



Community Banking Update

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Agenda:

- IRS Audit Issues / Uncertain Tax Positions / Schedule UTP
- Section 382 Limitations – Application, Developments and Planning
- Overview of Issues Arising in FDIC Assisted Acquisitions
- Overview of New Basis Reporting Requirements and Their Impact on Community Banks
- S-Corporation Developments
- Miscellaneous



IRS Audit Issues / Uncertain Tax Positions / Schedule UTP

Schedule UTP – Overview of Filing Requirements

- For 2010 and 2011, only applies to C-corporations that:
 - File form 1120, 1120-F, 1120-L, or 1120-PC and have consolidated total assets equal to, or in excess of, \$100 million;

and

- Issue audited financial statements (or are included in the audited financial statements of a related entity) covering any portion of the corporation's 2010 or 2011 tax year;

and

- Have taken one or more reportable uncertain tax positions on the tax return for any year beginning on or after 1/1/2010

Expanded Application in Future Years

- The applicable total assets threshold is reduced in future years as follows:

<u>Year</u>	<u>Total Assets</u>
2012	\$ 50 million
2014	\$ 10 million

- The IRS is also considering expanding the applicability to S-corporations and other pass-through entities
- Due to their highly leveraged balance sheets, many banks will be impacted by the reporting requirement if they issue audited financial statements and have uncertain federal tax positions

Reliance Upon Financial Statement Designations

- The IRS relies heavily upon the proper identification and analysis of uncertain tax positions under GAAP pronouncements (i.e. ASC 740-10, FKA FIN 48, *Accounting for Uncertainty in Income Taxes*) for purposes of determining required disclosures on Schedule UTP
- Uncertain federal tax positions for which a reserve is recorded must be disclosed on Schedule UTP in the year the reserve is recorded (except for positions taken in tax years beginning before 1/1/2010)

What if a Financial Statement Reserve is Not Recorded?

- It is necessary to determine **why** a reserve is not recorded
- If the uncertain position is:
 - Material;
 - Identified as an uncertain tax position and analyzed as such under the GAAP requirements; and
 - More likely than not to be settled (in litigation if necessary) for the full amount of the tax benefit claimed
- Then the position **must be disclosed** in the year it is determined that no reserve is necessary

What if a Financial Statement Reserve is Not Recorded?

- It is necessary to determine **why** a reserve is not recorded
- If no reserve is recorded because the uncertain position is not material for financial statement purposes, then disclosure of the position is **not required**
- If no reserve is recorded because the position is sufficiently certain, then disclosure of the position is **not required** (i.e. these positions are not really uncertain tax positions to begin with)

Bad Debts and Non-performing Loans

- Both areas have historically been the subject of significant disagreement between taxpayers and the IRS
- The issue centers on the timing of the deduction for worthless debt obligations and worthless accrued interest under §166
- The bad debt conformity election found in Reg. §1.166-2(d)(3) offers bank taxpayers a safe harbor for deducting worthless **loans**, provided these deductions conform to loan charge-offs claimed for book purposes and the taxpayer properly secures the “express determination letter” from its primary federal regulator

Bad Debts and Non-performing Loans

- Revenue Ruling 2007-32 extends the safe harbor provided by the bad debt conformity election to cover the charge-off of interest on non-performing loans
- If the bad debt conformity election is put in place, then there will be no significant uncertainty surrounding these issues, so neither issue would be given any consideration under ASC 740-10 / Schedule UTP

Bad Debts on Worthless Debt Securities

- Is governed by §166 for debt obligations held by a bank and evidenced by a security
- Is governed by §165 for all other taxpayers
- The significance of the loss being governed by §166 for a bank is that this section allows deductions for both partial and total worthlessness (no exchange is necessary)
- For non-bank taxpayers, §165(g)(1) provides only a deduction for total worthlessness in the absence of a taxable exchange

Bad Debts on Worthless Debt Securities

- In the current economic environment, debt securities may be considered wholly or partially worthless for tax purposes
- For tax purposes, worthlessness is based upon a demonstrated likelihood that the debt principal will be uncollectible in whole or in part and is generally based upon identifiable debtor events (i.e. default on the security, bankruptcy, mounting financial losses, lack of sufficient collateral, etc.) – see IRC §166
- Any deduction for partial worthlessness must be accompanied by a charge off of the worthless portion of the debt

Bad Debts on Worthless Debt Securities

- The GAAP standards for recording other-than-temporary impairment (“OTTI”) against investment securities is not determinative of the tax deduction
- The GAAP impairment standards are generally more liberal than the tax deduction standards and consider issues beyond the likelihood of principal recovery
- Consequently, there are likely to be circumstances under which a security is written down through OTTI for book purposes, but the level of worthlessness necessary to sustain a bad debt deduction under §166 has not been demonstrated

Bad Debts on Worthless Debt Securities

- The bad debt conformity election safe harbor does not apply to bad debt deductions for worthless securities.
- Consequently, these deductions must be justified based upon the underlying facts and circumstances and are likely to involve some subjective judgment
- If these deductions are material, they may constitute an uncertain tax position for which disclosure could be required on Schedule UTP

