Community Banking After Tax Reform

Presented by:

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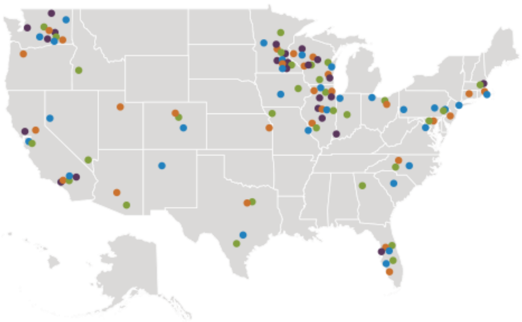

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Speaker Introductions

- Amanda Garnett is a principal in CLA's Peoria, Illinois office and assists clients with financial statement audits, internal audits, regulatory reporting, tax compliance, and consulting services. She has served financial institutions across the country ranging in size from $10 million to $5 billion in total assets.

- Charlie Cameron is the chief industry officer of CLA's financial institutions practice and has more than 30 years of combined experience in public accounting and the banking industry. He provides clients with engagement oversight in the areas of internal audit, compliance, loan review, and tax. In addition, Charlie provides board advisory and management consulting services of strategic and profit planning, mergers and acquisitions, asset/liability management, and administrative action assistance.

Key Provisions of Tax Reform

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Major Provisions for C Corporations

	Prior Tax Law	Tax Reform
C Corporation Tax Rate	Maximum rate of 35%	Flat rate of 21%
Corporate AMT	20% Corporate AMT rate	Corporate AMT repealed
Cash Basis of Accounting	< $5 million in gross receipts	<$25 million in gross receipts
Net Operating Losses	Carried back 2 years and forward 20 years. Can offset 100% of income.	Carried forward only. Do not expire. Can offset 80% of income.
Tax on dividends paid	Taxed at capital gains rates, Max of 23.8%	Taxed at capital gains rates, Max of 23.8%
State and local tax deduction	Fully deductible paid at corporate level	Fully deductible paid at corporate level
Estate Tax	$5.49 million per person in 2017 indexed for inflation	$11.2 million per person in 2018 indexed for inflation

Capital Gain and Qualified Dividends

2017 Capital Gains & Qualified Dividends Tax Rates (Pre-TCJA)				
Tax Bracket	**Single**	**MFJ**	**H of H**	**Estates & Trusts**
0%	37,950	75,900	50,800	2,550
15%	418,400	470,700	444,550	12,500
20%	**EXCESS**			

2018 – 2025* Capital Gains & Qualified Dividends Tax Rates (Under TCJA)				
Tax Bracket	**Single**	**MFJ**	**H of H**	**Estates & Trusts**
0%	38,600	77,200	51,700	2,600
15%	425,800	479,000	452,400	12,700
20%	**EXCESS**			

As a C Corporation, some shareholders can fall into the 0% qualified dividend bracket- effectively eliminating double taxation.

Shareholders may also be subject to 3.8% NIIT on dividends and capital gains if they exceed the thresholds.

Major Provisions for S Corporations

	Prior Tax Law	Tax Reform
S Corp Taxes	Taxed at individual shareholder rates	Taxed at individual shareholder rates with Section 199A deduction
Max Federal Tax Rate	39.60% (+ 3.8% NIIT for Passive SHs)	37% (+ 3.8% NIIT for Passive SHs)
Standard Deduction	Single = $6,350 Married = $12,700	Single = $12,000 Married = $24,000
Personal Exemption	$4,050 per person	Eliminated
State and Local Tax Deduction	Unlimited	Limited to $10,000 of real estate taxes + income taxes
Estate Tax	$5.49 million per person in 2017 indexed for inflation	$11.2 million per person in 2018 indexed for inflation

Personal Tax Rate Changes

2017 Individual Tax Rates (Pre-TCJA)			
Tax Bracket	Single	MFJ	H of H
10%	9,325	18,650	13,350
15%	37,950	75,900	50,800
25%	91,900	153,100	131,200
28%	191,650	233,350	212,500
33%	416,700	416,700	416,700
35%	418,400	470,700	444,550
39.6%		**EXCESS**	

2018 – 2025* Individual Tax Rates (Under TCJA)			
Tax Bracket	Single	MFJ	H of H
10%	9,325	19,050	13,600
12%	38,700	77,400	51,800
22%	82,500	165,000	82,500
24%	157,500	315,000	157,500
32%	200,000	400,000	200,000
35%	500,000	600,000	500,000
37%		**EXCESS**	

