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Financial Managers Society – New Jersey

Tax Update for Financial Institutions

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Agenda

- Deferred Tax Asset Regulatory Limitations Under Basel III
- Overview of ASU 2016-09 – Improvements to Employee Share-Based Accounting – Tax Aspects
- New York Tax Reform Overview – What New Jersey Bankers Need to Know

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Deferred Tax Asset Regulatory Limitations Under Basel III

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Limiting Deferred Tax Assets Included in Regulatory Capital

- A deferred tax asset (“DTA”) is generally a tax benefit generated in the current year that cannot be absorbed or utilized in the current year
- A DTA is often utilized in one of two ways:
  - 1) As a loss carryback to offset taxes paid in an applicable carryback period; or
  - 2) As a future deduction that will offset future taxable income
- Those DTAs that rely upon future income for realization are more tenuous and thus subject to limitation in the regulatory capital calculations
- This concept is not new, but the Basel III rules refine the calculation and require more analysis than the predecessor rules
- Common Equity Tier 1 Capital (“CET1C”) is the new regulatory capital standard

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Detailed Analysis and Segregation Required

- **The Basel III limitation analysis requires several steps:**
  - 1) Remove deferred tax assets and liabilities associated with Other Comprehensive Income adjustments if the Bank made OCI “opt out” election
  - 2) Remove deferred tax liabilities (only) associated with goodwill / intangibles and loan servicing rights (“threshold” items in the CET1C calculation) if elected
  - 3) Analyze the gross remaining deferred tax assets for hypothetical reversal and potential carryback as a Net Operating Loss (“NOL”) to measure what hypothetical tax refunds would result
  - 4) Segregate the remaining gross deterred tax assets into two buckets
    - A) Carryforward attributes (i.e. NOL and tax credit carryforwards); and
    - B) Remainder attributes (all other DTAs not yet accounted for)
  - 5) Allocate the remaining gross deferred tax liabilities (“DTLs”) between these two buckets based upon their relative amounts
  - 6) Apply the Basel III limitations to these various categories of net DTAs

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Basel III Limitations

- 1) DTA justified through hypothetical carryback refunds:
  - No limitation; 100% risk weighted in the CET1C calculation
- 2) Net carryforward attribute DTA (net of allocated DTLs):
  - 100% disallowed in the regulatory capital calculations
  - There is a phase-in schedule to determine how the disallowed amount is apportioned between CET1C and “Additional Tier-1 Capital”
  - However, banks with no Additional Tier-1 Capital must remove the disallowed net DTA entirely from CET1C
- 3) Net residual DTA (net of allocated DTLs):
  - Considered a “threshold limitation” that cannot exceed 10% of CET1C
  - Disallowed excess is subject to a phase-in schedule
  - 250% risk weighted in the CET1C calculation beginning in 2018 (100% until then)

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Observations From the Initial Calculations:

- Banks with income tax paid in recent years sufficient to support DTA realizability under the hypothetical carryback rule typically have no limitation
- Banks with significant net remainder DTAs may experience less of a disallowance under the Basel III threshold limitations than under the previous rules, but the net remainder DTA will be a 250% risk weighted asset beginning in 2018
- Banks whose net DTA is comprised heavily of tax loss and credit carryforwards may experience significant limitations on the inclusion of the net DTA in CET1C

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Example – Bank with Sufficient Carryback Ability:

Itemized DTA / DTL	DR. / (CR.)	Carryback Potential	Carryforward DTA	Residual DTA
Allowance for Loan Losses	1,000,000	1,000,000	N/A	N/A
Deferred Compensation	500,000	500,000	N/A	N/A
Other DTAs	50,000	50,000	N/A	N/A
Total DTLs	(100,000)	N/A	N/A	N/A
TOTAL	**1,450,000**	**1,550,000**	N/A	N/A
Limitation / Risk Weighting	No limitation 100% R/W			

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Example – Combined Carryback / Carryforward DTA:

Itemized DTA / DTL	DR. / (CR.)	Carryback Potential	Carryforward DTA	Residual DTA
Allowance for Loan Losses	1,000,000	1,000,000	N/A	N/A
AMT Credit Carryforward	500,000	-	500,000	N/A
Other DTAs	50,000	50,000	N/A	N/A
Total DTLs	(100,000)	N/A	(100,000)	N/A
TOTAL	**1,450,000**	**1,050,000**	**400,000**	N/A
Limitation / Risk Weighting		No limitation 100% R/W	Disallowed (subject to phase-in rule)	

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Example – Combined Carryback / Carryforward / Residual DTA:

Itemized DTA / DTL	DR. / (CR.)	Carryback Potential	Carryforward DTA	Residual DTA
Allowance for Loan Losses	1,000,000	380,952	N/A	619,048
AMT Credit Carryforward	500,000	-	500,000	N/A
Other DTAs	50,000	19,048	N/A	30,952
Total DTLs	(100,000)	N/A	(43,478)	(56,522)
TOTAL	**1,450,000**	**400,000**	**456,522**	**593,478**
Limitation / Risk Weighting		No limitation 100% R/W	Disallowed (subject to phase-in rule)	15% Threshold 250% R/W

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Overview of ASU 2016-09 Improvements to Employee Share-Based Accounting – Tax Aspects

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Improvements to Employee Share-based Accounting

- **ASU 2016-09** (Topic 718) issued Mar. 30, 2016
- Includes multiple improvements to the accounting for share-based payment awards
- Changes directly or indirectly affecting income taxes include:
  1. “Geography” – Recognizes all excess tax benefits and tax deficiencies through the income statement, effectively eliminating the concept of “APIC Pool”
  2. “Timing” – Removes the requirement to delay recognition of excess tax benefits until the benefit is actually realized
  3. Accounting for forfeitures
  4. Cash flow statement disclosures

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1. Current Guidance on Recognition "Geography"

- Excess Tax Benefit (*aka* "windfall")
  - Tax effect of an excess deduction: Tax return deduction > cumulative book compensation expense previously recorded for a stock-based award
- Tax Deficiency (*aka* "shortfall")
  - Tax effect of a deduction deficiency: Tax return deduction < cumulative book compensation expense previously recorded for a stock-based award
- Recorded to additional paid in capital (APIC) –
  - Excess tax benefits – when realized *(Topic 2)*
  - Deficiencies – only to the extent there is "APIC Pool" of previously recorded windfalls, then to Continuing Operations tax expense

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1. Current Guidance on Recognition "Geography"

- Windfalls and shortfalls are computed on an award by award basis as the awards are settled
- Dividends paid to award holders while the awards are outstanding are tax deductible
  - To the extent the dividend payment is recorded to equity, the tax effect of the deduction is an excess tax benefit recorded to APIC (when realized – *Topic 2*)

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1. New Guidance on Recognition "Geography"

- The tax effect of all excess deductions or deduction deficiencies will be recorded through the income statement (via a permanent Schedule M)
- Tax benefit of all dividends paid on outstanding share-based awards now will be recorded in the income statement, not through APIC
- Recorded as discrete items in the period they occur *(no change)*; not included in the estimate of annual effective tax rate used to record taxes at interim periods
- *Transition*: Above changes to be applied prospectively

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2. Current Guidance on Recognition "Timing"

- Excess tax benefits are only recorded to equity (and only increase APIC Pool) when their presence reduces cash taxes payable (or increases taxes refundable)
- When losses or other tax attributes are present (whether current year or carried forward) that reduce taxes payable to zero, the question arises whether excess benefits have been realized
- One of two determining approaches may be utilized and should be applied consistently once chosen –
  - Tax Law Ordering
  - With and Without

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2. Current Guidance on Recognition "Timing"

- The approach taken to determine excess tax benefit realization can affect presentation and disclosure
  - **Unrealized** excess benefits may be "embedded" in NOL carry forwards
    - The amounts of "NOL" that would be recorded to APIC when realized should be narratively disclosed
    - They would **not** be included in the NOL deferred tax asset
  - Only amounts of **realized** excess benefits should be presented in the statement of cash flows
- **Unrealized** excess benefits are carried and tracked off balance sheet

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2. New Guidance on Recognition “Timing”

- Excess tax benefits will be recorded in the period the award settles (and in the case of dividends on outstanding awards, in the period paid), regardless of whether a cash tax benefit can be realized at that time or not
  - Obviously, to the extent such excess deductions create a net operating loss carry forward, the resulting deferred tax asset should be analyzed for realizability (and any potential valuation allowance) via “normal” ASC 740 guidance
- *Transition*: Any excess tax benefits not previously recorded, due to not yet reducing taxes payable, should be recorded as a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption

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3. Current Guidance on Forfeiture Accounting

- Entities must estimate the number of award shares that are not expected to vest
- To the extent nonforfeitable dividends are paid on share-based awards not expected to vest, the dividends are recorded as compensation expense (vs. through equity), consistent with the forfeiture estimates for those awards
  - The tax deduction on such amounts occurs without a Schedule M needed; the tax effect is not an excess tax benefit and it is recorded to the income statement

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3. New Guidance on Forfeiture Accounting