Current Deduction of OREO Carrying Costs

- There have been a growing number of examinations in which the IRS has sought the capitalization of OREO carrying costs on non-income producing property
- The IRS argument is based upon an assertion that the OREO property is “inventory” acquired for resale and, consequently, §263A requires all carrying costs to be capitalized to the basis of the individual properties (which would permit them to be deducted upon disposal of the applicable properties)
- The IRS position appears to be coordinated

Current Deduction of OREO Carrying Costs

- The argument in support of deducting these costs as they are incurred is based upon an assertion that the OREO properties are not, in fact, “inventory”
- Instead, the properties are acquired in the ordinary course of the loan relationship in order to mitigate the potential loss on the worthless debt obligation, not to be sold at a profit
- Such an argument would support the deduction of the OREO carrying costs as an ordinary and necessary business deduction under §162

Limited Safe Harbor for MTM Valuations

- On April 6, 2011, the IRS issued a field directive (LB&I-4-1110-033) indicating the IRS will not challenge a taxpayer's use of financial statement market values for purposes of the MTM calculations required by §475, **provided the taxpayer is required to file public financial statements**
- In order to secure this safe harbor, taxpayers under examination must file with the examining agent a signed certification statement containing various representations within 30 days of the agent's request

Limited Safe Harbor for MTM Valuations

- The safe harbor use of the financial statement market values is elective and is only made while the taxpayer is under examination
- Taxpayers can elect the safe harbor and use the financial statement valuations even if these values were not used on the return as originally filed
- Several revisions are necessary for the representations required in the certification statement to be workable
- If elected (or the taxpayer anticipates electing as a protective measure under examination), use of the financial statement values would not give rise to an uncertain tax position

Treatment of Credit Card Interchange Income

- IRS Chief Counsel Notice CC-2010-018
- The IRS has announced that it will no longer challenge the treatment of credit card interchange income as Original Issue Discount (“OID”) on the underlying pool of credit card receivables
- This enables taxpayers to defer the recognition of this income as OID over the term of the outstanding credit card receivables, as opposed to recognizing it in current taxable income
- Acquiesces the decision in the *Capital One* case

Deducting Success-Based Fees in M&A Transactions

- Deductions for success-based investment banking and other fees have been the source of significant disagreement between taxpayers and the IRS
- The issue centers largely on the documentation requirements required by regulation and the fact that conforming documentation is often not available
 - i.e. the IRS wants timesheet documentation (or something similar) and many investment bankers do not keep or provide such documentation
 - See PLRs 200830009 and 201002036

Deducting Success-Based Fees in M&A Transactions

- As a result, most success-based fee deductions are supported by documentation that is somewhat subjective in nature and relies heavily upon representations made by the applicable service providers
- Due to the subjective nature of the issue (i.e. adequacy of supporting documentation), the often large dollar amounts involved and the generally permanent nature of the lost deduction (if related to a merger or stock purchase), this issue has been a common uncertain tax position

Deducting Success-Based Fees in M&A Transactions

- To eliminate much of the disagreement in this area going forward, the IRS issued Revenue Procedure 2011-29 in April 2011
- Applies to transactions described in Reg. §1.263(a)-5(e)(3) – most merger and acquisition transactions
- Provides an elective safe harbor to treat 70% of the success-based fee as non-facilitative (deductible) and 30% as facilitative (capitalized) without the need to gather any supporting documentation
- Available (separately) to both the buyer and the seller

Deducting Success-Based Fees in M&A Transactions

- The election is available for success-based fees paid or incurred in taxable years ending on or after April 8, 2011
- The election is irrevocable and is made by attaching a statement to the original federal income tax return for the taxable year the success-based fee is paid or incurred
- If not elected, the taxpayer must justify its deduction based upon the adequacy of its documentation

Deducting Success-Based Fees in M&A Transactions


- If the safe harbor is elected, the deduction is certain, so no consideration would be given to the tax benefit of the deduction under ASC 740-10 as an uncertain tax position
- As a result, no disclosure of the success-based fee deduction would be required on IRS schedule UTP

Deducting Success-Based Fees in M&A Transactions

- On July 28, 2011, the IRS issued a field directive (LB&I-04-0511-012) indicating the IRS will not challenge a taxpayer's deduction for success-based fees claimed on returns for tax years prior to the effective date of the safe harbor, provided:
 - The deduction is one that would have qualified under the safe harbor if incurred on or after the effective date [i.e. - described in Reg. §1.263(a)-5(e)(3)]
 - The capitalized portion of the fee is at least 30%
 - The deduction was claimed on an originally-filed tax return (i.e. no amended returns or refund claims)

Deducting Success-Based Fees in M&A Transactions

- In light of this development, taxpayers may need to re-evaluate their anticipated settlement position on these deductions claimed in prior years for ASC 740-10 purposes
- This may result in an adjustment during the quarter ended 9/30/2011 to any recorded reserve for affected positions