Section 199A Deduction

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New Section 199A Deduction

- Effective for: Tax years ending 2018 through 2025
  - Could be extended in the future or eliminated entirely
- Available to: Individuals, trusts, and estates
- 20% of a taxpayer’s qualified business income from a partnership, S Corporation, or sole proprietorship
  - Qualified business income does not include capital gains or dividend income
- Implied max. tax rate for active shareholder = 29.60% = (37% x 80%)
  - Plus 3.8% net investment income tax

Limitations on Section 199A

- Shareholders whose taxable income exceeds threshold are subject to limitations
  - $157,000 single or $315,000 joint
- Specialized Service Business Income (SSB)
  - Not eligible for 199A if over threshold
  - Guidance for banks on SSB income is needed
- Overall 199A limited to:
  - 50% of W2 wages with respect to trade or business OR
  - 25% of W2 wages plus 2.5% of qualified property
    - ◊ K-1 should provide allocated W2 wages and property
- Other limits could apply if shareholder has other businesses
  - Schedule C, Schedule F, Rentals, S Corps, Partnerships

Shareholder Level Examples

Bank K-1 Information Reported for All Examples:

- Qualified Business Income = $100,000
- Wages = $75,000
- Qualified Business Assets= $55,000
- Married Taxpayer

	SH Tentative Taxable Income	Additional Qualified Business Income	Wages and Qual. Assets	Section 199A Deduction
Example 1	$1,000,000	$0	N/A	$20,000
Example 2	$200,000	$50,000	$0 Wages $10,000 Assets	$30,000
Example 2	$1,000,000	$50,000	$0 Wages $10,000 Assets	$20,250
Example 3	$200,000	-$50,000	$0 Wages $10,000 Assets	$10,000
Example 4	$1,000,000	-$200,000	$500,000 Wages $100,000 Assets	$0

Re-Thinking Corporate Structure

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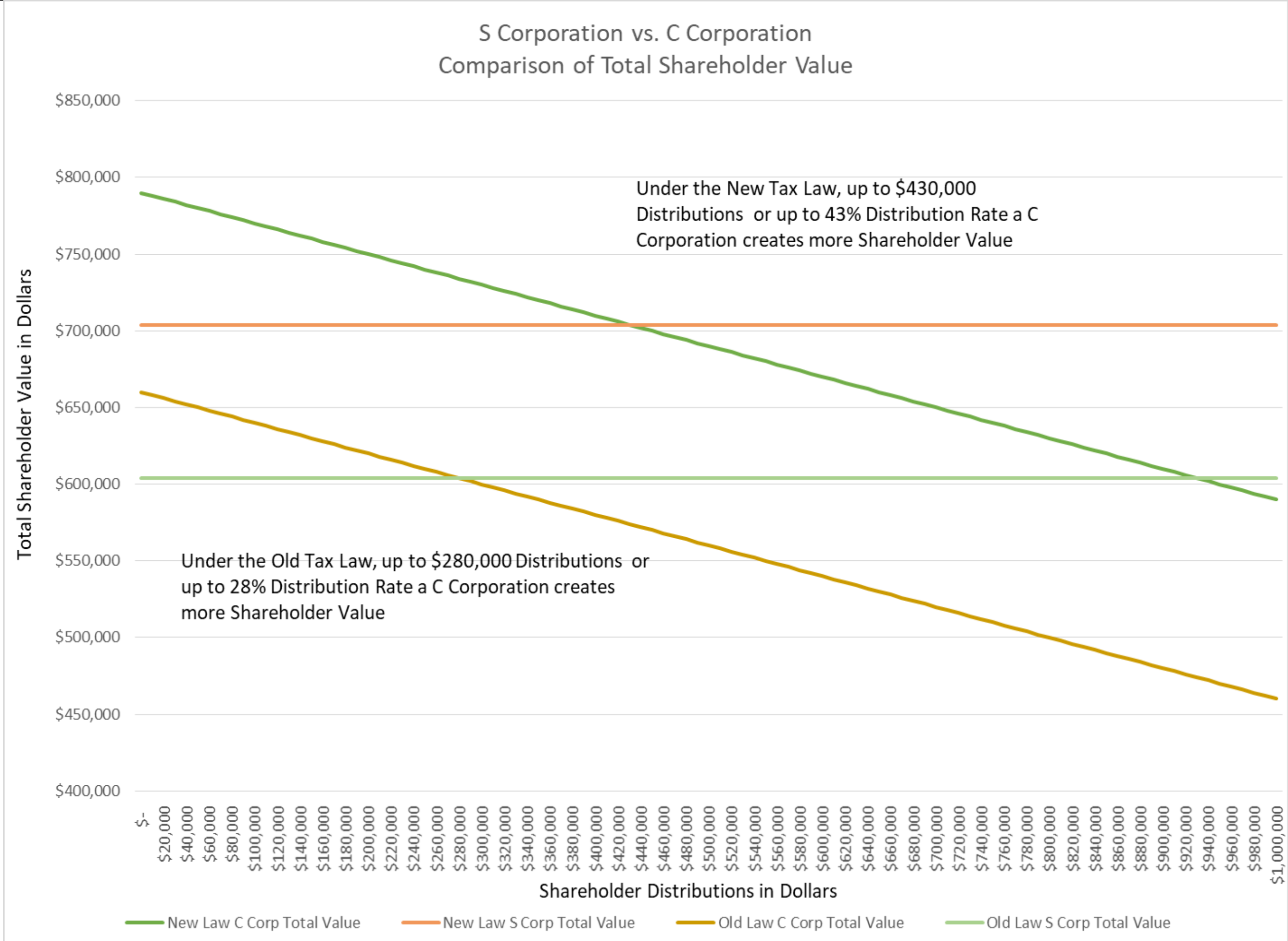
Re-Thinking Corporate Structure

