Community Banking After Tax Reform

Presented by:
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WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

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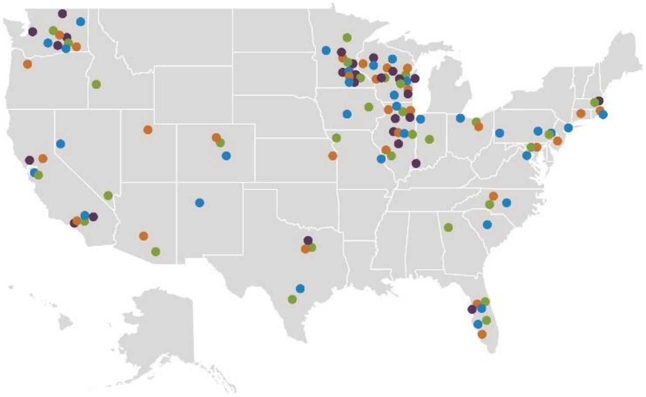

Speaker Introduction

Amanda C. Garnett, CPA

Amanda leads CLA’s financial institution tax practice. She has extensive experience in federal tax compliance, state tax issues, tax planning, and mergers and acquisitions. She serves community banks across the country ranging in size from $20 million to more than $3 billion in total assets.

In addition to tax services, Amanda performs consulting services and trainings for banks and banking associations across the country.

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Agenda

- Key tax considerations today
- The evolving shareholder base
- State tax trends
- Other recent news

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Key Tax Considerations Today

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C Corporation Taxation Today

	Current Tax Law
Corporate Tax Rate	21% Flat Rate – No expiration date
Shareholder Tax on Qualified Dividends	0%, 15%, or 20% capital gain rates apply, 3.8% NIIT applies if over threshold
Tax on Shareholder Sale of Stock	0%, 15%, or 20% capital gain rates apply, 3.8% NIIT applies if over threshold Stock basis does not change based on annual corporate earnings.
State tax deduction	All state taxes deductible by corporation

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What if there's a downturn?

- Net operating loss provisions changed significantly in tax reform
  - Net operating losses can no longer be carried back to claim refunds.
  - Carried forward only. Do not expire.
  - Can only offset 80% of income in future years.
- Alternative minimum tax has been eliminated
- Impact on capital
  - Deferred taxes on NOLs are deducted dollar-for-dollar from regulatory capital.
  - DTAs will be larger because they can no longer be carried back.

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Planning Opportunity: Cash basis of accounting

- New rule expands cash basis to $25 million gross receipts (3 year average)
  - Many more C Corporation banks are eligible
- Long term, semi-permanent deferral of tax revenue
  - Financial institutions expect accrued interest income to continue to exceed accrued expenses long term
  - Income continues to be deferred for tax purposes year after year
- Slows cash payments to the IRS and State
  - Allows for a rate of return on the cash that can be invested
- Positive impact for many community banks

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S Corporation Taxation Today

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	Current Tax Law
Shareholder tax rates on K-1 earnings	Maximum rate 37% + 3.8% Net Investment Income Tax Section 199A deduction of up to 20%
Shareholder tax on distributions	Not taxed at the shareholder level as long as corporations as adequate AAA
Tax on Shareholder Sale of Stock	0%, 15%, or 20% capital gain rates apply, 3.8% NIIT applies if over threshold Stock basis changes based on earnings and distributions
State Tax Deduction	Capped at shareholder level at $10,000 per year including real estate taxes and income taxes

Section 199A Considerations

- Temporary provision: Effective for 2018 through 2025
  - Could be extended in the future or eliminated entirely
- Deduction at the shareholder level of up to 20% of qualified business income
  - Can lower the effective tax rate paid by the shareholder group
- Specified Service Business Income (SSBI) Limitation
  - Trust, brokerage, and operations can result in corporation being considered a service business, which can reduce/eliminate benefit
  - Threshold 5% or 10% of gross receipts depending on size

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S Corporation Versus C Corporation Today

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- A number of S corporation banks across the company have chosen to voluntarily revoke S election
- The analysis today in benefits of a S corporation versus C corporation is very different than when the original S election was made

Historic Tax Rates		
	1997	2019
Maximum C Corporation Tax Rate	35%	21%
C Corp Dividend Rate	35%	20% + NIIT
Maximum Personal Tax Rate in 1997	39.60%	37% - Section 199A + NIIT
Maximum Bracket Begins for Single Individuals	$ 271,050	$ 510,300
Maximum Brack Begins for Married Individuals	$ 271,050	$ 612,350
State and Local Tax Deduction	Unlimited	$10,000 cap

The Shareholder Basis Problem

- New requirement beginning in 2018 when filing 1040s
  - Shareholders will need to attach basis schedules annually to their personal tax returns if they are receiving distributions
- Who is responsible for basis?
  - Today: We believe it's a shareholder level responsibility
  - Concern: What if this becomes a corporate responsibility similar to partnerships?
  - Reality: Many shareholders are going to need help even if they are using a qualified tax preparer

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Risk of Inadvertent Terminations

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- S corporation fails to maintain its eligibility as an S corp, the S election automatically terminates
- Disqualifying Events
  - Having more than 100 shareholders after considering family attribution rules
  - Having an ineligible shareholder
  - Having more than one class of stock
- Can typically be repaired with the IRS, but costly and time consuming
- Risk that bank would be treated as a C Corporation and subject to tax

The Evolving Shareholder Base

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Ballooning Shareholder List

- With generational changes, the number of individuals on some shareholder lists is growing quickly
  - Expect the trend to continue and accelerate over next 5 – 10 years
- Surveyed a group of S Corporation banks in fall 2018
  - Nearly all reported >75% of their shareholders age 50 or over
- Large driver of M&A and IPOs

