FMS
Tax Discussion
January 15, 2014

Today's Agenda

- Introduction/Overview
- IRS Examination Issues
- Depreciation Expensing/Bonus Update
- "New" Repair and Capitalization Rules
- State Taxes
- Reducing Your Effective Tax Rate
- Effect of Potential Tax Rate Change
- RC-R Call Report –Deferred Tax Asset Limitation
- Affordable Care Act – Medicare Tax Provisions
- SERP tax implications
- Questions

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- Established in 1911
- Offers Assurance, Tax, Business Consulting & Risk Management Services
- Offices located in Boston and Springfield, MA and Albany, NY
- Over 180 professionals
- PCAOB Registered & Inspected
- Member of AICPA Center for Audit Quality and PKF North America
- Our Financial Institution Expertise
  - Provide services to over 200 financial institutions:
    - Approximately 50 FIs with assets > $1 billion
    - Approximately 30 publicly traded FIs

Information

- Type of Bank
  - Public
  - Closely held
  - Mutual
  - S Corp

- Prepare tax provision (ASC 740, FKA FAS 109)

IRS Examination Issues

- Bad debt deduction – is it a “good” tax charge-off?
  - Based on facts and circumstances of each loan
  - Classified “loss” for book purposes – “watch list”
  - Focus on collateral value and financial condition of borrower and guarantees
  - IRS will review loan files
    - Loan officer comments and notes on possible collection – “self-serving”
    - Documentation should be current

IRS Examination Issues

- Bad debt deduction – is it a “good” tax charge-off? (cont’d)
  - Deduction for regulatory and financial statement purposes does not guarantee deduction for tax purposes
    - Conformity Election – minimizes problems but IRS still disallowing some charge-offs or portions of charge-offs
  - Charge-off below FMV (NRV) will likely be challenged
    - Selling costs
    - Foreclosure costs
  - IRS recently asked for comments as to whether conclusive presumption regs should be revised

IRS Examination Issues

- Non-accrual Interest
  - IRS position – must continue to accrue; then evaluate for worthlessness and treat as charge-off
  - So, if loan is charged-off, then interest is as well
  - Same standards as for bad debt deductions
  - Taxpayer - Rev. Rul. 80-361
    - Not taxable income “if the income item is uncollectible when the right to receive the item arises”
    - “No reasonable prospect of collection”
    - Subsequent payments applied to principal if uncollectible
    - Facts and circumstances on loan by loan basis
    - Administrative headache but can be worth it

IRS Examination Issues

- OREO
  - Write-downs post foreclosure FMV declines are deferred for tax
  - Operating costs on OREO
    - Good news - IRS finally concedes this issue
      - General Council Memorandum – released March 1, 2013
      - Operating costs are now deductible (former position was capitalized into tax basis of property)
      - IRS Agents instructed to drop issue / not raise issue on exams
    - Bad news – not an automatic change in accounting method - $7,000 fee to make the change

IRS Examination Issues

- Accrued bonus
  - Revenue Ruling 2011-29
  - “All Events” Test – if all events have taken place that fixes the liability with reasonable accuracy, then deductible
  - Is employee required to be employed when bonus payment is made (presuming overlap of year-end)?
  - If not required to be employed when paid, and if paid within 2 ½ months of year-end, deductible when accrued
  - If required to be employed when paid—but forfeited bonuses are reallocated and paid to remaining employees within 2 ½ months of year-end, deductible; if not, accrual is not deductible
  - Automatic change in accounting method

IRS Examination Issues

- Mandatory Tax Shelter Request
  - Asks for information related to “listed transactions”
  - Generally not applicable to community banks
  - But, need to affirm in writing that the bank has not conducted these activities
- Review of Senior Management Returns
  - Will request 1040’s and/or W-2s
  - Verify that senior management filed personal returns

IRS Examination Issues

- Change to Information Document Request (IDR) Process effective 1/2/14

- IRS examiner complaints – taxpayers don’t respond timely to IDRs

- Taxpayer complaints – IDRs aren’t understandable, ask for too much information, due dates aren’t reasonable

IRS Examination Issues

- Change to Information Document Request (IDR) Process (cont.)