- Entities can elect to account for forfeitures as they occur
  - But only to the extent service conditions are not met; forfeitures due to performance conditions must still be estimated
- If elected, all nonforfeitable dividends paid on the elected awards will be initially recorded to retained earnings, then reclassified to compensation expense when a forfeiture occurs
  - Tracking will be required to ensure that affected dividends are not tax-deducted twice and a tax benefit is not recorded twice
- *Transition*: Effect of the election to be recorded as a cumulative-effect adjustment to retained earnings as of the beginning of the adoption year

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4. Cash Flow Statement Disclosures

- Excess tax benefits
  - Current: Presented as a cash inflow from financing activities and a cash outflow from operating activities
  - New: Presented with other income tax cash flows as an operating activity
  - *Transition*: Apply prospectively or retrospectively
- Cash payments to tax authorities in connection with shares withheld to meet tax withholding requirements
  - Current: No clear guidance
  - New: Presented as a cash outflow from financing activities
  - *Transition*: Apply retrospectively

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ASU 2016-09 – Effective Date

- Public business entities:
  - Fiscal years, and related interim periods, beginning after Dec. 15, 2016
- All other entities:
  - Fiscal years beginning after Dec. 15, 2017 and interim periods in the following year
- Early adoption:
  - Permitted in any interim or annual period, but entire ASU must be adopted then
  - If early adopted after the first interim period, any adjustments must be reflected as of the beginning of the year
- *Note: This ASU contains other changes not discussed here*

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New York Tax Reform Overview – What New Jersey Bankers Need to Know

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New York Tax Law Changes Effective 2015

Nexus provisions:

Do we have to file a New York State return?

- Taxpayers with a physical presence in New York are required to file
- Taxpayers with no physical presence, but that receive $1 million or more in taxable income from New York customers in a given year (using the NY apportionment rules) are required to file
  - This is a significant change from prior law and may require those banks located in surrounding states to file a New York tax return beginning in 2015 if they do significant business with New York customers

Do we have to file a New York City return?

- Nexus (filing requirement) generally remains tied to physical presence standard and economic nexus is not asserted

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New York Tax Law Changes Effective 2015

- **Apportionment changes:**
- Single-factor receipts apportionment (NYC phasing into this)
- Interest on loans secured by real estate is apportioned to New York if the loan collateral is located in New York (NYC applies at city level)
- Interest on all other loans is apportioned to New York if the loan customer is located in New York (NYC applies at city level)
- Interest on U.S. obligations and New York municipal securities is not included in the apportionment numerator and is included fully in the denominator
- Interest on other state municipal securities is not included in the apportionment numerator and is included 50% in the denominator
- **For many other typical bank investment securities (asset-backed securities, agencies, etc.) interest is apportioned to NY at 8%**

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New York Tax Law Changes Effective 2015

- **Apportionment changes:**
- **Elective 8% apportionment for “Qualified Financial Instruments”**
- Potentially includes all loans and securities, except for loans secured by real estate
- However, in order to qualify for the election, the loans and securities must be marked-to-market for federal income tax purposes under IRC §475 (or at least one loan / security from each class must be marked to market in this manner)
- If elected, then 8% of the income from these loans and securities is included in the NY apportionment numerator and 100% in the denominator
- May substantially benefit banks with significant income from loans to NY customers that are not secured by real estate

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New York Tax Law Changes Effective 2015

- **Combined filing requirements:**
- Required for affiliates 50% commonly owned and that meet unitary definition
- Requires a captive REIT to join the combined return (this has been the requirement for banks with over $8 billion in total assets, but now applies to all captive REITs)
- May require other commonly owned affiliates to join in a combined return even if they are not part of the same consolidated federal income tax return

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New York Tax Law Changes Effective 2015

- **Subtraction modifications to taxable income:**
- For combined groups with less than $8 billion in total assets:
  - Grandfathered captive REIT entitled to a net 60% exclusion for dividends paid, provided the REIT was in existence on April 1, 2014
  - If no grandfathered captive REIT:
    - Choose between a 50% net interest exclusion for qualified residential and commercial loans to New York customers or an exclusion of up to 32% of modified taxable income (provided certain residential lending tests are met)
- For combined groups with $8 billion or more in total assets:
  - Only thrift charters that meet certain residential lending tests qualify for an exclusion of up to 32% of modified taxable income

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New York Tax Law Changes Effective 2015

- **Tax rate changes:**
- New York State tax rate remains the same for 2015 (7.1%)
- Tax rate drops from 7.1% to 6.5% for tax years beginning on or after 1/1/2016
- MTA surcharge rate is changed from 17% of the MTA tax base to 25.6% of the MTA tax base for 2015, 28% of the MTA tax base for 2016 and may be adjusted annually beginning in 2017
- NYC tax rate (for banks) drops from 9% to 8.85%
- The tax due is the greater of the income tax calculated on apportioned taxable income, an apportioned capital base tax or a fixed filing fee based upon NY gross receipts