Section 382 Limitations – Application, Developments and Planning

IRC § 382 Limitations - Generally

- Generally applies when a “loss corporation” experiences a change of greater than 50 percentage points in the equity ownership of 5% shareholders over a 36 month period
 - This includes shareholders who did not own any shares before the transaction giving rise to a “testing date”
- In addition to merger and acquisition transactions, § 382 is applicable to ownership changes of a loss corporation resulting from stock issuance transactions (TARP excepted), redemptions, sales by 5% shareholders, etc.
- This issue is becoming more commonplace in the banking industry, as some banks attempt to shore up deficient capital levels by turning to the capital markets to issue new stock
- The following are the sub-elements of an ownership change:
 - Loss Corporation; Testing Date; Transaction; Ownership Increase; Testing Period; and 5% Shareholders

Loss Corporation

- A “loss corporation” is a corporation with:
 - Tax loss or credit carryforwards;**and / or**
 - A net unrealized built-in loss (excess of tax basis over FMV of total assets) of greater than the **lesser of:**
 - \$10 million; or
 - 15% of the FMV of the corporation’s “variable assets” (generally total assets exclusive of cash and cash equivalents)

Testing Date

- Any date on which the loss corporation must determine whether an ownership change has occurred
- The computation of the percentage points of the ownership increase must be made as of the close of each testing date
- Transactions triggering a testing date include:
 - Owner shifts
 - Equity structure shifts
 - Option transactions
- A loss corporation with a testing date(s) during the year must file an information statement with its tax return
 - This statement must be filed even if an ownership change has not occurred as a result of the transaction
 - See Regs. Sec. 1.382-11(a) for specific requirements

Transaction

- Owner shift
 - Any change in the ownership of the stock of a loss corporation that affects the percentage of such stock owned by any 5% shareholder
 - Broad term encompassing nearly every kind of transaction in corporate stock
 - Special rules apply to public companies
 - Exclusions provided for gifts, bequests, and divorce transfers
- Equity structure shift
 - Most reorganizations under Code Section 368(a)(1)
 - A “failed” reorganization may also qualify
 - An equity structure shift cannot occur unless the former shareholders of the loss corporation receive or retain less than 50 percentage points in the reorganization survivor

Ownership Increase

- A comparison is made of each 5% shareholder's percentage ownership immediately after the close of a testing date with that shareholder's lowest percentage of stock ownership during the "testing period"
- The percentage of ownership is based upon the fair market value of the stock of the loss corporation as of the end of the day on which a testing date occurs and excludes certain types of preferred stock
 - Note: Preferred stock excluded in measuring an ownership change is counted in determining the value of the loss corporation in computing the Section 382 limitation
- All 5% shareholder ownership increases are aggregated to determine whether there has been an ownership increase of more than 50 percentage points
- A 5% shareholder is ignored if that shareholder's percentage has declined or remained the same

Testing Period

- The testing period is generally a 3-year period, measured backward from the time of a testing date
- The testing period ends on the date of an owner shift or equity structure shift (i.e., a testing date), whether or not the transaction qualifies as an ownership change
- The testing period measures time, not transactions
- All changes in stock ownership during the testing period must be recorded and considered
- Impact of loss carryback to years when not otherwise a loss corporation?

Testing Period

Exceptions to the 3-year testing period:

- Successive ownership changes
 - There can be no overlapping of testing periods
 - A testing period cannot begin on or before the date of an immediately-preceding ownership change
- First day of losses
 - The testing period cannot begin before the earlier of the first day of either:
 1. The first taxable year from which there is a loss or excess credit carryforward to the first taxable year ending after the testing date, or
 2. The taxable year in which the testing date occurs
 - This exception does not apply if the corporation has a “net unrealized built-in loss” (NUBIL) on the testing date, unless the corporation establishes the taxable year in which the NUBIL first accrued

5% Shareholder

- Any person or group holding 5% or more of the loss corporation's stock at any time during the testing period
- A shareholder's ownership is measured by the percentage of fair market value of the stock owned by that shareholder compared to the fair market value of the outstanding stock of the corporation
- Ignore percentage changes that occur solely by reason of fluctuations in stock value
- In addition to identifying direct 5% shareholders, a loss corporation must also identify certain "tiered" entities for purposes of determining the owners of these tiered entities who have an indirect ownership interest of 5% or more in the loss corporation
- Identification of these tiered entities and of owners with an indirect ownership interest can be complicated – may not have this information in records

Notice 2010-50 Fluctuations in Value

- Full Value Methodology
 - All shares “marked to market” on each testing date
 - Narrow interpretation – fluctuations in value do not cause testing date, but are taken into account on testing dates regardless of whether shareholder was a party to the transaction that gave rise to the testing date
- Hold Constant Principle - Generally
 - Share value relative to other stock is established on acquisition date
 - Ownership interest on subsequent testing dates of “tested share” is determined by factoring out fluctuations in the relative values of stock classes that have occurred since the tested share’s acquisition
 - Individualized for each acquisition of stock by each shareholder
 - Ownership interest represented by a tested share is adjusted for
 - Dilutive effects of subsequent issuances
 - Accretive effects of subsequent redemptions

