

# Year End Accounting and Tax Update

What Banks Need to Know for 2013



CliftonLarsonAllen

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# About CliftonLarsonAllen

- A professional services firm with three distinct business lines
  - Accounting and Consulting
  - Outsourcing
  - Wealth Advisory
- 3,600 employees
- Offices coast to coast
- Financial Institutions group serves more than 750 bank clients across the country



# Speaker Introductions

- **Todd Sprang, CPA**

Todd is a principal in the firm's financial institutions group. He has more than 20 years of audit and consulting experience and serves as an engagement partner on privately-held banks and SEC registrant banks throughout the United States. Todd serves as a member of the AICPA Depository Institutions Expert Panel and is a frequent speaker at national banking industry conferences.

- **Amanda Garnett, CPA, CFSA**

Amanda is a manager in CLA's financial institutions group. She has more than eight years of experience serving financial institutions and has extensive experience in the coordination and supervision of tax services for bank clients including knowledge in federal tax compliance, state tax issues, mergers and acquisitions, and FDIC assisted transactions. Amanda also performs financial reporting, SEC reporting, and regulatory reporting including call report and Federal Reserve report preparation.

# Learning Objectives

- At the end of this session, you will be able to:
  - Identify, examine, and apply accounting changes affecting banks at 2013 year-end
  - Evaluate the effect of recent tax regulations and IRS pronouncements that impact your bank



# Accounting Update

Todd Sprang, CPA



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# Topics

1. What's Effective for 2013
2. Year End ALLL Calculation Considerations
3. Troubled Debt Restructuring (TDR)
4. Other Real Estate Owned
5. Investments
6. Expected Loss Model

## Effective for 2013 – Community Banks

- No newly effective pronouncements requiring adoption for year ending December 31, 2013.
- No new financial statement disclosures for year ending December 31, 2013.

# Year End ALL Calculation Considerations

- To release or not release, that is the question
- Not release (or maintain)
  - Real or perceived regulator reaction
  - Farmland and commodity pricing
  - Risk rating accuracy
  - Credit risk uncertainty
- Release
  - Historical losses have declined
  - Declining impaired loans
  - Lack of loan growth
  - High unallocated reserves



# Year End ALL Calculation Considerations

- Historical losses
  - Stability of loss environment
  - Document reasons for changes to historical loss periods

# Year End ALLL Calculation Considerations

- Qualitative factors
  - Directional consistency
  - Adding and documenting additional influences or indicators
  - Incorporating range of loss

# Year End ALLL Calculation Considerations

- Specific reserves on impaired loans
  - Size of gains or losses on past impaired loans
  - Troubled Debt Restructurings with zero reserve
- Unallocated reserves
  - Establishing an acceptable range

# Interagency Guidance on TDRs

Interagency Guidance (FIL 50-2013) issued October 24, 2013 which addresses:

1. Loan classification for TDRs
2. Classifying TDRs as collateral dependent or not collateral dependent
3. Proper measurement of TDRs for regulatory reporting purposes

[Financial Institutions Get Clarification on Treatment of Troubled Debt Restructurings](#)

# Once a TDR always a TDR?

## Initial assessment of a TDR

1. Financial reporting
2. Accrual vs. Nonaccrual
3. Impairment calculation

When do these initial assessments change?



# Other Real Estate Owned

EITF Exposure draft issued on July 19, 2013

1. Addresses timing of transfers from loan to OREO
2. Addresses variance in current practices across the industry
  - Terms such as in substance repossession, foreclosure, and physical possession are not defined in the current accounting guidance, which has led to different applications and interpretations of this standard.

# Other Real Estate Owned

*A creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon one of the following occurring:*

- the creditor obtaining legal title to the residential real estate property*
- completion of a deed in lieu of foreclosure or similar legal agreement under which the borrower conveys all interest in the residential real estate property to the creditor to satisfy that loan, even though legal title may not yet have passed*

# Investments

## Transfers from AFS to HTM

- Securities classification shall be reassessed at each reporting date
- HTM to AFS introduces tainting concept, but AFS to HTM does not

# Investments

## Transfers from AFS to HTM (continued)

- Halts further unrealized losses in a rising rate environment
- Additional considerations:
  - Liquidity
  - Possible manual processes for tracking and recording amortization
  - Disclosure
  - Significance of benefits

# ALLL – Expected Loss Model

It is unclear how this initiative proceeds, but the following options have been discussed:

- FASB explores additional models
- FASB proceeds without re-exposure
- FASB revises model with re-exposure
- Convergence with IASB



# Tax Update

Amanda Garnett, CPA



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# Objectives

- Discuss recent tax regulations and IRS pronouncements
  - Expiring Tax Provisions
  - Final Repair and Maintenance Regulations
  - OREO Expenses
- Discuss tax planning opportunities
- Discuss S Corporations in the new rate environment

# Expiring Tax Provisions Affecting Banks

- Section 179 Limitation
  - Maximum Expense in 2013 = \$500,000
    - ◇ Total Investment Limit = \$2,000,000
  - Maximum Expense in 2014 and beyond= \$25,000
    - ◇ Total Investment Limit = \$200,000
  - Allowed on new and used:
    - ◇ Office equipment
    - ◇ Computers and technology equipment
    - ◇ Certain software
  - Special limits apply for vehicle purchases



# Expiring Tax Provisions Affecting Banks

- Bonus Depreciation
  - 50% Bonus Depreciation allowed in 2013
  - No Bonus Depreciation scheduled for 2014 and beyond
  - Allowed only on new:
    - ◇ Office equipment
    - ◇ Computers and technology equipment
    - ◇ Certain software
    - ◇ Qualified leasehold improvements (15 year property)
  - Special limits apply for vehicle purchases
  - Can be used in conjunction with Section 179

# Expiring Tax Provisions Affecting Banks

- Tax Planning Fixed Asset Purchases
  - Assets must be purchased and placed in service by December 31, 2013 to take advantage of provisions
  - Building or remodeling branches
    - ◇ Branch must open prior to December 31, 2013
    - ◇ Consider fixed asset study to shorten the tax life of certain building components and maximize bonus depreciation and Section 179
    - ◇ Fixed asset study should be completed before tax return is filed, but not necessarily prior to year end

# Expiring Tax Provisions Affecting Banks

- S Corporation Built in Gains Tax
  - Built in Gains period for 2013 = 5 years
    - ◇ For S Corporations that have already been S Corp for 5 years
  - Built in Gains period for 2014 and beyond = 10 years
  - Tax planning opportunity banks between 5 and 10 years of being an S Corporation:
    - ◇ Dispose of buildings or branches with BIG potential
    - ◇ Dispose of investments with BIG potential

# Final Repair and Maintenance Provisions

- Effective for 2014, but some action may need to be taken by January 1, 2014
- Taxpayer must capitalize amounts paid to acquire or produce tangible property unless:
  - Qualified as materials or supplies
  - Qualifies under the de minimis safe harbor and conforms to the taxpayer's safe harbor election

# Final Repair and Maintenance Provisions

- De minimis safe harbor election
  - Corporations with audits or 10-Ks filed with SEC
    - ◇ Limit is \$5,000 per invoice or item
    - ◇ Must have written capitalization policy in place by January 1st
    - ◇ If expensed for tax purposes, must expense for book purposes
    - ◇ Annual election at time tax return is filed
  - Corporations without audits
    - ◇ Limit is \$500 per invoice or item
    - ◇ All other requirements apply

# Final Repair and Maintenance Provisions

- Tax Planning de minimis safe harbor election
  - Used for any fixed assets purchased including:
    - ◇ Computers and technology equipment
    - ◇ Office equipment
  - Must be applied consistently
    - ◇ \$5,000 capitalization threshold then all purchases less than \$5,000 should be expensed
    - ◇ Section 179 can be used more selectively
  - Consistent treatment for book and GAAP
    - ◇ Lowers taxable income but also book income and capital
    - ◇ Can result in a tax loss

# Final Repair and Maintenance Provisions

- Capitalizing Repairs- capitalize if repair results in:
  - Material addition to unit of property (enlargement)
  - Material increase in productivity
  - Material correction of problem/defect
  - Repair to operating condition after significant deterioration or damage
  - Adaptation of property for new or different use

# Final Repair and Maintenance Provisions

- Repairs to Existing Buildings
  - For application of improvement rules, “building systems” are now treated as separate units of property from the building structure
    - ◇ Building systems = HVAC, plumbing, electrical, elevators, escalators, fire-protection and alarm, security, and gas distribution
    - ◇ Building Structure = roof, walls, windows, floors, ceilings
  - “Building Systems” approach lowers the threshold for whether improvements to these components are significant and must be capitalized



