensation and benefit plans
- Requires senior management/board oversight and risk assessment
- Cash Surrender Value (CSV) generally limited to 25% of Tier 1 capital

Tax Consequences

- Increase in CSV is tax-exempt – but for C Corporation banks, 75% is included in Alternative Minimum Taxable Income (same as tax-exempt interest)
- Death benefit is tax free provided proper notice given to covered employee and written consent received. Again, 75% included in AMTI for C Corps (in excess of previously recognized amounts)
- If policy is cashed in early, gain is taxable. Also likely to be a 10% “MEC” penalty

Tax Consequences continued

- For S Corporation banks, cashing in a BOLI policy could result in built-in gains tax
- Can exchange policies tax-free under Sec. 1035

Potential Extenders

Brad Mattson

Annual Extenders

- Section 179 Expense
  - Current law allows for $25,000 of Sec. 179 expense tangible property acquisitions of $200,000 (dollar for dollar phase out in excess of $200k)
  - The extension will revert to the 2010 – 2014 amounts of $500,000 of Sec. 179 with a phase-out starting at $2 Million of eligible purchases.
  - The bill extends the definition to include computer software and $250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.
  - The bill also modifies the provision by indexing for inflation the $500,000 and $2 Million limits for years beginning after 2014.

Annual Extenders

- Bonus Depreciation
  - The bill would extend 50% bonus depreciation on qualified property placed in service before January 1, 2017.

- 15-year straight line cost recovery for qualified leasehold improvements, and qualified restaurant and qualified retail improvement property
  - The bill would extend for 2 years the 15 year (vs. 39 year) tax lives for the above properties.

Annual Extenders

- S Corporation Built in Gains tax recognition period
  - American Recovery and Reinvestment Act reduced the recognition period from 10 years to 7 for sale of assets in 2009-2010.
  - The Small Business Jobs Act reduced that period to 5 years in 2011.
  - The current bill extends the 5 year period through 2016.
  - This would relieve selling S Corp banks of the double taxation if they elected S before 1/1/2011 (if sold in 2015)

Annual Extenders

- Mortgage debt relief
  - Up to $2 Million of forgiven debt is eligible to be excluded
- Mortgage insurance premium deduction
  - Available to taxpayers with less than $110,000 of AGI

Annual Extenders

- New Markets Tax Credit
- Qualified Zone Academy Bonds (QZAB)
- Work Opportunity Tax Credit (WOTC)
- Tax Free distributions from IRA plan for charitable purposes.
  - Individuals over 70-1/2 generally can exclude up to $100,000 per year in distributions made directly from the IRA to certain public charities.

Increase in Information Return Penalties

- Information returns due after 2015

	Old	New
• Each failure	$100	$250
• Corrected within 30 days	$30	$50
• Corrected by August 1	$60	$100
• Intentional disregard	$250	$500

- Very limited de minimis exception
  - No greater than 10
  - Must file by August 1

Tax Return Due Dates

- C Corporation Returns
  - Due date is the 15th day of the fourth month following the close of the corporation's year
  - Corporations will be allowed a 5 month extension instead of the current 6 months – (through 2026)
  - Effective for tax years beginning after December 31, 2015, except if the C corp. has a June 30 year end. The new rules wont apply until years beginning after 2025.

Tax Return Due Dates – Cont'd

- Partnerships
  - Due date is March 15 (for calendar year partnerships) and the 15th day of the third month following the close of the year for fiscal year partnerships
  - IRS directed to allow a maximum extension of six months for Forms 1065
  - Effective for tax years beginning after December 31, 2015

New 1098 Reporting Requirements

- Requires third parties to provide additional information on returns relating to mortgage interest including,
  - Amount of outstanding principal (as of the beginning of the year)
  - Address of the property securing the mortgage
  - The date of the origination of the mortgage

The provision applies to returns and statement due after December 31, 2016.

Tax Credits

Tim Malecha

Executive Summary

- The Concept
  - Historic Tax Credits are a tool to reduce federal tax liabilities and promote traditional real estate lending
- The Opportunity
  - Reduce quarterly and annual tax payments
  - Promote construction lending and “bridge financing”
  - Drive IRR > 20%
- The Potential
  - Invest in quality real estate redevelopments while simultaneously marketing investor

Benefits to HTC Investor

- Significantly reduce federal and state tax liabilities
- Deploy available cash
- Since many projects are located in distressed urban areas, fosters positive public relations through creation of jobs and urban revitalization
- Opportunities to provide construction/mini-perm financing as well as "bridge financing"

Tax Credits in General

- Tax credits have been available as a tax planning tool dating back to the 1960's
- Credits, unlike deductions, represent a $ for $ reduction of tax liabilities
- Credits can offset up to 75% of current year liability including AMT
- Excess credits are available for carryback 1 year and carryforward 20 years

The Historic Tax Credit (HTC)

- The HTC has been available in current form dating back to 1986
- In general, the federal HTC is a 20% tax credit available for the rehabilitation of historic buildings listed on the National Register of Historic Places
- HTCs become available when a rehabilitated building is placed in service
- HTCs can be secured by corporate investors through investment in partnerships or LLC's that undertake the rehabilitation
- Many states have programs that mirror the federal HTC

Corporate use of HTCs Created By Others

- HTCs are often generated for a particular rehabilitation project by a developer who can not use the HTCs
- A 3rd party corporate investor can utilize the HTCs by investing in a partnership or LLC that owns the property being rehabilitated
- The corporate investor invests money into a partnership or LLC and receives an allocation of HTCs in addition to profits, losses and cash flow
- A “Fair Market Value Put” is negotiated as a part of the transaction for the investor’s exit beginning in month 61 after recapture period ends

