
THE BANK TAX TUTORIAL CASE STUDY ANSWERS

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CASE 1 - Interest and Fee Income

- **ANSWER:**

- Bank must recognize \$850,000 in the current year for tax purposes, plus whatever income would accrue on the \$300,000 of points under the OID rules in the current year
- The \$600,000 of loan origination fees to cover services rendered and the \$250,000 in commitment fees collected can not be deferred under the OID rules

CASE 2 - Interest and Fee Income

- **ANSWER:**

- Bank must recognize \$545,000 in the current year for tax purposes
- The \$500,000 of general ledger fee income takes into account the recognition of fee income over the lives of the underlying loans (SFAS 91)
- The ending deferred fee balance on the balance sheet represents life-to-date fees collected that have not yet been recognized into book income

CASE 3 - Interest and Fee Income

- **ANSWER:**

- Bank must recognize \$470,000 in the current year for tax purposes
- Because the Bank utilizes the proper OID accrual method for recognizing deferred points, no book-tax difference is necessary for the deferred points (i.e. it is already appropriately considered in the \$500,000 of general ledger fee income for the current year)

CASE 4 - Interest and Fee Income

- **ANSWER:**

- The market discount is \$15,000
- If no current election is in place, no taxable income must be recognized prior to sale or maturity with respect to the market discount
- Upon maturity, the entire \$15,000 of market discount must be recognized in taxable income
- This taxable income is ordinary income, not capital gain or tax-exempt interest

CASE 5 - Interest and Fee Income

- **ANSWER:**

- The market discount is zero
- The OID is \$15,000
- Given that OID is treated as interest income, no taxable income is recognized (i.e. because the interest is tax-exempt)
- No taxable income is recognized at maturity because there is no market discount

CASE 6 - Mortgage Servicing

- **ANSWER:**

- The gain and basis determination are calculated as follows:
 - Step 1 – allocate the tax basis in the loans to the loans and servicing asset based upon their relative fair market values:
 - Value of loans = \$10,000,000
 - Value of servicing = \$50,000
 - Total value of both = \$10,050,000
 - Servicing asset basis = $50,000 / 10,050,000 \times 10,000,000$, or \$49,750

CASE 6 - Mortgage Servicing

- **ANSWER:**

- The gain and basis determination are calculated as follows:
 - Step 2 – compute the gain on the loan sale using the reduced loan basis of \$9,950,250 (\$10,000,000 - \$49,750)
 - Sales proceeds = \$10,000,000
 - Loan basis = \$9,950,250
 - Taxable gain = \$49,750 (the gain is increased by the amount allocated to the servicing asset)

CASE 6 - Mortgage Servicing

- **ANSWER:**

- The balance of the loan servicing asset will offset the taxable income that would otherwise be recognized from the stream of servicing income to be collected by the seller/servicer
- The servicing asset is usually amortized over the anticipated life of the servicing arrangement as a partial offset to this income

CASE 6 - Mortgage Servicing

- **ANSWER:**

- BONUS QUESTION ANSWER:
- The tax treatment of the excess servicing asset has no impact on the overall amount of taxable income to be recognized under the sale / servicing arrangement
- These adjustments only impact the timing of the income recognition, and therefore constitute a tax method of accounting

CASE 7 - Mortgage Servicing

- **ANSWER:**

- If the level of servicing fees to be collected did not result in “excess servicing fees,” then no basis allocation would be required for tax purposes (i.e. the gain on the loan sale would simply be measured by the difference between the sales proceeds and the loan basis; no servicing asset would be amortized)
- For financial accounting purposes, basis allocations are generally required whether or not the servicing fees are “normal” or “excess;” thus the book gain / amortization would have to be reversed in the tax calculation

CASE 8 - Bad Debts

- **ANSWER:**

- The bad debt deduction available to bank is \$130,000 (\$150,000 - \$20,000)

CASE 9 - Bad Debts

- **ANSWER:**

- Bank would have taxable *income* of \$130,000 (\$150,000 of taxable recoveries and \$20,000 of current bad debt deductions)

CASE 10 - Bad Debts

- **ANSWER:**

- IRS may challenge bank's deductions for the bad debts on a loan-by-loan basis, if the loans were not charged-off in obedience to specific regulatory orders
- Bank would be required to defend these deductions based upon the facts and circumstances surrounding each individual loan
- The conformity election would likely protect the Bank's deductions *if the applicable procedures are followed*

CASE 11 - Bad Debts

- **ANSWER:**

- Step 1 – determine the largest available reserve balance:
 - “Experience method reserve”
 - Sum of total 6-year charge-offs = \$1,200,000
 - Divided by sum of 6-year total loans = \$1,000,000,000
 - Multiplied by total current total loans = \$200,000,000
 - \$240,000 ($1,200/1,000,000 \times 200,000,000$)

CASE 11 - Bad Debts

- **ANSWER:**

- Step 1 – determine the largest available reserve balance:
 - “Base year reserve”
 - Total loans at the end of the current year = \$200,000,000
 - Divided by total loans at the end of the base year = \$125,000,000
 - Equals base year ratio, but not greater than 1.0
 - Multiply by base year reserve balance = \$120,000 (1.0 x \$120,000)

