

Welcome

2021 Tax Update for
Financial Institutions

December 2, 2021

wipfli.com

WIPFLI

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Federal Tax Update

- Overview
 - ▶ Tax Revision
 - ▶ Tax Planning Strategies
 - ▶ SALT Limitation Workaround
 - ▶ PPP Loan Processing Fees
 - ▶ Employee Retention Credit
 - ▶ Bank Owned Life Insurance (BOLI) – M&A

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Tax Revision

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Where It All Stands

- On November 19, the House passed the Build Back Better (BBB) tax and spending proposal
- Senate back this week to start debating on the proposal
- Senate Majority Leader Chuck Schumer wants it to pass by Christmas
- Still fluid and some revisions are expected

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Corporations

- No change to the current tax rate of 21%
 - ▶ Since the election, there have been expectations of an increase to 26.5% or higher
 - ▶ The House version does not include a corporate rate increase
- Instead of rate increase, bringing back a form of minimum tax

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Corporations

- A 15% minimum tax on corporations with over \$1 billion of book income
 - ▶ Applies to corporations with three-year average book income, before federal and state income taxes, of \$1 billion or more
 - ▶ Similar to former minimum tax, there is a credit carryforward
- A 15% country-by-country minimum tax on foreign profits of US corporations
- Both minimum taxes are effective for tax years beginning after December 31, 2022

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Corporations

- Stock “Buy-Back” Excise Tax
 - ▶ A 1% tax on corporate stock “buy-backs”
 - This is a reduction from 2% in previous versions
 - ▶ Some exceptions (not a complete list)
 - Total repurchases during the year are less than \$1 million
 - The repurchased stock, or its equivalent value, is contributed to an ESOP or similar plan
 - The repurchase is a dividend for tax purposes
 - The repurchase is part of a tax-free reorganization

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Corporations

- Stock “Buy-Back” Excise Tax (continued)
 - ▶ S corporations and closely held C Corporations
 - No specific language for exclusion
 - As written, currently refers twice to “publicly traded US corporation” which can be interpreted to exclude S corporations and nonpublic C Corporations
 - ▶ Effective for taxable years beginning after December 31, 2021

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Individuals

- No longer includes rate increase on incomes over \$400,000
 - ▶ Previously expected top rate to increase from 37% to 39.6%
- Net Investment income tax expansion
 - ▶ 3.8% income tax on income derived from ordinary conduct of a trade or business
 - ▶ Applies if “taxable income” exceeds \$400,000 for individuals or \$500,000 for joint filers
 - ▶ Appears to be directed towards S corporation shareholders, partners, and members of LLCs taxed as partnerships
 - ▶ Effective for tax years beginning after December 31, 2021

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Individuals

- Replacing the rate increase with
 - ▶ 5% surtax on the adjusted gross income over \$10 million
 - ▶ Additional 3% surtax on adjusted gross income over \$25 million
 - ▶ Appears that the surtaxes apply to capital gains that increase the total income over the thresholds
 - ▶ No mention of exception for one-time gains causing individual to go over thresholds (such as sale of business)

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Individuals

- Qualified small business stock gain exclusion
 - ▶ Section 1202(a) would be amended to remove the 75% and 100% exclusion for gain on small business stocks to individuals with AGI over \$400,000
 - ▶ Cliff disallowance
 - ▶ 50% exclusion remains intact for those with AGI over \$400,000
- Qualified Small Business (QBI) Deduction
 - ▶ Remains intact

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Individuals

- SALT Limitation
 - ▶ Increase the limitation from \$10,000 to \$80,000 from 2021 through 2030 then reverting to \$10,000 in 2031
 - ▶ Currently, cap set to expire in 2025 if not amended
 - ▶ This is one of the Senate democrats' noted items of disagreement – argue that it provides tax break to the rich

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Polling Question

- Which American singer was born on 12/12/1915?
 - ▶ Tony Bennett
 - ▶ Frank Sinatra
 - ▶ Bob Hope
 - ▶ Aretha Franklin

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Accounting for

Corporate Rate Increase

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Accounting for Increased Tax Rate

- Rate increase would provide a one-time benefit in the month of enactment if in a net deferred tax asset position (most community banks)
 - ▶ Dr. – Deferred Tax Asset (DTA)
 - Cr. - Income

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Accounting for Increased Tax Rate