Notice 2010-50 Fluctuations in Value

- Hold Constant Principle
 - Alternative Methodology 1: Look Back from Testing Date
 - Factor out changes in relative value since acquisition date
 - Calculate percentage interest represented by a tested share on a testing date, beginning with the value of the tested share on the testing date
 - Make adjustments based on change in relative value compared to other classes of stock that have occurred since the tested share was acquired
 - Alternative Methodology 2: Ongoing Adjustments from Acquisition Date
 - Track percentage interest from the date of acquisition forward
 - Adjust for subsequent dispositions and for subsequent issuance or redemption of other stock
- See September 2010 Tax Adviser Article

5% Shareholder

- Aggregation and segregation rules further complicate an already complex set of rules by providing various ways shareholders owning less than 5% can be separated into more than one aggregated group
 - Equity structure shifts - The less-than-5% shareholders of the new loss corporation, who became such because of the reorganization, are aggregated into a different public group
 - Stock issuances (e.g., public offering) - The new less-than-5% shareholders will be aggregated into a different public group from the less-than-5% shareholders before the stock issuance
 - Redemption of shares from one or more of the less-than-5% shareholders - The redeemed shares are treated as owned by a different group than those who own the shares that are still outstanding
 - Sale by first tier entity or individual that owns a direct ownership interest in the loss corporation of 5% or more to public shareholders - Segregate public group that purchased from public groups existing prior to disposition

5% Shareholder

- There are 2 types of stock issuances that may be excepted from the segregation rules and will not be considered as acquired by a separate public group, but are treated as issued on a pro rata basis to the aggregated public groups existing immediately prior to the issuance
 - Small issuance exception - Stock issuance does not exceed 10% of the value of the stock outstanding at the beginning of the loss corporation's taxable year on either a corporation-wide basis or a class-by-class basis
 - Cash issuance exception - Stock issued solely for cash up to an amount equal to one-half of the stock held (before the issuance) by the small shareholders
- Limit: amount of stock excepted cannot exceed the total amount of stock issued in the issuance less the amount of that stock owned by a 5% shareholder (other than a direct public group) immediately after the issuance

IRC § 382 Limitations

- Complicated rules and numerous assumptions apply in determining whether the corporation has experienced an ownership change
- If applicable, then two potential limitations are placed on the tax attributes of the corporation after the date of the ownership change:
 - 1) Existing NOLs and tax credit carryforwards are subject to an annual use limitation;

AND

- 2) Certain built-in losses existing within the corporation's total assets that are triggered within five years of the ownership change are also subjected to this limitation

Notice 2003-65

- Provides for 2 safe harbor approaches for the identification of built-in items via 15 examples:
 - The 1374 approach
 - Depreciation/amortization is not RBIL up to the amount of such deduction that would have been allowed had the loss corporation purchased the asset for its FMV on the change date
 - Bad debt deductions taken during the first 12 months of the recognition period for debts owed at the beginning of that recognition period are RBILs
 - The 338 approach
 - Under the 338 approach, built-in gain assets may be treated as generating RBIG even if they are not disposed of at a gain during the recognition period, and deductions for liabilities, particularly contingent liabilities, that exist on the change date may be treated as RBILs
 - Hypothetical amortization of an asset with change-date built-in gain over the actual amortization deduction claimed during the recognition period is treated as RBIG
 - May use either approach, but may not mix

ACE Basis

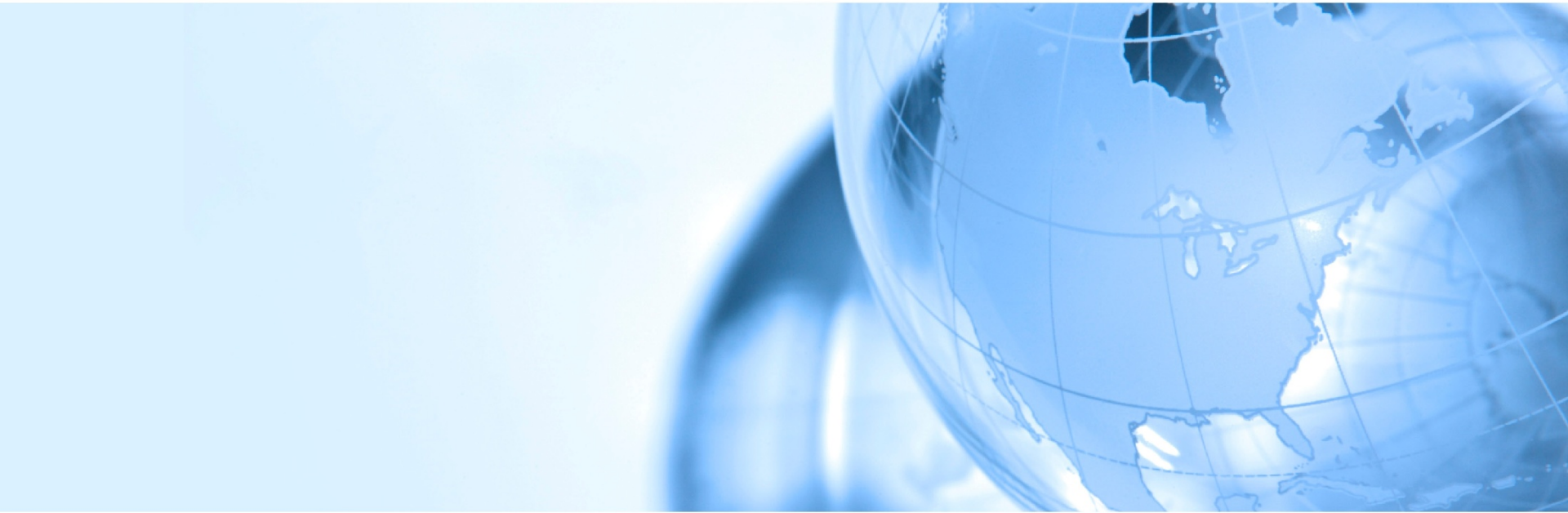
- The loss corporation must determine if it has a NUBIL for purposes of computing adjusted current earnings (“ACE”) (note: it is possible to have NUBIL for ACE purposes and not for regular tax purposes)
- If so, the adjusted basis of each asset is deemed equal to its proportionate share of the FMV of the assets of the corporation immediately before the ownership change
- This rule provides a permanent reduction in the bases of corporate assets for purposes of computing ACE, including in computing depreciation and any gain or loss on disposition
- Such permanent reduction will be considered for the life of the asset, not just the recognition period, and will require separate record keeping
- Result – no deduction for losses that occurred pre-change in computing the ACE adjustment