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New York Tax Law Changes Effective 2015

- **New York State capital base tax:**
  - 0.15% for 2015 tax year
  - 0.125% for 2016 tax year
  - 0.10% for 2017 tax year
  - 0.075% for 2018 tax year
  - 0.05% for 2019 tax year
  - 0.025% for 2020 tax year (tax is fully phased out after 2020)

- **New York City capital base tax:**
  - 0.15%, less $10,000
  - No phase-out applies

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Structural Planning Suggestion for NJ Banks with REIT Subsidiary

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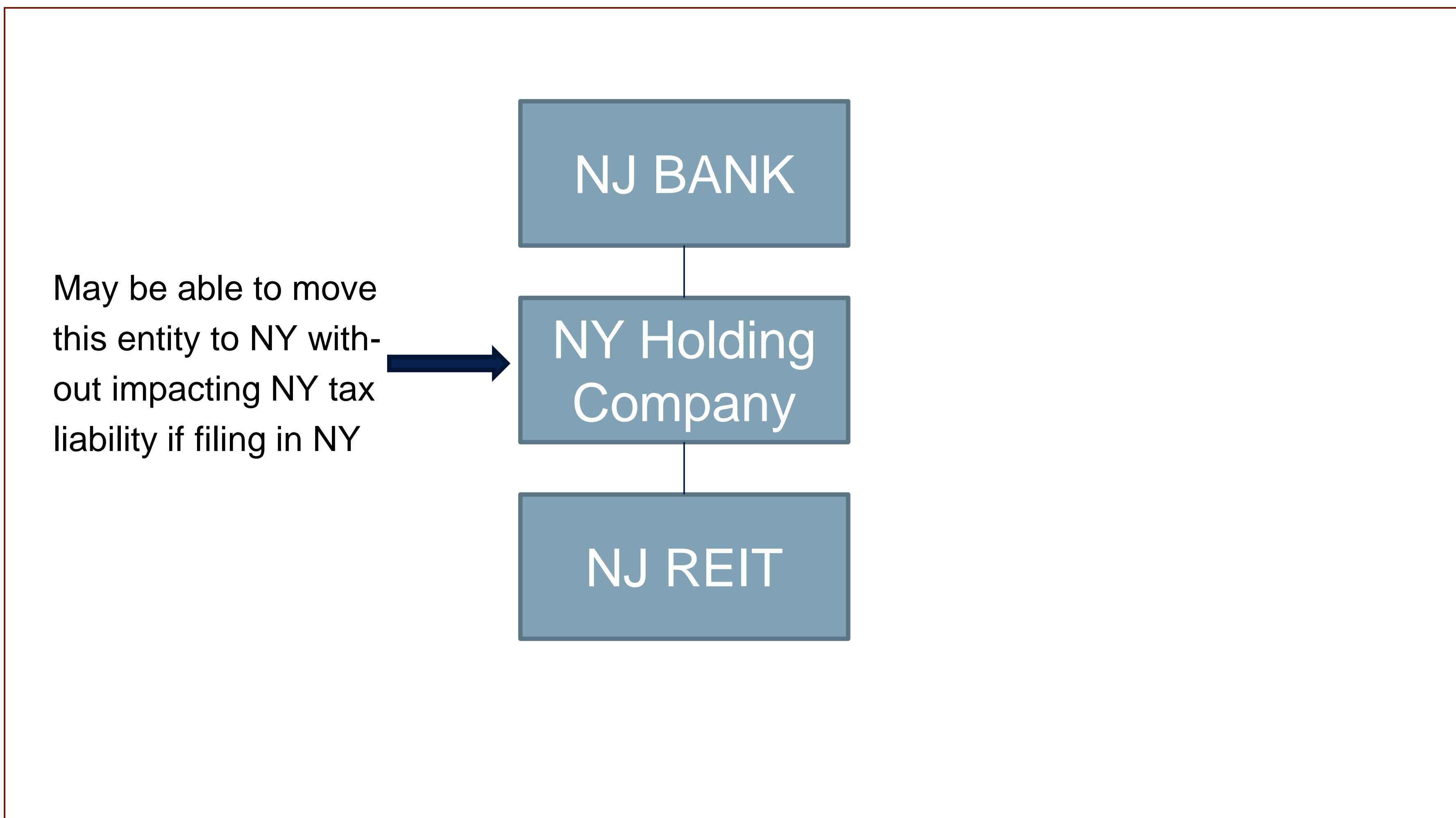
Structural Planning Suggestion for NJ Banks with REIT Subsidiary



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