- This re-measurement is recorded through income tax expense, even for DTAs and DTLs recorded through Other Comprehensive Income (“OCI”)
 - ▶ Will create another occurrence of the so-called “stranded deferred tax effect” in OCI
 - ▶ Will FASB again offer a balance sheet reclassification between retained earnings and OCI to rectify this stranded deferred tax effect? (see Accounting Standards Update “ASU” No. 2018-02)

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OCI Accounting – Example

- Day 1 (before rate increase)

Account	Dr.	Cr.
Unrealized Gain on AFS Securities	1,000,000	
DTL at 21%		\$210,000
AOCI		\$790,000

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OCI Accounting – Example

- Day 2 (rate increase to 28%)

▶ Journal Entry:

- Dr. Income Tax Expense (not OCI) \$70,000
 - Cr. Deferred Tax Liability \$70,000

Account	Dr.	Cr.
Unrealized Gain on AFS Securities	1,000,000	
Stranded Deferred	70,000	
DTL at 28%		\$280,000
AOCI		\$790,000

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OCI Accounting – Example

- ASU 2018-02 provided a one-time fix for the impact of Tax Cuts and Jobs Act
 - ▶ Reclassify the stranded effect to retained earnings
 - ▶ Disclose in financials
- Hopefully, something similar will come if rates change

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Tax Planning

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Tax Planning

- If rate increase is expected, then “reverse” tax planning
 - ▶ Accelerate income and defer deductions
 - ▶ Goal to pay tax at the lower rate before increases
 - ▶ Increase the net DTA that will be re-measured for the rate increase
- Accounting method changes, elections, and fact changes
 - ▶ Some can be determined as late as the filing of the return
 - ▶ If using recurring item exception, do not pay liability before filing return

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Tax Planning

- Income Acceleration
 - ▶ Sale of appreciated securities
 - Do you have securities in your AFS portfolio that you want to reset basis?
 - ▶ FHLB redemption
 - Many banks have lower tax basis in FHLB stock
 - ▶ Capitalize loan origination costs
 - Defer the deduction over the life of the loan

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Tax Planning

- Defer Deduction
 - ▶ Depreciation
 - No bonus, Section 179, or accelerated methods
 - ▶ Opt out of partial charge-off of loans
 - ▶ Modify bonus plan to fix liability after year-end or extend payment beyond 2 ½ months
 - ▶ Opt out of the prepaid expense deduction
 - ▶ Pension plan contributions

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Polling Question

- When is St. Nicholas Day?
 - ▶ Dec. 2
 - ▶ Dec. 6
 - ▶ Dec. 12
 - ▶ Dec. 25

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State and Local Tax (SALT) Workaround

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SALT Workaround

- Background
 - ▶ TCJA applied a cap on state and local taxes (SALT) as an itemized deduction on Schedule A of individual returns
 - This caused most S-corporation shareholders to be limited on their SALT deduction
 - ▶ In response to the unfavorable tax law change, some states (including Alabama, Georgia, Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island, and Wisconsin) passed special legislation that allowed businesses to pay taxes at the entity level, effectively giving rise to a full SALT deduction
 - About 20 states have current legislation and others are considering

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SALT Workaround

- The details differ from state to state
 - ▶ Some states treat the pass-through income as “previously taxed income,” excluded from state taxable income
 - ▶ Some include the pass-through income in state taxable income but pass through a state credit for the tax paid by the entity
 - Consider whether nonresident shareholders get credit in resident state for tax deemed paid to another state by pass-through entity
 - ▶ Election requirements also vary among the states
 - Entity election
 - Shareholder or partner election
 - Some require elections by both the entity and the owner

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SALT Workaround

- Items to consider
 - ▶ Determine if the state(s) they file in have a statute that complies with the requirements of the notice and what steps are necessary to make the election
 - ▶ Understand the impact on shareholder tax distributions
 - Does the S corporation have any tax-exempt shareholders such as an ESOP
 - How are tax exempt shareholders treated under the state statute
 - How will they be equalized by the entity
 - ▶ Ensure tax sharing agreements that reflect payments between related parties are handled correctly if election is made

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Paycheck Protection Loans

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PPP Loan Fees

- PPP loan fees
 - ▶ The SBA paid a “processing fee” to the originating bank based on a percentage of the initial loan principal
 - ▶ GAAP Accounting
 - Made adjustment to the interest yield and deferred and accreted into income over the life of the loan
 - Deemed immaterial, recognized into income when received
 - Recognized as a gain if the loan was sold