Tax Attributes

- The application of the § 382 limitation can significantly lengthen the number of years over which the carryforward tax attributes and triggered built-in losses of the corporation can be used / deducted
- In some cases, the application of the § 382 limitation can terminate the corporation's (or an acquiror's) ability to utilize these tax benefits, due to the statutory time limitations on the allowable carryforward
- Any recorded tax benefit on the books of the corporation associated with these tax attributes will have to be valued in light of the § 382 limitation to determine if they have any diminished value after the ownership change
- Tax attribute protection plans are becoming increasingly prevalent among financial institutions to discourage anyone from triggering a § 382 ownership change by acquiring 5% or more of its shares

Current Developments

- **PLR 201051019** provided guidance that § 382(l)(5) or 382(l)(6) did apply to the parent company in a consolidated group that had filed for bankruptcy while its subsidiaries remained outside of bankruptcy, and that in computing the group's § 382 limitation post-bankruptcy filing, all outstanding liabilities prior to the ownership change should be taken in to account at the adjusted issue price, regardless of whether they were discharged subsequently.
- **PLR 201105031** provided confirmation that a bad debt deduction properly taken into account after the first 12 months of the post-ownership change recognition period is not treated as RBIL under the 1374 approach of Notice 2003-65.
- **In PLR 201110006**, the Service provided guidance on acceptable methods of determining actual knowledge for purposes of identifying any overlapping ownership between Target and Acquiring and only required that such determination be made immediately before and after the proposed transaction rather than throughout the entire testing period.
- **CCA 201132022** advised that RBIL in excess of the § 382 limitation is a special attribute that may only be carried forward



Overview of Issues Arising in FDIC Assisted Acquisitions

Typical Acquisition of a Failed Bank From the FDIC

- Structured as a direct purchase and assumption of the failed bank's assets and liabilities (including deposit liabilities)
- The failed bank charter is not acquired
- Subsidiaries of the failed bank are often acquired by the purchasing bank in the transaction
- The transaction may or may not contain a negotiated amount of loss share coverage (i.e. guarantees) on the acquired loans and OREO to be provided by the FDIC for a pre-determined time period

Tax Treatment of the Transaction

- Is considered to be a taxable asset purchase
- Purchase price paid by the purchaser (generally the failed bank liabilities assumed) is allocated to the classes of assets acquired under the rules of §338 / §1060
- Any resulting allocation of purchase price to intangible assets (Classes VI and VII) constitutes a §197 intangible and can be amortized over 15 years
- None of the carryforward tax attributes (NOL and tax credit carryforwards) of the failed bank are available to the purchaser

Application of §597

- If the purchaser receives financial assistance from the FDIC in the form of a cash payment or loss share coverage, then the transaction is governed by §597
- §597 contains special rules:
 - Forces a particular approach to determining the purchaser's basis in certain categories of acquired assets
 - May result in a bargain purchase gain for tax purposes (excess of assigned tax basis over the actual purchase price paid) which is required to be recognized evenly over 6 tax years, beginning with the year of the acquisition
 - Requires taxable asset purchase treatment within the acquired subsidiaries, similar to a §338(h)(10) election

Discrepancies in the Book v. Tax Purchase Price Allocations

- If §597 applies to the transaction due to the presence of a loss sharing agreement, there may be significant differences between the purchase price assigned to loans and OREO for book and tax purposes
- Under §597, the tax basis of loans and OREO covered by the loss share agreement are recorded at their FMV, but not in an amount less than the guaranteed balance
- For book purposes, the loans are recorded at GAAP FMV, which is generally the discounted amount of the anticipated cash flows from the loans

Discrepancies in the Book v. Tax Purchase Price Allocations

- This may result in a significant discrepancy between the recorded book value of acquired loans and OREO and the tax basis of these assets (i.e. the tax basis is likely to be much greater than the book basis)
- In addition, GAAP requires the recording of a “FDIC indemnification asset” which represents the value of the anticipated indemnification payments to be received from the FDIC under the loss sharing agreement
- There is no tax basis assigned to this FDIC indemnification asset, which also causes a potentially significant book v. tax disparity