# Final Repair and Maintenance Provisions

- Dispositions of Assets- proposed regulation
  - Allows taxpayer to claim a loss when disposing of a portion of an asset
  - Example:
    - ◇ Remove an old roof to replace it
    - ◇ Allocate a portion of the original building being depreciated to the old roof
    - ◇ Take a loss on the disposition
  - Opportunity to clean up fixed asset listing for past dispositions
  - If you elect the disposal method, you must capitalize the replacement

# Tax Treatment of OREO Expenses

- Historical Tax Treatment
  - IRS Position that OREO is inventory
  - Non-income producing property- capitalize expenses until property is sold
  - Income producing property- deduct expenses as incurred
- IRS Memo issued in 2013
  - Bank's acquire OREO as an extension of lending not for resale
  - Capitalization of expenses not required

# Tax Treatment of OREO Expenses

- Implementation
  - IRS has not issued final guidance we can rely on for a tax position
  - Until final guidance is released, continue to capitalize expenses
  - Remains unclear at this time how capitalized expenses from prior years will be treated

# S Corporations in the New Rate Environment

- S Corporation Advantages
  - Mitigates double taxation on earnings
  - Build shareholder basis as corporation has earnings
- S Corporation Disadvantages
  - Limited to 100 shareholder families
  - Limited to one class of stock
  - Limits to certain types of shareholders (individuals, certain trusts, estates, certain tax exempt orgs)
  - Potential for Built in Gains tax
  - Tax must be paid on earnings by shareholders regardless of cash distributions available to pay the taxes

# S Corporations in the New Rate Environment

- Higher Rate Brackets Affecting Shareholders
  - 6 brackets and rates continued from 2012
    - ◇ No expiration date (2012 ATRA made permanent)
  - Added 39.6% bracket, effective on taxable income above:
    - ◇ \$400,000 (Single)
    - ◇ \$450,000 (MFJ)
  - Phase-out of itemized deductions and personal exemptions:
    - ◇ \$250,000 (Single)
    - ◇ \$300,000 (MFJ)
  - Medicare surtax= 3.8% on net investment income

# S Corporations in the New Rate Environment

- 3.8% Medicare Surtax, computed as the lesser of:
  - Net investment income, or
  - Excess of modified AGI over
    - ◇ \$200,000 (Single)
    - ◇ \$250,000 (MFJ)
- Definition of net investment income (NII)
  - Interest, dividends, annuities, royalties, rents
  - Net gains from property (except active business)
  - Passive business income and trading = S Corp Income

# S Corporations in the New Rate Environment

- Tax Rates for C Corporations
  - Maximum Corporate tax rate = 34%
  - Higher rates on qualified dividends and long term capital gains (on stock sales)
    - ◇ Low brackets (Ord. 10-15%) = 0%
    - ◇ Mid brackets (Ord. 25-35%) = 15%
    - ◇ Top bracket (Ord. 39.6%) = 20%

# Example #1 - Taxes Owed Summary

Row A	C corporation
Row B	S corporation – All non-passive shareholders
Row C	S corporation - All passive shareholders

	Current Tax	Potential Benefit	Potential Net Tax
A	343,400	-	343,400
B	316,800	(76,640)	240,160
C	347,200	(83,966)	263,234



# Example #1- C Corporation

Net income per books	1,000,000
Municipal bond interest	(200,000)
Federal taxable income	800,000
<b>Federal tax @ 34%</b>	272,000
Obamacare Sur-tax	-
Real dividends paid	300,000
Shareholder Federal tax on dividends	60,000
Obamacare Sur-tax	11,400
<b>Summary</b>	
Federal tax paid on bank earnings	272,000
Obamacare Surtax on bank earnings	-
Shareholder Federal tax on dividends	60,000
Obamacare Surtax on dividends	11,400
<b>Total taxes paid</b>	<b>343,400</b>

## No Shareholder Stock Basis Step-Up

# Example #1 S Corp – Non-Passive Shareholders

Net income per books	1,000,000
Municipal bond interest	(200,000)
Federal taxable income	800,000
<b>Federal tax @ 39.6%</b>	316,800
Obamacare Sur-tax	n/a
Real dividends paid	300,000
Shareholder Federal tax on dividends	n/a
Obamacare Sur-tax	n/a