- Actions that must be performed:
  - Identify and state the issue that caused IDR
  - Discuss the IDR with taxpayer before issuance
  - Both parties discuss and determine a reasonable time frame for response (date cannot be reset)

IRS Examination Issues

- Change to Information Document Request (IDR) Process (cont.)
- Enforcement has 3 steps:
  1. Delinquency Notice signed by Team Manager
     - Partial responses considered delinquent
     - IRS must discuss unresponsiveness within 10 days after deadline
     - Additional 15 calendar days for compliance
     - Extension only in extreme situations
     - No exceptions

IRS Examination Issues

- Change to Information Document Request (IDR) Process (cont.)
- Enforcement has 3 steps:

2. Pre-Summons Letter prepared by audit team and Counsel, signed by Territory Manager
    - Discussed with and delivered to next level of taxpayer management
    - Final notice to respond before Summons is issued
    - Taxpayer has 10 calendar days to respond
3. Summons is issued with Counsel's involvement

Depreciation Expensing

- Section 179: first year expensing of personal property additions
  - American Taxpayer Relief Act of 2012
    - For tax years beginning 2013-expires 12-31-13
    - Deduction of up to $500,000
    - Phase-out begins when costs exceed $2,000,000
    - Extends Section 179 treatment for software

Bonus Depreciation

- Bonus Depreciation
  - Federal only – most states “de-coupled”
  - 50% for qualified assets through 12/31/13

New Repair and Capitalization Regulations

- Issued December 23, 2011 as temporary regulations, and finalized in September 2013

- Effective years beginning on or after January 1, 2014, but can be effective for years beginning on or after January 1, 2012 with an amended return

- Change to Capitalization Standards

New Capitalization Rules

- Capitalization Standards:
  - Betterment
  - Restoration
  - New or Different Use

- Unit of Property (“UOP”) Designation
  - For non-buildings, functionally interdependent components comprise a single UOP
  - Each building and its structural components are one UOP

New Capitalization Rules

- Building Systems Components:
  - HVAC Systems
  - Plumbing
  - Electrical
  - Elevators and Escalators
  - Fire and Alarm Systems
  - Others

New Capitalization Rules

- De minimis safe harbor
  – Must have written accounting policy
  – Must be expensed in the Applicable Financial Statements
  – Ceiling limit – cannot exceed $5,000 per invoice, or per item as substantiated by the invoice

- Revenue Procedure giving further guidance has been delayed by the shutdown – should come by year-end

State Tax Update

Economic Nexus

- Definition
- State by state
  - Connecticut – “bright line” text – gross receipts of $500,000
  - Maine
  - Massachusetts- 3 factors bright line
  - New Hampshire
  - New Jersey
  - New York
  - Rhode Island
  - Vermont

State Tax Update

Other State Issues

- Combined Reporting
- Multi-state Reporting
  - How to recognize the need and begin tracking
- Multi-state allocation and apportionment factors
  - Special rules for Banks (inclusion of loans as tangible property)
  - Fixed assets cost vs net book value
- Tax depreciation rules by state (179 & Bonus)
- Federal to State Income Adjustments
- Estimated Tax Payments