Discrepancies in the Book v. Tax Purchase Price Allocations

- Furthermore, the forced allocation of purchase price to loans and OREO under §597 sometimes leads to little or no tax basis assigned to other types of miscellaneous assets (i.e. fixed assets, certain securities, prepaid expenses, loans and accounts receivable not covered under the loss sharing agreement, etc.)
- This can also cause significant book v. tax disparities in the allocation of purchase price
- All of these differences require the recording and tracking of deferred tax assets and liabilities for GAAP purposes

Tracking Issues Going Forward – the “Day-2 Dilemma”

- Once the significant book-tax basis differences in loans are established at acquisition, proper tracking of the correct taxable income from these loans going forward becomes problematic
- This is because the book accounting systems and reports used for financial reporting purposes will probably no longer provide the correct taxable income for the loans

Tracking Issues Going Forward – the “Day-2 Dilemma”

- For book purposes, any interest accrued is likely being calculated on the recorded balance of the loan, not on the contractual loan terms as required for tax purposes
- In some cases, the rate used to accrue interest on the discounted loan for GAAP purposes may not comport with the loan’s stated interest rate
- In addition, there will be differences in the amount and methodology employed to calculate the accretion of the loan purchase discount because this amount is calculated on a different loan basis for book and tax purposes and may not be accreted on some loans for book purposes

How Are the Tracking Issues Being Addressed?

- A variety of approaches are being used in the marketplace
- **Specialized software**
 - Benefits:
 - Precision
 - Automatic calculations
 - Detailed support for the schedule M adjustments
 - Drawbacks:
 - Price
 - Output is only as good / reliable as data input

How Are the Tracking Issues Being Addressed?

- A variety of approaches are being used in the marketplace
- **Manual calculations (i.e. spreadsheets)**
 - Benefits:
 - No additional software to purchase
 - Complete control over the calculations / assumptions
 - Drawbacks:
 - Time consuming
 - Calculations are complex
 - May not be possible if there are too many loans to track

How Are the Tracking Issues Being Addressed?

- A variety of approaches are being used in the marketplace
- **Deferred Tax Asset / Liability Approach**
 - Benefits:
 - No additional software to purchase
 - Often tied to movements in the associated GAAP purchase accounting adjustments or MTM calculations of loans remaining at year end so calculations are simpler (macro)
 - Drawbacks:
 - Precision is lower than with other methods
 - Often lacks detailed support for schedule M calculations (relies more on a conceptual process than upon raw data)



Overview of New Basis Reporting Requirements and Their Impact on Community Banks

Basis Reporting on Form 1099-B - §6045(g)

- Form 1099-B has historically required those acting in the capacity of a broker to report the gross proceeds from sales of stock or securities to the seller
- New laws now require the broker to report the tax basis of certain covered securities and indicate whether the resulting gain/loss is short-term or long-term

Basis Reporting on Form 1099-B - §6045(g)

- The basis reporting requirement only applies to the following covered securities, provided they are held in a brokerage or similar custodial account:
 - Shares of stock (other than mutual fund and dividend reinvestment plan shares) acquired for cash on or after 1/1/2011
 - Mutual fund and dividend reinvestment plan shares acquired for cash on or after 1/1/2012
 - Debt securities acquired for cash on or after 1/1/2013, or such later date determined by the Treasury
 - Other securities as the Treasury may designate in future years

Transfer Statement Requirements - §6045A

- Enacted in tandem with the new Form 1099-B basis reporting requirement
- Generally requires that brokers and professional custodians who effect transfers of stock to other brokers/custodians issue a “transfer statement” to the receiving broker/custodian within 15 days of the transfer

Transfer Statement Requirements - §6045A

- The transfer statement contains various identification and other information about the transferred securities, including a designation regarding whether the transferred securities are covered securities
- If the transferred securities are covered securities, the transfer statement must contain the original acquisition date and tax basis of those securities

Transfer Statement Requirements - §6045A

- The transferee broker will need this basis information on covered securities in order to eventually fulfill its basis reporting obligations with respect to those securities
- Brokers/Custodians who receive transferred securities are required to request the transfer statement if it is not properly provided by the transferor
- If the proper information is not provided by the transferor, then the transferee broker is not required to report the basis information for those transferred securities upon their eventual sale

Transfer Statement Requirements - §6045A

- Penalties apply for failure to timely provide an accurate transfer statement
- However, IRS Notice 2010-67 suspended all penalties for failure to issue transfer statements related to 2011 transfers between broker/custodians that are “not incidental” to a sale/purchase of the transferred securities

Reporting Organizational Actions - §6045B

- Enacted in tandem with the new Form 1099-B basis reporting and transfer statement requirements
- Requires issuers of stock and securities to report actions undertaken by the issuer that affect a holder's per-share basis in such securities
- Reporting is made to the owners of the applicable securities and to the IRS
- The ultimate goal is to provide owners of such securities with information needed to calculate the impact of the action on the basis of their securities

