INCOME TAX DEVELOPMENTS AND PLANNING STRATEGIES

November 2023

2023 Crowe Financial Services Conference

Guide your organization through industry volatility

As of Nov. 3, 2023

AGENDA

1 Tax Planning in a Rising Interest Rate Environment

2 1% Federal Excise Tax on Stock Repurchases

3 IRS Audit Exposure Areas

4 Miscellaneous Developments

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TAX PLANNING IN A RISING INTEREST RATE ENVIRONMENT

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TAX PLANNING STRATEGIES IMPACTED BY RISING INTEREST RATES

- Strategies directly impacted by rising interest rates / interest expense

  Examples:
  - Minimizing the bank TEFRA interest expense disallowance
  - Minimizing the impact of IRC Section 163(j)
- Strategies that defer the payment of income taxes by accelerating deductions and deferring taxable income recognition

  Examples:
  - Accelerated fixed asset tax depreciation
  - Market discount accretion deferral

TEFRA INTEREST EXPENSE DISALLOWANCE

- IRC Sections 265(b) and 291(e) require a formula-driven allocation of interest expense to a bank's investment in tax-exempt municipal bonds / loans (i.e., "munis")

Interest Expense / Average Total Assets x Average Munis

- This formula is often referred to as the "TEFRA penalty" and applies only to a bank, <u>even if</u> the bank is a member of a consolidated group of corporations

TEFRA INTEREST EXPENSE DISALLOWANCE

- Interest expense allocation is permanently nondeductible and impacts the effective tax rate ("ETR")
  - However, only 20% of allocated interest is disallowed for "bank-qualified" munis
- Many banks are seeing a significant increase in the TEFRA penalty due to the sharp rise in interest rates / interest expense

"Bank-qualified" munis are issued by small issuer municipalities that generally issue no more than $10 million in municipal debt annually

TEFRA INTEREST EXPENSE DISALLOWANCE

- Separating the munis from the Bank will likely remove them from the TEFRA formula
  - There is judicial support for this position – *PSB Holdings, Inc. v. Commissioner*, 129 T.C. No. 15 (Nov. 1, 2007)
- However, care must be taken to ensure there is no debt within the subsidiary that could be directly allocated to the munis
- The PSB case did not address the direct transfer of munis to the subsidiary, but the rationale behind the decision likely extends to those assets

There would be no need for the subsidiary to limit its municipal investments only to "bank-qualified" munis; could also invest in non-bank-qualified munis

TEFRA INTEREST EXPENSE DISALLOWANCE

However, there are some potential **risks:**

- Once the munis are separated from the bank, they no longer receive the protection of IRC Section 582(c); so, losses incurred on these munis may be capital losses and not ordinary losses
- Proper tax planning requires the subsidiary to be a legitimate, functioning corporation, with a proper corporate structure, books and records, etc.
- Having a business purpose other than federal income tax savings (alone) is strongly recommended
    - E.g., state tax savings, streamlining the municipal lending operation, enabling the subsidiary to offer competitive pricing (rate) on municipal loans

MINIMIZING THE IMPACT OF IRC SECTION 163(J)

- IRC Section 163(j) imposes an annual limitation on the deductibility of “net business interest expense” equal to 30% of adjusted taxable income (excess is generally carried over indefinitely)
- Net business interest expense is determined on a consolidated basis as the excess, if any, of interest expense > interest income
  - So, application to a bank group would be very rare
- Planning strategies aim to capitalize the otherwise limited interest expense to the balance sheet (i.e., fixed assets / inventory) in order to enable deduction via the asset

STRATEGIES THAT DEFER THE PAYMENT OF INCOME TAXES

- These strategies reduce the current tax liability in favor of pushing that liability into a future tax year
  - Accomplished by accelerating deductions / deferring taxable income
  - However, for perpetually recurring deductions / deferrals, the effect of the planning may be a permanent “interest-free loan” from the government (e.g., perpetual application of the accelerated deduction for short-term prepaid expenses)
- Does not result in a permanent tax savings, so no reduction to income tax expense (i.e., no reduction to the ETR)
  - However, the value of the cash flow benefit increases with rising interest rates

STRATEGIES THAT DEFER THE PAYMENT OF INCOME TAXES

- Tax savings is recorded as a deferred tax liability or a reduction to a net deferred tax asset
  - This may provide some banks with a regulatory capital benefit:

    DR. Income Tax Payable $$$
    CR. Deferred Income Taxes $$$

- Planning often involves low-risk / zero-risk strategies aimed at maximizing the use of available tax elections and accounting methods