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State Tax Update

State Tax Matrix

	MASSACHUSETTS	CONNECTICUT	RHODE ISLAND	NEW HAMPSHIRE	VERMONT*	MAINE**	NEW YORK	NEW JERSEY	PENNSYLVANIA****
Excludes US Gov't interest	No	No	Yes	Yes	Yes	No	Partial	No	Yes
Bonus Depreciation (add back)	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	No
Tax-Exempt Interest Income (add back)	Yes	Yes	Yes - non-RI	Yes - non-NH	Yes - non-VT	No	Partial	Yes	Yes - non-PA
TEFRA Interest Expense Disallowance (Deducted)	Yes	No	Yes	Yes	Yes	No	Yes	Yes	Yes - non-PA
NOL carryover allowed	No	Yes	No	Yes	Yes	No	Yes	Yes	Yes
Capital Loss carryover allowed	No	Yes	No	No	No	No	No	No	No
Deduct Other State Taxes	No	No	Yes	No	No	Yes	Yes	No	Yes
Alternative Minimum Tax	No	No	No	No	No	No	Yes	Yes	No
Passive Investment Corp	No	Yes	Yes	No	No	No	No	No	No
Real Estate Investment Trust (REIT)	No	No	No	No	No	No	Yes***	No	No
Combined Return if unitary	Yes	Allowed, not required	No	Yes	Yes	Yes	Yes	No	No
Dividend Deduction on non intercompany dividends	No	Yes	No	No	No	No	No	0	No
Credits	Various	Various	Various	Various	Various	Various	Various	Various	Various
Apportionment	Multi	Single	Multi	Multi	Multi	Multi	Multi	Multi	Multi
Tax Rate	9.0%	7.5%	9.0%	8.5%	8.5% with no location in VT	1.0%	7.1%	9.0%	11.5%
Surtax		1.5%							
Economic Nexus - bright line test	Yes - $10MM loans, $500k receipts or 100 customers	Yes - $500k receipts	No	No	No	No	No	No	No

* VT column provided information for VT Corporation Income Tax. Non-VT banks would pay based on this methodology provided they have no VT locations. Banks with VT locations pay only an excise tax on deposits.
** Maine tax for banks is 1% of apportioned financial statement net income plus .008% of apportioned total assets
***NY - REITs allowed for bank groups with less than $8 Billion in assets, and a 17% surcharge if operating in the MTA district.
****PA column provides information for PA income tax on mutual thrift institutions - Stock banks located in PA pay tax based on capital stock

Reducing Your Effective Tax Rate

2012 Effective Tax Rates – 61 MA-Chartered Banks

• Up to $250 Million (8)	19.5%
• $250 Million - $400 Million (11)	25.1%
• $400 Million - $525 Million (8)	25.1%
• $525 Million - $750 Million (13)	29.2%
• $750 Million - $1.1 Billion (9)	31.8%
• Over $1.1 Billion (12)	32.8%
• Overall	31.3%

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Reducing Your Effective Tax Rate

- Bank-owned life insurance (BOLI)
  - Increase in cash surrender value is tax exempt if hold until death of insured
  - Death proceeds tax exempt
  - Like-kind exchange treatment (tax free) if exchanged for policy on same insured for same or greater coverage
  - Surrender is taxable event
    - Gain = cash proceeds in excess of cumulative premiums paid
    - Deduction for loss only in very few instances

Reducing Your Effective Tax Rate

- Tax-exempt municipal bonds
  - Interest income is tax-exempt
  - If held by bank
    - Interest expense disallowance
      - Ave basis tax-exempt muni securities / Ave total assets X interest expense
      - Reduced to 20% if securities are “bank qualified”
        - Less than $30 million of debt issued by issuer
        - Designated as such by issuer
  - If not held by bank
    - Interest expense disallowance only if direct tracing of debt to acquire or carry tax-exempt obligations

Reducing Your Effective Tax Rate

- Qualified dividend income
  - Generally 70% dividends received
  - Regulatory issues

- Tax Credits - most common
  - Low income housing
  - New markets
  - Solar/wind energy

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Other Tax Planning Ideas

- Use of NJ Investment Company
- Use of REITs for NYS banks with assets below $8B
- Use of MA security corp.
  - Difficult in this current economic environment
  - Balance of tax benefits with liquidity issues
  - Pledging limitations
  - Changes character of debt securities to capital
- Use of RI or CT passive investment company
  - Virtually eliminates state tax
  - Not necessary if high levels of RI tax-exempt and US treasury interest income – both are RI tax-free

Reducing Your Effective Tax Rate

- Now that you have reduced your effective tax rate… have you increased your bottom line?