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PPP Loan Fees

- PPP loan fees
 - ▶ Income tax accounting
 - IRS has not issued guidance on this topic
 - Are these truly loan fees and an adjustment to interest yield on the loan, or
 - Are they a reimbursement for services rendered to the SBA by the bank?
 - ▶ The consensus among some leading bank tax practitioners is that
 - There is reasonable support for both tax accounting methods
 - The processing fees were a “new” item of income for which the bank could choose its accounting method in the 2020 return

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PPP Loan Fees

- Loan fees as an adjustment to yield
 - ▶ Many banks have been recognizing loan fees in book income when received because they deemed the fees to be “immaterial”
 - Those banks have generally followed book recognition for income for tax purposes (establishing a method of tax accounting for loan fees)
 - To defer the SBA loan fees, a bank would need to file Form 3115 to change accounting methods (automatic change under Rev. Proc 2019-43 Section 30.01)
 - ▶ Loan origination fees that have been deferred and accreted into income are treated as original issue discount (OID) for tax purposes and recognized as ordinary income over the life of the loan as an adjustment to yield

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PPP Loan Fees

- Services rendered by the bank
 - ▶ The statute and SBA guidance uniformly refers to the fees as “fees for processing PPP loans”
 - ▶ SBA PPP regulations state that the fee is to compensate the bank for processing the loan
 - ▶ The Bank retains the fee if it sells the loan, suggesting the fee is for services already provided
 - ▶ The fee is unaffected by loan forgiveness
 - ▶ Bank incurred significant expenses learning how to originate the loan; those costs will be deducted in the year the loan was originated, so income should be recognized to match the expense
 - ▶ Income is recognized when fee is received

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Polling Question

- When was the first New Year’s Eve celebration in Times Square?
 - ▶ 1904
 - ▶ 1914
 - ▶ 1924
 - ▶ 1934

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Employee Retention Credit

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Employee Retention Credit

- Refundable credit introduced under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)
- 2020
 - ▶ Eligible employers can claim a tax credit equal to 50% of qualifying wages paid between March 13, 2020, and December 31, 2020 (\$10,000 annual cap)
 - ▶ Maximum credit for entire year is \$5,000 per employee (50% of \$10,000)

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Employee Retention Credit

- 2021
 - ▶ Eligible employers can claim a tax credit equal to 70% of qualifying wages paid between January 1, 2021, and September 30, 2021 (\$10,000 quarterly cap)
 - ▶ The September 30 stop date was introduced in proposed Build Back Better
 - ▶ Maximum credit for entire year is \$21,000 per employee (70% of \$10,000 x 3 quarters)

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Employee Retention Credit

- 2020 Qualifying Wages:
 - ▶ Qualifying wages are determined in one of two ways based on the average number of employees in 2019
 - Employers with fewer than 100 employees – the credit is based on wages paid to all employees regardless if they worked or not
 - Employers with more than 100 employees – the credit is allowed only for wages paid to employees who did not work during the calendar quarter

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Employee Retention Credit

- 2021 Qualifying Wages:
 - ▶ Qualifying wages are determined in one of two ways based on the average number of employees in 2019
 - Employers with fewer than 500 employees – the credit is based on wages paid to all employees regardless if they worked or not
 - Employers with more than 500 employees – the credit is allowed only for wages paid to employees who did not work during the calendar quarter

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Employee Retention Credit

- Eligibility:
 - ▶ Available to employers who meet one of the following criteria:
 - The employer's business is fully or partially suspended by government order due to COVID-19 during the calendar quarter
 - 2020 – The employer's gross receipts are below 50% of the comparable quarter in 2019
 - 2021 – The employer's gross receipts are below 80% of the comparable quarter in 2019
 - Recovery Start-up Business is eligible
 - First began conducting business after February 15, 2020, and
 - Had less than \$1 million annualized gross receipts for its first year
 - De novo banks from 2020 and 2021 are likely eligible

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Employee Retention Credit

- Bank qualification under business suspension orders may be difficult due to the “essential business” designation often applied to banking
- Are Banks Eligible?
 - ▶ Employer’s business is fully or partially suspended by government order due to COVID-19
 - Generally, banks were considered an “essential business” and allowed to stay open
 - Many banks partially suspended some operations, including closing lobbies. In most cases, doing so was voluntary and not due to a government order
 - General operations did not change (accepted deposits, made loans, etc.)