Real World Examples

	K-1s Issued		
	2012	2018	Increase
Bank A	73	87	19.2%
Bank B	357	390	9.2%
Bank C	226	256	13.3%

United State Statistics

US Life Expectency of Male	76.30 Years
US Life Expectency of Female	81.30 Years
Baby Boomers were born	1943 - 1960
Baby Boomers age today	59 -76 Years

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The Cost of Being a Widow(er)

- Tax rates increase significantly for some couples after the death of the first spouse
- At the same time, may need additional cash to fund long term care needs
- Remaining spouse may be less familiar with tax aspects of S Corp

S Corporations	Married Filing Jointly	Single
Rate	Begins At	Begins At
12%	19,050	9,525
22%	77,400	38,700
24%	165,000	82,500
32%	315,000	157,500
35%	400,000	200,000
37%	600,000	500,000

Cap Gains/Dividends	Married Filing Joint	Single
Rate	Begins at	Begins At
0%	$0	$0
15%	$77,200	$38,600
20%	$479,000	$425,800

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Estates and Gifts

- Tax reform increased gift/estate tax limit significantly
  - $11.4 million per person, indexed annually
  - With estate portability, a married couple has a combined federal estate exemption of over $22 million
  - Annual gift exclusion remains at $15,000 per person
  - Scheduled to expire in 2025
- IRS has stated no gift “clawback” even if higher limits sunset
  - If law change is expected, expect massive amounts of gifting
- More families could hold stock until death for basis step up
  - S Corp step up benefit is nullified, if shares are held until death

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Strategic Planning Considerations

- Have we had conversations with major shareholders about their estate plans and met the next generation?
- What major shareholder changes might happen in the next 3-5 years?
- If families need/want to sell their shares, are we prepared?
- Can current liquidity needs be addressed through our distribution policy or special distributions?
- Have we considered a formal stock buyback program?
- How do we connect with and retain non-local shareholders?

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State Tax Trends

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State Tax Nexus

- Today many community banks only file in their home state
- Wayfair vs. South Dakota case
  - Sales tax case with wide implications
  - Economic nexus is constitutional
- Economic nexus
  - Do not need to have employees or branches in a state to be taxed there
  - Customers that live out of state can create nexus
  - Collateral on loans located out of state can create nexus
- States are getting better at tracking out of state lending activities

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Some Key States and Cities to Consider

State/City	Gross Receipts Threshold
Alabama	$500,000
California	$500,000
San Francisco	$500,000
Colorado	$500,000
Connecticut	$500,000
Indiana	$1
Kentucky	$1
Michigan	$350,000

State/City	Gross Receipts Threshold
Minnesota	$1
New York State	$1,000,000
Ohio	$500,000
Oregon	$750,000
Philadelphia	$100,000
Tennessee	$500,000
Virginia	$1
Washington	$250,000
Wisconsin	$1

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Managing State Tax Risk

- Determine the population:
  - Review list of loans secured by out of state property annually
  - Review unsecured loans to out of state customers annually
  - Consider other revenue sources including fee income to out of state customers
- Estimate the exposure by state
  - Include penalties and interest. Go back at least seven years.
- Consider your own risk preferences
- Consider the evolving detection risk

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S Corporation Considerations

- Filing in multiple states can be cumbersome for shareholders
  - K-1s issued in multiple states
  - Non-resident withholding requirements and/or composite returns
- Consider impact if you are “caught” by a state later
  - Impact on shareholders who may need to amend personal returns
  - Potential tax liability for the bank
- Consider the cost of tax compliance
  - For the corporation and for your shareholders individually
- Can become an issue on mergers and acquisitions

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C Corporation Considerations

- Uncertain tax positions
  - Choosing not to file in a state where you may have nexus could be an uncertain tax position
  - Need to quantify the amount of exposure including penalties and interest
  - Need to carry reserves if it is more likely than not the tax would be imposed
    - ◊ You have to assume you would be audited
- May be additional disclosures required on audited financial statements
- Can become an issue on mergers and acquisitions

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Other Recent News

Republican Proposal to Change Capital Gains

- Ted Cruz and 20 other senators sent a letter dated July 29, 2019 to Treasury Secretary Mnuchin
  - Urges him to use an executive order to index stock basis to inflation
  - Example: Coca-Cola stock purchased in 1998 for $32.38 indexed for inflation would be $50.50 today. Current stock price $48.13
    - ◊ If sold today, gain of $15.76 share. With change, loss of $2.38 per share
  - Cruz argues Congressional action isn't necessary for the change
  - President Bush looked at the idea and dropped it over legal concerns
  - Some estimating could cost $100 billion over a decade

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Democratic Proposals to Change Capital Gains

- Ten of the current Democratic candidates proposing raising the capital gains rates
  - Joe Biden advocates doubling the rate for those making over $1 million
  - Proposals range but could put capital gains rates closer to the current personal income tax rates some with rates up to 40%
- Changing capital gain rates would require an act of Congress

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Captive Insurance Arrangements

- Many banks across the country have captive insurance companies
- Currently listed on IRS' dirty dozen list and are a reportable transaction to the IRS
- More than 500 docketed microcaptive cases sitting at the Tax Court
  - IRS asserting that some lack the attributes of genuine insurance and are merely tax shelters
  - Three high profile cases settled to date
- Speculation that IRS is working on a settlement initiative to close cases and shutdown fault captive insurance arrangements

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SALT Limitation Workarounds

- The $10,000 state and local tax credit has been a very debated provision
- States have been investigating work arounds
- Some approach S Corporation income essentially moving the tax from the shareholder level to the corporate level
  - Wisconsin is one of the key states so far
  - More states could move in that direction
  - Can have varying effectiveness for shareholders depending on where they reside
- Final validation of these plans is still pending from IRS

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Questions?

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