STRATEGIES THAT DEFER THE PAYMENT OF INCOME TAXES

Examples:

- Defer market discount accretion on qualifying securities purchased at a discount
- Consider adopting the bank "conformity election" for bad debts, as it minimizes the recognition of taxable interest on non-performing loans (see Rev. Rul. 2007-32)
- Ensure current deduction for qualifying loan origination costs is being claimed
- Elect bonus depreciation on qualifying fixed assets
- Engage specialist to conduct a "cost segregation analysis" on current / recent construction projects to ensure maximum acceleration of depreciation deductions
- Claim current deduction for qualifying short-term prepaid expenses
- Modify cash incentive plan to claim employee bonus deductions in year of accrual (but be mindful of IRC section 162(m) impact of such a change)

STRATEGIES THAT DEFER THE PAYMENT OF INCOME TAXES

- Question – aren’t these the same strategies we were considering in reverse when a corporate tax rate increase was anticipated?
  - ANSWER – Yes!
  - A corporate rate increase is now unlikely, so these strategies are back “on”

1% FEDERAL EXCISE TAX ON STOCK REPURCHASES

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1% EXCISE TAX ON STOCK REPURCHASES

- Applies to all corporations whose stock is traded on an established securities market
  - Listed exchanges, OTC, “pink sheets,” etc.
- Applies on a consolidated basis to repurchases made by >50% affiliated corporations and partnerships
- Applies if the total amount paid for stock repurchases during the year is >$1 million
  - This is a threshold amount, not an exemption
  - Applied to gross repurchases before exclusions
- Effective for repurchases of stock occurring after Dec. 31, 2022

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1% EXCISE TAX ON STOCK REPURCHASES

- Calculation of taxable amount:
  - Gross repurchases for the corporation's taxable year (same as the tax year for income tax purposes)
  - LESS – the value of shares issued that year
  - LESS – the value of shares issued or provided to employees (including stock-based compensation)
    - Value at date of transfer / vesting / exercise
    - If shares are withheld for any purpose (e.g., income tax withholding), use net shares provided
  - LESS – the value of shares contributed to an employer-sponsored retirement plan
    - Value is determined using average cost of shares repurchased during the taxable year
    - Can elect to treat shares contributed before the tax return filing date as contributed in the current year

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1% EXCISE TAX ON STOCK REPURCHASES

- Treasury regulations are pending, but the IRS released interim guidance – IRS Notice 2023-2 / IRS Announcement 2023-18
  - Tax to be reported on an annual IRS Form 720 (federal excise tax return) due at the end of the month following the first quarter after the close of the taxable year – i.e., so 4/30/2024 for a 2023 calendar year taxpayer
    - **IRS Announcement 2023-18 postpones reporting / payment until regulations are issued**
  - For fiscal year filers, only shares purchased after 12/31/2022 are included, but reductions are determined based upon full fiscal year ending after 12/31/2022
  - Cash used in mergers will trigger the 1% tax for the target:

    Example – Bank A acquires Bank B in a standard merger transaction in which Bank B merges with and into Bank A. Consideration paid to Bank B shareholders is $70 million worth of Bank A stock and $30 million cash (not including cash paid in lieu of fractional shares)
    - The $30 million cash paid to Bank B shareholders is subject to the 1% tax