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Employee Retention Credit

- Treasury guidance suggests that:
 - ▶ Closing retail locations and/or limiting retail space (such as operating a drive-through window only) qualifies if done in direct compliance with a governmental order
 - ▶ Such actions do not qualify if taken voluntarily by an “essential business” that is allowed to remain open under the order
 - ▶ A business that is able to continue its operations remotely and is therefore not significantly impacted by the order does not qualify
 - ▶ A business with multiple locations and/or multiple affiliates qualifies even if only a single location/affiliate qualifies

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Employee Retention Credit

- “Significant Decline in Gross Receipts”
 - ▶ 2020 – Gross receipts during a calendar quarter in 2020 are less than 50% of gross receipts in the same quarter of 2019
 - ▶ 2021 – Gross receipts during either
 - The current quarter of 2021 are less than 80% of the gross receipts during the same quarter of 2019, or
 - Gross receipts during the immediately preceding quarter are less than 80% of the equivalent quarter in 2019

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Employee Retention Credit

- If the bank qualifies under the gross receipts test, it is more likely to be during 2021 than 2020
- In summary, only a small number of banks are likely to qualify
- The credit could be material, so banks should at least consider the possibility of qualifying for the credit
- The credit is claimed on the federal payroll tax return (IRS Form 941) and is not an income tax

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Polling Question

- Which Christmas movie premiered on TV on 12/9/1965?
 - ▶ Miracle on 34th Street
 - ▶ It's a Wonderful Life
 - ▶ Christmas Carol
 - ▶ Charlie Brown Christmas

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Bank-Owned Life Insurance – M&A

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Bank-Owned Life Insurance – M&A

- General Rule – proceeds received by reason of death are tax free
 - ▶ However, if BOLI policy is transferred for value (i.e., the purchase of an existing policy), the death benefit is no longer tax free, unless exception applies
- Prior to TCJA, transfers in most taxable stock purchase transactions and tax-free reorganizations did not encounter the transfer for value rule
 - ▶ The acquirer's income tax basis in the seller's BOLI policy carried over

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Bank-Owned Life Insurance – M&A

- TCJA introduced a new concept of “reportable policy sale”
 - ▶ A “reportable policy sale” is the acquisition, whether direct or indirect, of an interest in a life insurance contract where the acquirer has no substantial family, business, or financial relationship with the insured
 - ▶ Even if basis carries over, the “reportable policy sale” activates the transfer for value rule
- This caused a lot of uncertainty and controversy as to whether the BOLI proceeds would remain tax-free through acquisition

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Bank-Owned Life Insurance – M&A

- Treasury published final regulations in October of 2019 to clarify
- C Corporation Carve-Out Exception
 - ▶ The final regulations preserve the tax-free treatment of BOLI policies acquired from another C Corporation if two criteria are satisfied:
 - First, the transfer results in the acquisition of a beneficial ownership interest in the C Corporation stock.
 - Second, at the time of acquisition, not more than 50% of the fair market value of the acquired C Corporation's assets is composed of BOLI.

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Bank-Owned Life Insurance – M&A

- ▶ The C Corporation carve-out will exempt most bank acquisitions from being a “reportable policy sale”
- ▶ The transaction will still need to result in carryover basis as before the TCJA
 - The Carve-Out does not apply to transactions taxed as asset sales

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Bank-Owned Life Insurance – M&A

- S corporations not protected by C Corporation Carve-Out Exception
- S corporations should look to definition of “substantial family, business, or financial relationship with the insured”
 - ▶ Final regulations also clarify this
 - Includes a policy on the life of an individual who was an officer, director, or highly compensated employee of the target immediately preceding the acquisition, and
 - If immediately after the acquisition, the acquirer has an ongoing financial obligation to the insured individual related to his or her employment with the target (e.g., retirement obligations)
 - ▶ Most BOLI policies acquired in context of banking mergers or acquisitions should qualify for the exceptions

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Bank-Owned Life Insurance – M&A

- Transfer for Value “Traps”
 - ▶ Deemed asset sales
 - ▶ Sections 338 and 336(e) elections to treat the sale as a sale of assets
 - ▶ Purchase and assumption of assets
- Consult with tax advisor

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Polling Question

- What day is Boxing Day?
 - ▶ Dec. 2
 - ▶ Dec. 6
 - ▶ Dec. 12
 - ▶ Dec. 26

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Questions?

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