- Post tax reform, all community banks should actively discuss their corporate tax structure and long term strategic plans
- C Corporation 21% tax rate is permanent, unless there are legislative changes
  - Still subject to double taxation on dividends
- S Corporation 20% deduction on Section 199A is temporary, unless extended
  - Maximum personal rate of 37% is temporary
  - Avoid double taxation and offers step up in basis

Simplified Example

- Looking to maximize shareholder value in the long term
  - Balance cash needs of shareholders vs. equity needs of bank
- Total Increase in Shareholder Value = After Tax Cash Flow to Shareholder + Equity Retained by the Bank during the Year
  - Does not consider basis step up as S Corp

	New Tax Law	Old Tax Law
Taxable Income	$1,000,000	$1,000,000
C Corporation Tax Rate	21%	34%
C Corp Dividend Tax Rate	20%	20%
S Corp Tax Rate	37% - Section 199A	39.60%


S Corporation vs. C Corporation
Comparison of Total Shareholder Value
Under the New Tax Law, up to $430,000 Distributions or up to 43% Distribution Rate a C Corporation creates more Shareholder Value
Under the Old Tax Law, up to $280,000 Distributions or up to 28% Distribution Rate a C Corporation creates more Shareholder Value
Total Shareholder Value in Dollars
$850,000
$800,000
$750,000
$700,000
$650,000
$600,000
$550,000
$500,000
$450,000
$400,000
$-
$20,000
$40,000
$60,000
$80,000
$100,000
$120,000
$140,000
$160,000
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$840,000
$860,000
$880,000
$900,000
$920,000
$940,000
$960,000
$980,000
$1,000,000
Shareholder Distributions in Dollars
New Law C Corp Total Value
New Law S Corp Total Value
Old Law C Corp Total Value
Old Law S Corp Total Value

Key Considerations

- How much cash do shareholders need/expect in the short and long term?
  - Need to consider after tax "free" cash flows to shareholders
  - But also consider psychological impact of dividend payments
- What are the short and long term capital needs of the bank?
- Who are the shareholders and how well do they understand the S Corporation structure?
- Will shareholders likely hold their shares until death or will they sell?
  - Automatic step up in basis on death of shareholders through estate
  - What is the average age of shareholders?

S Corporation Costs and Benefits

- Costs of Maintaining Shareholder Eligibility
  - Bank may not be aware of all shareholder deaths, which makes it difficult to monitor shareholder eligibility
  - S Election issues can be fixed with IRS but are costly
- Cost for shareholder tax compliance
  - Small shareholders likely pay more to file their tax return with the S Corp K-1 than they get in benefit
  - Particularly if shareholders have less than $5,000 in annual K-1 income
- Benefit of Step Up in Tax Basis each year
- Possible benefit on sale of bank as S Corporation

Case for Simplicity

- C Corporations eliminate much of the complexity for shareholders
  - Shareholders pay tax only on the cash received
  - File 1099-DIVs instead of K-1s
  - No limitations on transfers of ownership
  - Easier tax preparation
- Broader options for capital long term
  - Borrowing at the holding company level
  - Public offering, IRAs, more than 100 individuals
  - Can retain capital when needed for growth or acquisitions
  - Could acquire using stock instead of cash