Recent IRS Guidance

- The IRS, in Historic Boardwalk Hall (“Boardwalk”), challenged the position that a third party tax credit investor was truly a partner in the transaction
- The 3rd Circuit Court of Appeals in September 2012 ruled in favor of the IRS denying the third party investor an allocation of the tax credits
- The IRS issued Revenue Procedure 2014-12 establishing a “safe harbor”, which, if followed, precludes the IRS from challenging the allocation of tax credits to partners including third party corporate investors

Terms of Typical Investment

- Investment size of $1.3 million of federal Historic Tax Credit (“HTC”)
- Investment made in partnership in amount of $.88 per $1 of HTC
- Investor Cost
  - $1.144 million – ($.88 x $1.3 million)
- Investor Funding
  - 20% upon execution of Operating Agreement
  - 70% upon construction completion
  - 10% upon National Park Service approval (3 – 6 months after completion)
- Investor Benefits
  - $1.3 million federal HTC available upon construction completion
  - Annual preferred cash distributions of 2% of investors’ capital contributions of $1.144 million
  - “Put” rights at fair market value of interest after end of recapture period (5% of capital contributions)

Terms of Typical Investment – Cont’d

- Guarantees provided by developer/sponsor
  - Construction completion
  - Operating deficits
  - Tax credit recapture
  - Environmental indemnity
- Subordination and Nondisturbance Agreement (“SNDA”) prohibits lender from taking any action against the property that would cause a recapture event to investor during the 60 month credit recapture period

Risks of HTC Investments

- IRS
  - Attacks structure and ability of investor partner to claim tax credits
  - Mitigation strategy – If Rev Proc 2014-12 is followed, IRS is required to respect partnership allocations of tax credits
- Real Estate
  - Failure of project to be completed or achieve stabilized occupancy
  - Mitigation strategy
    - ◊ Reputable developer – history of rehabs
    - ◊ Guarantees provided by developer/sponsor
    - ◊ SNDA's often negotiated to preclude a foreclosure event from triggering recapture
- Act of Nature
  - A tornado, hurricane or flood triggers recapture
  - Mitigation strategy
    - ◊ Investor named as insured on property & casualty insurance policy

Merger and Acquisition Considerations

Amanda Garnett

Merger and Acquisition Environment

- From January 2014 thru September 2015:
  - Approximately 480 M&A deals completed or pending across the country
  - Midwest market has been particularly active- over 190 deals
- Premiums on sales are returning
  - Averaging in the range of 110% to 160% of tangible common equity
- CLA Bank Team has seen a significant increase in the number of institutions inquiring about M&A structures and potential transactions in the last 12 months

Transaction Structures – Overview

- Multiple ways to structure a M&A transaction.
  - Traditional Holding Company Merger
  - Traditional Merger with 338(h)10 Election
  - Transfer of the Stock of the Bank to Buyer
  - Sale of some or all of the Bank assets
- Different structures have different tax consequences
- Early in negotiations consult with tax professional
- One of the biggest determinations is whether for tax purposes the transaction will be structured as a stock transaction or asset transaction

Two Basic Tax Transaction Structures

Stock Purchase

- Generally favorable to seller
  - Avoids potential for double taxation
- Seller pays tax on activity thru sale date
  - Seller's Shareholders pay tax on sale of stock
- Buyer steps into the shoes of the seller for basis of all assets
  - No step up in basis for the premium paid on the purchase
- Any goodwill or intangibles recorded by buyer will not be tax deductible
- Buyer can use loss carryovers, credit carryovers leftover from the seller
  - Subject to limits in the IRS code
- Stock can be purchased for cash or in a stock for stock exchange

Asset Purchase

- Generally favorable to the buyer
- Seller pays tax on activity thru the sale plus gains on sale of assets
  - Seller's Shareholders also pay tax on sale of stock
  - Can create double taxation if ordinary gains exist
- Seller could be subject to built in gains tax
- Buyer gets stepped up basis in all assets
  - Fair market value = tax basis
- Any goodwill or intangibles recorded by buyer are tax deductible
  - Amortized over 15 years
- Buyer can not use any carryovers or credits left over from seller
- Asset purchase can occur depending on the structure of the agreement even if you negotiate on the price of the stock

Seller Considerations

- S Corporation Sellers:
  - Built in Gains potential on an asset sale
  - Classification of any gains/losses on sales of assets as ordinary gains/losses or capital gains/losses
- C Corporation Sellers:
  - Net operating losses and other carryforwards
    - ◊ Subject to Section 382 limit if transferable
    - ◊ Very limited value of purchased by S Corporation
  - Realizability of deferred taxes may have to be assessed prior to closing
    - ◊ Deferred tax assets are not valued by an S Corporation buyer
  - Accuracy of tax account accruals
    - ◊ Does the corporation have adequate tax liability accrued prior to closing to cover any taxes that will be due on the final return

Buyer Considerations

- S Corporation Buyer:
  - An exchange of stock for stock may or may not be an option due to S corporation shareholder rules
  - Built in gains potential on acquired property
    - ◊ Particularly if management plans to change investment mix, sell branches, etc.
  - When will timing differences reverse and impact shareholder taxes
- C Corporation Buyer:
  - Limitations on NOL and other tax carryforwards
  - Deferred tax balances and the impact on pro-forma capital ratios
  - When will timing differences reverse and impact taxable income
  - Accuracy of tax account accruals of the seller

Take-Aways

- Consider the tax consequences of the merger not just the premium offered
- Get an experience bank tax professional involved early in discussions
- Consider whether it will be structured as a stock purchase or an asset purchase
  - For S Corps, consider the impact of future built-in gains and how shareholder taxable income will be impacted
  - For C Corps, consider impact of deferred taxes, carryforwards, and future taxable income

Questions?

Thank you!

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