CASE 11 - Bad Debts

- **ANSWER:**

- Step 1 – determine the largest available reserve balance:
 - Larger of the two reserve balances = \$240,000 (the experience method reserve)

CASE 11 - Bad Debts

- **ANSWER:**

- Step 2 – determine the adjusted reserve balance before any current year deduction:
 - Reserve balance at the beginning of the year = \$180,000
 - Less net charge-offs for the current year = \$100,000
 - Equals the adjusted reserve balance before the current year deduction = \$80,000
(\$180,000 - \$100,000)

CASE 11 - Bad Debts

- **ANSWER:**

- Step 3 – determine the current year deduction:
 - Available reserve balance at the end of the current year = \$240,000
 - Adjusted reserve balance before any current year deduction = \$80,000
 - Current year deduction = \$160,000 (\$240,000 - \$80,000)
 - NOTE – the amount of tax deduction is not directly tied to the current year net charge-offs

CASE 12 - Nonperforming Loans

- **ANSWER:**

- The agent will not likely challenge the \$40,000 of non-accrued interest because it relates to loans that the taxpayer has legitimately charged-off
- The agent is likely going to question the \$60,000 of non-accrued interest related to loans 90 days past due as a matter of policy
- The taxpayer will need to defend the non-accrual of the \$60,000 amount on the basis of the facts and circumstances underlying each individual loan

CASE 13 - Capital Gains and Losses

- **ANSWER:**

- The gains and losses from the loans and corporate bonds are ordinary and are therefore fully recognized in the current year
- The 2008 legislation made losses on the FNMA preferred stock ordinary as well (for sales of this stock after 2007), so this is an ordinary loss
- Bank realizes a net capital loss of \$40,000 in the current year from the sale of the mutual funds (equity investments)
- The net capital loss could be carried back 3 years and forward 5 years

CASE 14 - Capital Gains and Losses

- **ANSWER:**

- Bank Holding Company realizes a net capital gain of \$70,000 in the current year
- The corporate bonds are capital assets in the Holding Company, as §582 does not apply to that corporation
- Thus, there is no net disallowed capital loss in the current year

CASE 15 - Mark to Market Rules

- **ANSWER:**

- If Bank properly identified the investment securities as exempt from §475, then \$35,000 of taxable gain must be recognized under the MTM rules in the current year
- If Bank purposefully did not identify the investment securities as exempt from §475, then \$315,000 ($\$35,000 - \$350,000$) of taxable loss must be recognized under the MTM rules in the current year

CASE 16 - Interest Expense

- **ANSWER:**

- \$75,000, determined as follows:
 - Total interest expense = \$5,000,000
 - Divided by average total assets = \$400,000,000
 - Multiplied by average tax-exempt bonds = \$30,000,000
 - Equals \$375,000 of allocated interest expense
 - However, because the tax-exempt bonds and loans are all “qualified,” only 20% of this amount (\$75,000) is disallowed

CASE 17 - Interest Expense

- **ANSWER:**

- \$375,000 determined as follows:
 - Total interest expense = \$5,000,000
 - Divided by average total assets = \$400,000,000
 - Multiplied by average tax-exempt bonds = \$30,000,000
 - Equals \$375,000 of allocated interest expense

CASE 18 - Capitalization of Intangible Costs

- **ANSWER:**

- \$950,000 of Bank's loan origination costs are currently deductible (the \$700,000 of allocated compensation and overhead and the \$250,000 of costs qualifying for the de minimis exclusion)
- The remaining \$500,000 of costs must be capitalized and amortized over the lives of the underlying loans (both the \$200,000 and \$300,000 do not qualify under the de minimis exception)
- The current amortization of the capitalized costs would also be deductible in the current year

CASE 19 - Capitalization of Intangible Costs

- **ANSWER:**

- Only the \$100,000 prepaid maintenance contract would qualify under the 12 month rule
- The \$120,000 prepaid insurance contract does not meet the 12 month requirement because the period of benefits to be provided under the contract would not have expired as of the close of the following tax year
- The \$90,000 prepaid insurance contract does not meet the 12 month requirement because the renewal periods must be considered in determining the life of the prepaid

CASE 20 - Capitalization of Intangible Costs

- **ANSWER:**

- \$575,000 is currently deductible (the \$125,000 of pre-bright-line legal services and 45% of the \$1 million of investment banking fees allocated to pre-bright-line deductible services)
- The \$85,000 of legal fees related to drafting the merger agreement are inherently facilitative
- The \$140,000 of legal fees are facilitative because they were incurred after the bright-line date
- 55% of the investment banker fees are either inherently facilitative and/or allocated to services performed after the bright-line date

CASE 21 - Special Rules for S-Corporation Banks

- **ANSWER:**

- Yes; if the total shareholders counted under the family attribution rules number 100 or fewer, a bank can qualify for the S-corporation election no matter how many actual shareholders there are (i.e. the bank S-corporation may send well over 100 shareholder forms K-1 under this scenario)

CASE 22 - Special Rules for S-Corporation Banks

- **ANSWER:**

- No; the one share of stock that the IRA acquired after October 22, 2004 causes the IRA to be a disqualified shareholder
- As such, the entire bank is prohibited from qualification as an S-corporation
- However, IRA could sell the one disqualified share to its owner and then the Bank would be eligible to proceed with the S-corporation election