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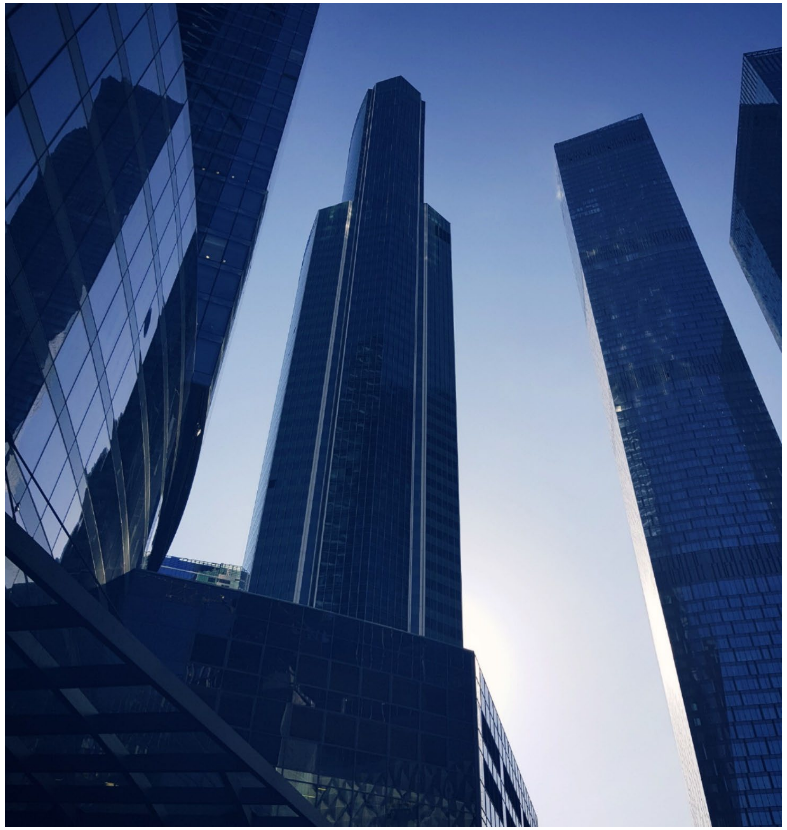
1% EXCISE TAX ON STOCK REPURCHASES

- The excise tax is not deductible for federal income tax purposes
- The tax is likely to be recorded for book purposes through equity



IRS AUDIT EXPOSURE AREAS

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THE IRS RECEIVED $80 BILLION OF NEW FUNDING

- The *Inflation Reduction Act* provided $80 billion of new funding to the IRS
  - Although Congress recently reduced this amount
- The funding is intended to modernize the IRS, while expanding enforcement efforts
  - $45.6 billion of the original funding was earmarked for expanded enforcement
- The Congressional Budget Office (CBO) estimated the expanded funding would raise over $200 billion of additional tax revenue, presumably through taxpayer audits
- Banks may see increased audit activity as a result

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THE IRS WILL LIKELY AUDIT EMPLOYEE RETENTION CREDIT CLAIMS

- The Employee Retention Credit (“ERC”) is a COVID-era payroll tax credit enacted in 2020 under the CARES Act
- The ERC may provide generous tax benefits to certain qualifying taxpayers in the form of refundable payroll tax credits
- However, as a result of aggressive marketing of the tax credit and liberal application of the qualification requirements by some taxpayers / promoters, the IRS has recently issued strongly worded warnings to taxpayers filing “aggressive” claims for the credit
    - e.g., see IRS News Release IR-2023-49

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THE IRS WILL LIKELY AUDIT EMPLOYEE RETENTION CREDIT CLAIMS

- The case for eligibility is strong for taxpayers that meet the gross receipts reduction threshold tests
  - 2020 – qualification in any quarter if the gross receipts for that quarter are less than 50% of the gross receipts for the corresponding quarter in 2019
  - 2021 – qualification in any of the first three quarters if the gross receipts for that quarter are less than 80% of the gross receipts for the corresponding quarter in 2019 (but can elect to compare the receipts for the prior 2021 quarter to the corresponding 2019 quarter)
- Taxpayers that can point to a COVID-related government lockdown order directly ordering the involuntary closure of one or more locations may also have a strong case for eligibility

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THE IRS WILL LIKELY AUDIT EMPLOYEE RETENTION CREDIT CLAIMS

- Taxpayers that cannot point to a compulsory closure of one or more locations may qualify for the credit, but the qualification may be more subjective
  - Banks were often designated as an "essential business" during COVID lockdowns and allowed to remain open

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THE IRS WILL LIKELY AUDIT EMPLOYEE RETENTION CREDIT CLAIMS

- Recent pronouncements clearly suggest the IRS believes many overly aggressive ERC claims were filed by taxpayers

- The IRS has warned that, in addition to repayment of taxes and interest, penalties may be assessed for overly aggressive ERC claims