Tax Planning Strategies

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S Corporation Distributions

- Reconsider distribution policies in light of tax law changes
  - Review existing shareholder agreements to determine if distribution rate can be decreased
  - Consider equity needs of bank and holding company
  - Consider shareholders on safe harbor payments in 2018
- Consider distribution calculation changes related to:
  - Section 199A deduction
  - State income tax deduction on federal return
- Communicate with shareholders about distribution policy for 2018 and beyond
  - If distributions aren't decreasing, consider educating shareholders on the fact that they are getting a better rate of return

Investment Strategies

- Lower corporate and shareholder tax rates may make tax-exempt bonds/loans or BOLI products less attractive
  - Decline in rates lowers the tax equivalent (TE) yield
  - Change will impact the pricing of municipal bonds
- Repeal of the AMT could also impact investment strategies for some C Corporations with large investment portfolios

Coupon Rate	Approx. TE Yield Today (40% Blended Rate)	Approx. TE Yield After Change (25% Blended Rate)
3.0%	5.00%	4.00%
4.0%	6.66%	5.33%
5.0%	8.33%	6.66%

C Corporations - Expanded Cash Basis

- New rule expands cash basis to $25 million gross receipts
  - 3 year average gross receipts test
  - 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

Large AAA Distribution

- Problem: Shareholders looking for Liquidity
- Possible Solution: Large payout of AAA from S Corporation
  - One time payout of as much as possible form AAA to give shareholders tax free cash
    - While S Corp or within 1 year after becoming C Corp
  - Convert to a C Corporation and don’t pay any dividends for a period of time
    - Single layer of taxation
  - Borrow at the holding company level, if necessary, to fund payout or use excess capital
    - Small banking holding company extended to $3 million
  - Remain C Corporation for at least 5 years

Shareholder Buyback Program

- **Problem**: Shareholders are looking for additional liquidity
- **Possible Solution**: Pre-Arranged Shareholder Buy Back Program
  - Work with attorneys to set up legal documents for buy back
  - Offer to buy back set amount of stock annually
    - ◊ Perhaps $200,000 or 1,000 shares per year
  - Create a pre-established price
    - ◊ Book value per share or a set discount or premium
  - Notify all shareholders about program
    - ◊ Take requests and create a waiting list if necessary
  - Can also help with non-local shareholders

Employee Stock Ownership Plan

- **Problem**: Shareholders are looking for additional liquidity
- **Possible Solution**: Establish ESOP Plan
  - Work with attorneys and benefits team to create/expand an ESOP Plan
  - Qualified retirement plan for tax purposes
  - ESOP can buy shares from existing owners and can be leveraged, if necessary
  - Offers employees a chance to participate in corporate ownership and benefit from growth
  - ESOP does not pay tax on annual S Corp earnings or C Corp dividends
    - ◊ Participants pay tax on withdrawals from plan

Other Tax Reform Changes

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Other Key Provisions

	Prior Tax Law	Tax Reform
Accelerated Depreciation	50% bonus depreciation	100% bonus depreciation
Section 179	$510,000 in 2017	$1 million
Entertainment Expenses	50% deductible in most cases	Not Deductible
Business interest deduction	Generally deductible by all businesses	Businesses > $25 million in gross receipts are limited to 30% of taxable income. Banks are not limited as interest income > interest expense.
Home Mortgage Interest	Interest on $1,000,000 of acquisition/improvement indebtedness + $100,000 of other home equity related indebtedness can be itemized	Interest on $750,000 of acquisition/improvement indebtedness can be itemized

Entertainment Expenses

- Previously entertainment expenses were 50% deductible as long as they were not lavish or extravagant
- Beginning in 2018, entertainment expenses are not deductible. Items potentially included:
  - Sport, theme park, and theatre tickets
  - Fishing and hunting trips
  - Golfing, boating, skiing
- Meals will generally still be 50% deductible unless they are tied to an entertainment event. Further guidance is needed.

Home Mortgage Interest Deduction

- Deduction for acquisition indebtedness
  - Loan size reduced from $1 million to $750,000
  - Loans must be used for acquisition, construction, or substantial improvement to home or second residence
  - Refinancing of loans is okay for deduction
- Home equity loan deduction- eliminated
  - Deduction going forward will depend more on how the funds are used
- Form 1098 reporting includes all loans secured by real estate
  - Doesn't currently specify the use of funds

Questions?

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Thank You!

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