Reporting Organizational Actions - §6045B

- Any organizational action that impacts the basis of the securities must be reported, including (but not necessarily limited to):
 - Mergers and tax-free reorganizations
 - Stock dividends
 - Stock splits
 - Non-dividend distributions
- The reporting must include identification of the affected securities and a detailed description of the impact the organizational action has on the basis of the securities

Reporting Organizational Actions - §6045B

- Reporting is required on two fronts:
 - 1) Reporting to each holder of record by January 15th of the year following the calendar year in which the organizational action was executed; **and**
 - 2) Reporting to the IRS within 45 days following the organizational action or, if earlier, January 15th of the year following the calendar year in which the organizational action was executed
- However, both reporting requirements can be satisfied by timely posting the required information on the taxpayer's public website within 45 days of the organizational action and keeping it available there for 10 years

Reporting Organizational Actions - §6045B

- The reporting requirement is first applicable to organizational actions occurring on or after 1/1/2011
- However, IRS Notice 2011-18 suspended all penalties for failure to report the action to the IRS within 45 days, provided the issuer properly reports to the IRS or posts the information to a public website by 1/17/2012
- The penalty protection does not apply to the reporting required to the holders of record by 1/17/2012
- The IRS anticipates offering further guidance before 1/17/2012 regarding the reporting format

How Will Banks be Impacted by These Provisions?

- Unless the bank acts as a broker/custodian of its own stock, it is not likely required to file forms 1099-B
- However, if the bank acts as its own transfer agent, it will likely be required to comply with the transfer statement provisions of §6045A
- Those banks who employ professional transfer agents to handle transfers of their stock will not likely be impacted by the transfer statement or basis reporting requirements
- However, all banks are potentially subject to the organizational action reporting requirements of §6045B if they undertake an action that affects their shareholders' stock basis



S-Corporation Developments

TEFRA Interest Expense Disallowance

- Action on Decision 2010-006
 - Issued December 13, 2010
 - IRS acquiesced “in result only” on *Vainisi v. Commissioner*, U.S. Seventh Circuit Court of Appeals decision reversing the decision of the Tax Court
 - IRS will not apply Section 291 to a QSub bank or an S-Corp bank unless the bank (or any predecessor) was a C-Corp bank in the three immediately preceding taxable years
 - This issue should be effectively resolved pending any future legislative changes

Small Business Jobs Act of 2010

Built-In Gains Tax:

- Including overlap of ARRA provision

Tax year converted to S Corp	BIG Tax applicable for 2009?	BIG Tax applicable for 2010?	BIG Tax applicable for 2011?	BIG Tax applicable for 2012?
2001	NO	NO	N/A	N/A
2002	NO	NO	NO	N/A
2003	YES	NO	NO	YES
2004-2006	YES	YES	NO	YES
2007 or later	YES	YES	YES	YES

Small Business Jobs Act of 2010

Built-In Gains Tax:

- When ARRA was enacted in 2009, the AICPA S Corporation Technical Resource Panel requested clarification from Treasury on a number of issues related to the BIG Tax suspension
- For example, an S Corp which converted from a C Corp to an S Corp in 2002 has a built-in gain from a sale of property in 2009, but has no taxable income in 2009 or 2010
 - Absent ARRA, the built-in gain would be suspended and treated as a built-in gain in the subsequent tax years – i.e., 2011
 - Since the built-in gain was generated during a suspension year, will it now be subject to BIG Tax in 2011?
- Is there a similar impact from suspension of 2011 built-in gains under the Small Business Jobs Act?

Job Creation Act of 2010

- Extends the tax cuts enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) an additional 2 years – through December 31, 2012
- This includes the enhanced capital gains and dividends tax rates in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)
- Plus, for tax years effective after Dec. 31, 2012, higher-income taxpayers will be subject to an additional 0.9% Medicare tax on earned income above \$250,000 (married filing joint) and a 3.8% Medicare tax on the lesser of net investment income or modified AGI in excess of \$250,000 (married filing joint)
 - Investment income will include S Corp pass-thru income for passive investors in an active trade or business

Individual Tax Rates – Impact of “Sunset” in 2013

Income Type	Pre-2013 Rates	Post-2012 Rates
Ordinary	35.0%	39.6%
Dividends	15.0%	43.4% ^
Capital Gains	15.0%	20.0% *

^ Includes 3.8% additional Medicare tax on net investment income

* 18% capital gains rate for assets held over 5 years

C Corp vs. S Corp Tax Benefit Analysis

Impact of Post-2012 Rate Increases:

	<u>C CORP</u>	<u>S CORP</u>
Pre-tax income	\$ 1,000,000	\$ 1,000,000
Corporate level income tax	\$ (340,000)	\$ N/A
Tax distribution @43.4%	<u>\$ 0</u>	<u>\$ (434,000)</u>
After-tax income	\$ 660,000	\$ 566,000
Capital retention	<u>\$ (500,000)</u>	<u>\$ (500,000)</u>
Additional dividend	\$ 160,000	\$ 66,000
Income tax @39.6% dividend rate	\$ (63,000)	\$ N/A
Add'l Medicare tax @3.8% rate	<u>\$ (6,000)</u>	<u>\$ N/A</u>
Net cash to shareholders	\$ 91,000	\$ 66,000
Benefit from increase in basis	<u>\$ 0</u>	<u>\$ 90,000</u>
Total return to shareholders	<u>\$ 91,000</u>	<u>\$ 156,000</u>

Net benefit from S election = \$65,000

NOTE: Assumes all shareholders are in 39.6% tax bracket and are passive investors (i.e., additional 3.8% Medicare tax applies). The tax benefit of the stock basis adjustment is equal to 18% multiplied by the net basis increase of \$500,000 (not discounted for future value). Amounts are rounded to nearest \$1,000.