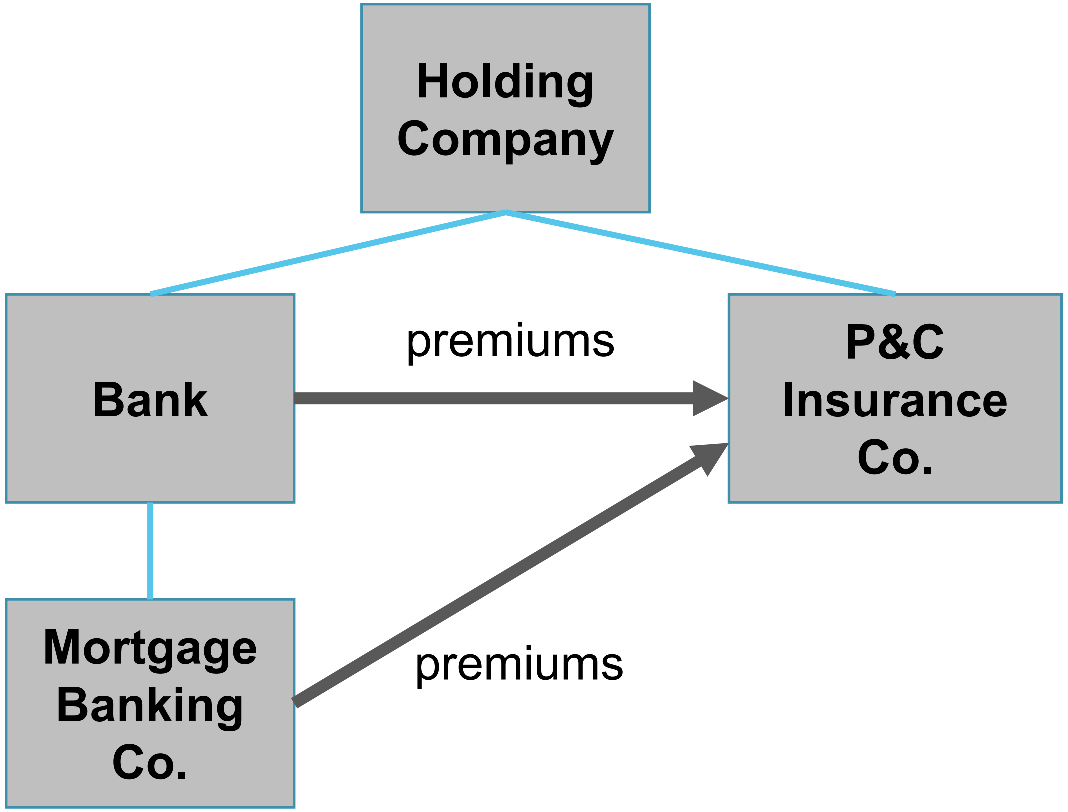
THE IRS WILL LIKELY AUDIT EMPLOYEE RETENTION CREDIT CLAIMS

- Receiving the refund does not necessarily mean the IRS has accepted the ERC claim
  - The IRS pays first, audits later
- Financial statement reserves may be needed if the ERC claim was determined to be aggressive and is material
- The statute of limitations for the IRS to audit Q3 2021 ERC claims has been extended to 5 years (as opposed to the typical 3-year statute)

PROPOSED REGULATIONS ON "MICRO" CAPTIVE INSURANCE ARRANGEMENTS

- Micro captive insurance structures have been used by many smaller banks to add formal structure to the bank's property and casualty (P&C) insurance coverage
- The structure involves maintaining a P&C insurance company within the bank group, which underwrites insurance coverage to the other affiliates
- The structure often involves a generous tax benefit by way of the P&C insurance company qualifying for, and making, the election to be taxed as a "small" insurance company
  - Taxed only on investment income; premiums and claims are excluded

PROPOSED REGULATIONS ON "MICRO" CAPTIVE INSURANCE ARRANGEMENTS



Taxed only on investment income; premium revenue is exempt

PROPOSED REGULATIONS ON "MICRO" CAPTIVE INSURANCE ARRANGEMENTS

- The IRS has a long history of challenging these structures under audit and, in some cases, in the courts – e.g., see IRS Notice 2016-66
- The IRS challenge often centers on whether the IRS agrees the P&C insurance company is a legitimate insurance company
- One of the current areas of focus is the "loss experience ratio" of the P&C claims compared to premium revenues
    - An electing small P&C captive insurance company with very low loss experience (i.e., claims) vs. premium revenue will maximize the tax benefit of the small insurance company election

PROPOSED REGULATIONS ON "MICRO" CAPTIVE INSURANCE ARRANGEMENTS

- Treasury recently issued proposed regulations that, if adopted in their current form, may negatively impact many of these micro captive insurance arrangements – see REG-109309-22, 4/11/2023
- As proposed, Treasury would automatically designate any small captive insurance company with an annual claim loss / premium ratio of <65% as:
  - Retaining its current status as a "transaction of interest", if the period during which this cumulative 65% loss ratio has not been met is less than 10 tax years (including those micro captive structures that are not yet 10 years old)
    - Not yet known what this means in terms of a formal IRS challenge – if any
  - A "listed transaction" if this cumulative 65% loss ratio has not been met for a period of 10 tax years (including short tax years)
    - Required disclosures / a formal challenge likely and / or a potential settlement initiative