## Summary

Federal tax paid on bank earnings	316,800
Obamacare Surtax on bank earnings	n/a
Shareholder Federal tax on dividends	n/a
Obamacare Surtax on dividends	n/a
<b>Total taxes paid</b>	<b>316,800</b>
Federal taxable income	800,000
Tax-exempt income	200,000
Tax distributions paid	(316,800)
Real dividends paid	(300,000)
Shareholder basis step-up	383,200
<b>Potential Benefit of Basis Step-Up</b>	<b>76,640</b>

# Example #1 S Corporation – Passive Shareholders

Net income per books	1,000,000
Municipal bond interest	(200,000)
Federal taxable income	800,000
<b>Federal tax @ 39.6%</b>	316,800
<b>Obamacare Sur-tax</b>	30,400
Real dividends paid	300,000
Shareholder Federal tax on dividends	n/a
Obamacare Sur-tax	n/a

## Summary

Federal tax paid on bank earnings	316,800
Obamacare Surtax on bank earnings	30,400
Shareholder Federal tax on dividends	n/a
Obamacare Surtax on dividends	n/a
<b>Total taxes paid</b>	<b>347,200</b>

Federal taxable income	800,000
Tax-exempt income	200,000
Tax distributions paid	(347,200)
Real dividends paid	(300,000)

Shareholder basis step-up 352,800

**Potential benefit of basis step-up 83,966**

# Example #2- Taxes Owed Summary

Row A	C corporation
Row B	S corporation – All non-passive shareholders
Row C	S corporation – All passive shareholders

	Current Tax	Potential Benefit	Potential Net Tax
A	272,000	-	272,000
B	316,800	(136,640)	180,160
C	347,200	(155,366)	191,834

# Example #2- C Corporation

Net income per books	1,000,000
Municipal bond interest	(200,000)
Federal taxable income	800,000
<b>Federal tax @ 34%</b>	272,000
Obamacare Sur-tax	-
Real dividends paid	-
Shareholder Federal tax on dividends	-
Obamacare Sur-tax	-
<b>Summary</b>	
Federal tax paid on bank earnings	272,000
Obamacare Surtax on bank earnings	-
Shareholder Federal tax on dividends	-
Obamacare Surtax on dividends	-
<b>Total taxes paid</b>	<b>272,000</b>

**No Shareholder Stock Basis Step-Up**

# Example #2 S Corp – Non-Passive Shareholders

Net income per books	1,000,000
Municipal bond interest	(200,000)
Federal taxable income	800,000
<b>Federal tax @ 39.6%</b>	316,800
Obamacare Sur-tax	n/a
Real dividends paid	-
Shareholder Federal tax on dividends	n/a
Obamacare Sur-tax	n/a
<b>Summary</b>	
Federal tax paid on bank earnings	316,800
Obamacare Surtax on bank earnings	n/a
Shareholder Federal tax on dividends	n/a
Obamacare Surtax on dividends	n/a
<b>Total taxes paid</b>	<b>316,800</b>
Federal taxable income	800,000
Tax-exempt income	200,000
Tax distributions paid	(316,800)
Real dividends paid	-
Shareholder basis step-up	683,200
<b>Potential Benefit of Basis Step-Up</b>	<b>136,640</b>

# Example #2 S Corporation – Passive Shareholders

Net income per books	1,000,000
Municipal bond interest	(200,000)
Federal taxable income	800,000
<b>Federal tax @ 39.6%</b>	316,800
<b>Obamacare Sur-tax</b>	30,400
Real dividends paid	-
Shareholder Federal tax on dividends	n/a
Obamacare Sur-tax	n/a

## Summary

Federal tax paid on bank earnings	316,800
Obamacare Surtax on bank earnings	30,400
Shareholder Federal tax on dividends	n/a
Obamacare Surtax on dividends	n/a
<b>Total taxes paid</b>	<b>347,200</b>
Federal taxable income	800,000
Tax-exempt income	200,000
Tax distributions paid	(347,200)
Real dividends paid	-
Shareholder basis step-up	652,800
<b>Potential Benefit of Basis Step-Up</b>	<b>155,366</b>



# Questions?

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# Thank you

**Todd Sprang**  
**Principal – Financial Institutions**  
**630-954-8175**  
**Todd.Sprang@CLAconnect.com**



**Amanda Garnett**  
**Manager – Financial Institutions**  
**309-495-8842**  
**Amanda.Garnett@CLAconnect.com**



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