Potential Federal Rate Change

- Apparent consensus – Federal corporate tax rate is too high
  - Currently 35% (34% if taxable income < $10 million)
  - Tax reform – potentially reduce rate to 28%
  - But, how to pay for it?
    - Part of overall tax reform package
    - Revenue neutral vs. Revenue-raising
    - Loss of deductions

Potential Federal Rate Change

- Be careful what you wish for….
- Reduction in rates would require a reduction in the deferred tax asset (DTA)
- Example:
  - $10 million in deferred asset items, net of state tax
  - Federal DTA at 35% rate = $3.5 million
  - Federal DTA at 28% rate = $2.8 million
  - Resulting DTA adjustment = $700,000

RC-R Call Report DTA Limitation

- Calculation determining whether the deferred tax asset will be recognized for regulatory purposes
  - Allows for a two year carryback and 12 month carry forward
  - If there is a limitation, then it can not be included for Tier 1 capital based on the capital guidelines of the reporting bank's primary federal supervisory authority
- Basel III update:
  - Effective January 1, 2015
  - Carry overs not allowed
  - AOCI one time election

Affordable Care Act – Medicare Tax

3.8% Medicare Surtax on Net Investment Income

- Beginning in 2013, higher-income individual taxpayers are subject to a new 3.8% surtax on net investment income.
- Surtax is the lesser of:
  - Net Investment Income, or
  - The excess of adjusted gross income over:
    - $250,000 for joint returns or surviving spouses,
    - $125,000 for married filing separately, or
    - $200,000 for all other taxpayers

Affordable Care Act – Medicare Tax

3.8% Medicare Surtax on Net Investment Income (cont.)

- Net Investment income includes the following:
  - Interest, dividends, annuities, rents unless derived from an active trade or business
  - Other gross income from a passive trade or business
  - Net gains on property other than property held in an active trade or business
  - Deductions allocable to these items reduce NII

Affordable Care Act – Medicare Tax

3.8% Medicare Surtax on Net Investment Income (cont.)

- Surtax is considered a tax for estimated tax purposes
  - May need to increase withholding
- Surtax calculated on form 8960, to be included in the individual’s tax return

Affordable Care Act – Medicare Tax

3.8% Medicare Surtax on Net Investment Income (cont.)

- Planning Opportunities (if feasible)
  - Take capital losses to offset capital gains
  - Use of installment method
  - Defer income
  - Convert passive activity to active (with advisor assistance)
- Regulations issued last week
  - Clarification of calculation
  - Entities and individuals subject to taxation

Affordable Care Act – Medicare Tax

0.9% Additional Medicare Tax

- Additional Medicare tax of 0.9% of wages and self-employment income in excess of:
  - $250,000 for joint returns,
  - $125,000 for married filing separately, or
  - $200,000 for all other taxpayers
- Additional tax is on the combined wages of the employee and spouse

Affordable Care Act – Medicare Tax

0.9% Additional Medicare Tax (cont.)

- Employer is required to withhold additional tax on wages in excess of $200,000 regardless of filing status or wages paid by another employer
- Excess withholdings can be claimed as a credit on the employee’s tax return
- Tax is calculated on Form 8959, to be included in the individual’s tax return

SERP / Deferred Comp Tax Implications

- Sec 409A
  - Distribution elections must be made prior to earning income
- Regular tax
  - Payments taxable to retired executive (employee) when received
  - Reported on Form W-2, not Form 1099R
  - Deductible by the bank in the year paid
  - Planning for deferred tax considerations
    - Will tax benefit be realized in the year of deduction?
    - If not, a valuation allowance may be needed against the deferred tax asset

SERP / Deferred Comp Tax Implications

- FICA/Medicare tax
  - Taxable as of later of when services are performed or when no longer a substantial risk of forfeiture (i.e., at vesting)
  - Exception for “nonaccount balance plans” where amount is not reasonably ascertainable when earned or vested
    - Deferred until reasonably ascertainable
    - Some flexibility as to particular year – to avoid FICA
    - Early inclusion at vesting is an option with a “true-up” adjustment at payment in favor of IRS

Questions?

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