PROPOSED REGULATIONS ON "MICRO" CAPTIVE INSURANCE ARRANGEMENTS

- The proposed regulations are not yet effective and are pending consideration of taxpayer input received during the public comment period
- Therefore, it may be premature for affected taxpayers to record any financial statement reserves, as the potential impact of the final regulations are not yet known
  - The regulations are expected to be finalized in Q4
- For taxpayers whose P&C insurance company is a member of an insurance "pool," the termination of the pool may eliminate the ability of the captive to operate going forward

RESEARCH AND DEVELOPMENT TAX CREDITS

- Many banks continue to qualify for the research and development (R&D) tax credit
- For most banks, the credit arises from their development of internal technology and customized software applications
- To qualify for the credit, these activities must involve technical uncertainty, a systematic process of evaluating alternative solutions and economic risk – <u>all of which are somewhat subjective</u>
- Not surprisingly, IRS audit exposure for R&D tax credits is a very common ASC 740 (FKA FIN 48) unrecognized tax benefit

MISCELLANEOUS DEVELOPMENTS

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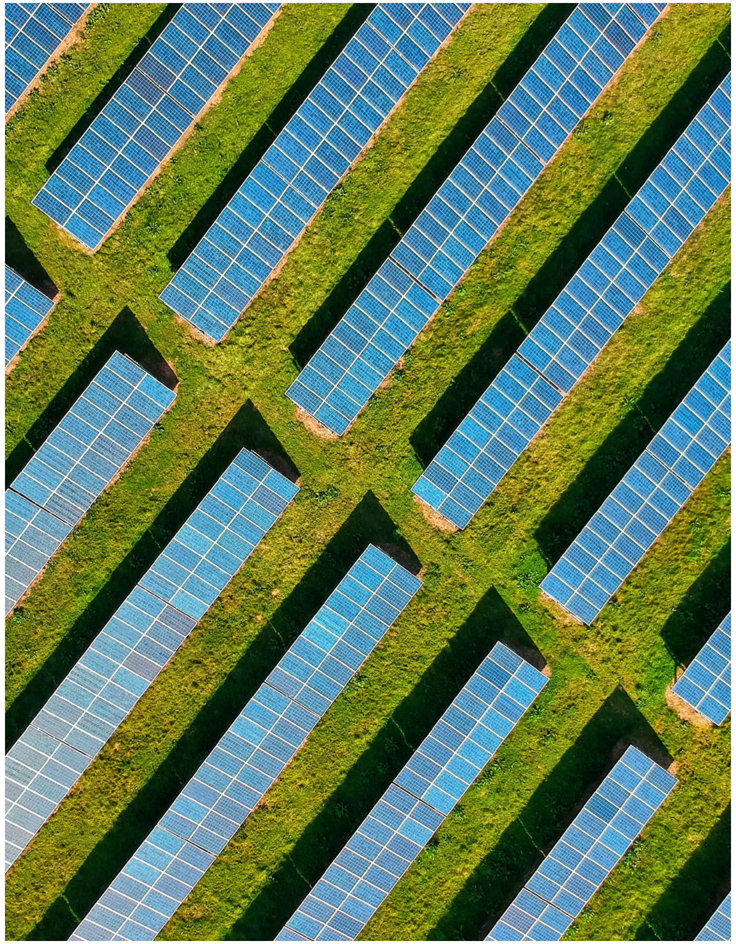
FEDERAL TAX CREDIT DEVELOPMENTS

- For most energy tax credit ventures on which construction begins on or after 1/29/2023, the tax credit percentage on qualifying costs remains at 30%, but only if the project meets:
  1) A newly imposed prevailing wage requirement
  2) A newly imposed apprenticeship requirement
- A bonus credit percentage of up to 10% may apply to projects located in certain economically or environmentally distressed areas



FEDERAL TAX CREDIT DEVELOPMENTS

- Energy credits can now be purchased on the secondary market
  - Must be purchased for cash
  - Only available in the year the credit originates
    - Cannot sell tax credit carryforwards
  - Buyer would purchase at a market-driven discount
    - No taxable gain or loss is recognized by either party
    - Books would reflect seller's "loss" and buyer's "gain" through income tax expense
  - Buyer is responsible for recapture events
    - So, indemnification agreements will be needed
- Proportional amortization accounting is now available for all types of qualifying tax credit equity investments in flow-through entities
  - ASU 2023-02 to be discussed later today