Proposal to Tax “Large” S Corps

- Treasury developing a proposal to levy corporate taxes on flow-through businesses (including S Corps) with more than \$10 million in annual gross income or deductions
- Not intended to lead to a tax increase, but rather an attempt to address a widely acknowledged information gap resulting from difficulty matching tax returns of flow-through businesses with their owners’ returns
- Proposal does not address impacts to the flow-through owners – for example, would shareholders be given a credit against their personal income tax liabilities for taxes paid at the corporate level?
- Would likely impact most S-Corp banks with assets of \$150 million or more
 - As of June 30, 2011, per FDIC website, this would include approximately 900 S-Corp banks on a stand-alone basis (i.e., not including smaller S-Corp banks that may be part of a multi-bank holding company structure)

Private Letter Ruling 201017019

- Release Date April 30, 2010
- S Corp shareholder agreement required a company to make payments to its shareholders based on each shareholder's pro-rata share of taxable income for a given tax year to ensure that the shareholders had sufficient funds to pay income taxes on their respective share of the company's income
- Company sought a ruling on a discretionary payment provision, allowing the company to assist its shareholders in paying additional tax liability resulting from an increase in taxable income or a decrease in creditable foreign taxes
- Company believed it was more efficient and equitable to base distributions under the discretionary payment provision on the shareholders' interests during the taxable period to which the adjustment relates, rather than the shareholders' interests at the time the distributions are made
- IRS ruled favorably – the discretionary payment provision, and distributions made pursuant to it, did not cause the company to have more than one class of stock

David E. Watson, P.C. v. United States

- District Court of Iowa, Dec. 23, 2010
- Reasonable compensation case involving a sole shareholder of an S Corp
- Shareholder was an employee of a successful accounting firm typically working 35-40 hours per week
- The following factors should be considered in assessing reasonable compensation:
 - Nature of the S Corp's business
 - Employee qualifications, responsibilities, and time devoted to business
 - Compensation compared with non-shareholder employees or amounts paid in prior years
 - What comparable businesses pay for similar services
 - Compensation as a percentage of corporate profits and compared with distributions
- See Tax Adviser, August 2011

Santa Clara Valley Housing Group, Inc. v. U.S.

- District Court of California, Sept. 21, 2011
- Warrants issued by an S Corp to its shareholders constituted a second class of stock
- Case involved a tax strategy later declared an abusive tax shelter
- Warrants were in direct violation of the provisions of Reg. Sec. 1.1361-1(l)(4)(ii)
 1. They constituted equity or otherwise resulted in the holder being treated as the owner of the stock; AND
 2. A principal purpose of issuing the warrants was to circumvent the rights to distribute or liquidate proceeds conferred by the outstanding shares of stock
- As a result, the taxpayer's S election terminated as of the date of the issuance of the warrants



Miscellaneous

Fixed Asset Depreciation

- The 50% bonus depreciation provisions have been extended for qualified property placed in service before 1/1/2013
- However, the bonus depreciation amount is increased to 100% for qualified property acquired after 9/8/2010 and placed in service before 1/1/2012
- Guidance is provided in Revenue Procedure 2011-26
- In addition, the §179 direct deduction limitation is increased to \$500,000 for qualified property placed in service during tax years beginning in 2010 and 2011
 - The phase out begins at \$2 million of qualified purchases

Fixed Asset Depreciation

- Qualified property for both provisions generally includes all depreciable fixed assets and software, but does not include buildings and their structural components
- However, certain leasehold improvements made to the interior of a leased building may qualify if the building is more than three years old
- Bonus depreciation only applies to new property (not used), but §179 applies to both new and used property
- Cost segregation opportunities abound for construction projects, especially those placed into service in 2011

Miscellaneous

- Reminder – beginning in 2011, taxpayers that are obligated to make payments to merchants in settlement of credit / debit card transactions must file annual transaction reports with the IRS (and the merchant) to report the gross payments to each individual merchant
- Banks doing business with foreign financial institutions will need to be mindful of the Foreign Account Tax Compliance Act (“FATCA”) provisions

State Taxation – Economic Nexus Assertions

- Holds that a physical presence in the state is not necessary to trigger “nexus” – i.e. sufficient contact with the state to require filing of tax returns and apportionment of taxable income
- A growing number of states are enacting, reinforcing, or defending these laws and have been emboldened by recent state Supreme Court decisions and inaction on this issue by the U.S. Supreme Court and Congress
- The issue is essentially a constitutional one
- Presents a potential uncertain tax position under ASC 740-10, as you are not permitted to factor detection risk into the determination of tax reserves

Questions?

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