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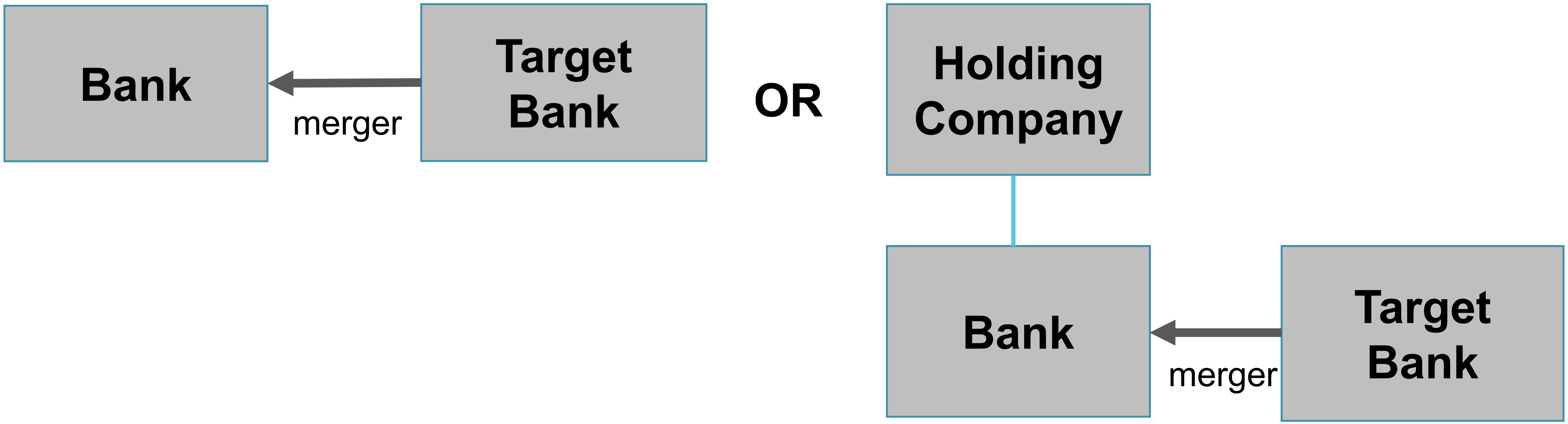
FAVORABLE DEVELOPMENTS ON BOLI "REPORTABLE POLICY SALES"

- The *Tax Cuts and Jobs Act* introduced a new "reportable policy sale" rule that applies to certain indirect acquisitions of corporate-owned life insurance policies (including BOLI)
- If triggered, this rule would cause the loss of the tax-exempt status of the policies going forward from the transfer date
- Treasury regulations issued in 2019 confirmed that direct merger transactions would cause the rule to apply, even if the transaction was otherwise a tax-free reorganization

FAVORABLE DEVELOPMENTS ON BOLI “REPORTABLE POLICY SALES”

These merger structures were a concern under the 2019 Treasury regulations



FAVORABLE DEVELOPMENTS ON BOLI "REPORTABLE POLICY SALES"

- On 5/10/2023, Treasury issued proposed regulations that retroactively reverse this position for certain qualifying transactions
  - See REG-108054-21, May 10, 2023
- The proposed regulations hold that a reportable policy sale is not triggered if:
  - The transaction is a tax-free reorganization
  - Target is a C corporation conducting an active trade or business and life insurance contracts comprise no more than 5% of the gross value of its assets
- Also exempts most IRC Section 1035 exchanges
- Regulations can be applied retroactively

RECENT LAW CHANGES TO WATCH FOR

- The *Tax Cuts and Jobs Act* contains a requirement to capitalize internal research and development (R&D) costs effective for tax years beginning after 12/31/2021
  - Includes R&D costs under IRC Section 174 that qualify for the R&D tax credit, but the capitalization requirement is broader
  - Also includes all internal software development costs
  - Amortization period is 5 years (15 years if the R&D is conducted outside the U.S.)
  - Guidance provided in IRS Notice 2023-63; formal Treasury regulations expected soon
  - There is bipartisan support for repealing this provision, but no action so far
- The 50% deduction limitation for business meals returns in 2023
  - COVID-era legislation provided for a 100% deduction for business meal expenses incurred in calendar years 2021 and 2022 for meals provided by a restaurant

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QUESTIONS?

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