FOCUS ON BUSINESS VALUE
2022 Crowe Financial Services Conference

Income Tax Developments and Planning Strategies

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Presented by:

Crowe Industry Specialists

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Recently Enacted Tax Legislation and Legislative Outlook

Inflation Reduction Act

Signed into Law August 16, 2022

Tax provisions included:

- 15% corporate Alternative Minimum Tax
- 1% excise tax on stock repurchases
- $80 billion in new funding for the IRS
- Expansion / extension of energy tax credits
- Extension of existing loss limitations for non-corporate taxpayers

Summary of estimated revenue/ (spending) impact over 10-years

• 15% corporate AMT	$ 183 billion
• 1% stock repurchase tax	$ 55 billion
• $80 billion IRS funding (net)	$ 152 billion
• Extend Individual tax loss limitations & misc. tax items	$ 68 billion
• Prescription drug pricing	$ 329 billion
• Expand energy credits	$ (332) billion
• Other energy / climate items	$ (116) billion
• ACA premium subsidies	$ (70) billion
• Other health care provisions	$ (34) billion
• Deficit reduction (non-dynamic)	$ (235) billion

Source: The Tax Foundation revenue scoring 8/12/2022

15% Corporate Alternative Minimum Tax (“AMT”)

- Applies if the prior three-year average adjusted pre-tax book income reported in the applicable financial statements is >$1 billion
  - Applied on a controlled group consolidated basis
  - Applies to U.S. corporations with a foreign parent if the three-year average is >$100 million AND the consolidated international enterprise meets the >$1 billion test
- The pre-tax book income used to determine the three-year average is adjusted to follow the statutory tax treatment of:
  - Fixed asset depreciation
  - Defined benefit pension plan deductions, and
  - Mortgage servicing

15% Corporate Alternative Minimum Tax ("AMT")

- The current year AMT is determined by applying the 15% rate to pre-tax book income adjusted as follows:
  - Follow tax treatment of fixed asset depreciation
  - Follow tax treatment of defined benefit plans
  - Follow tax treatment of mortgage servicing
  - Deduct certain financial statement net operating loss ("NOL") carryforwards (80% limitation)
- The current year AMT is reduced by:
  - AMT foreign tax credit
  - General business credits (e.g., low-income housing tax credits, energy credits, historic rehabilitation credits, new markets tax credits, etc.) – up to 75%

15% Corporate Alternative Minimum Tax (“AMT”)

- The tax works in similar fashion to the pre-2018 corporate AMT
  - Liability, if any, is equal to AMT > regular tax
  - AMT credit carryforward is available in future years to the extent that regular tax > AMT
- Will impact large corporations with certain tax exemptions and deductions not reflected in current year pre-tax book income
  - E.g., tax-exempt municipal interest, BOLI
  - E.g., stock-based compensation deductions
  - E.g., tax > book NOL carryforward deductions
- Effective for taxable years beginning after December 31, 2022

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
- Effective for repurchases of stock occurring after December 31, 2022

1% Excise Tax on Stock Repurchases

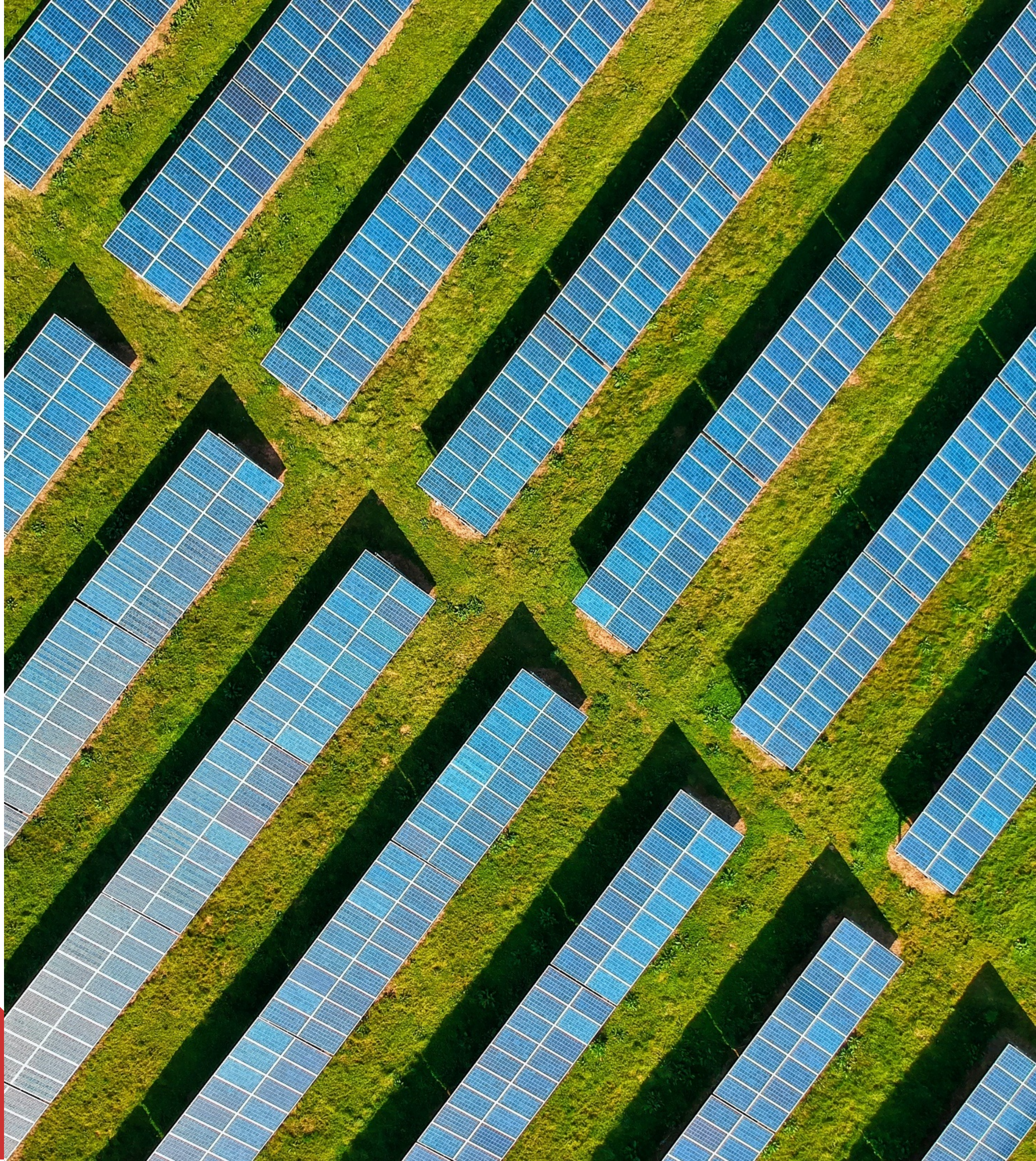
- Taxable repurchases are reduced by the fair market value of:
  - New shares issued during the year
  - Shares issued or provided to employees (including stock option exercises)
  - Share repurchases contributed to certain employer-sponsored retirement plans
  - Shares repurchased in connection with certain tax-free reorganizations
  - Certain repurchases by dealers, RICs and REITs
- Not an income tax and will be nondeductible for income tax purposes
- Likely to be capitalized to treasury stock for GAAP purposes

$80 Billion in New Funding for the IRS

- The funding is intended to modernize the IRS while expanding enforcement efforts
  - $45.6 billion of the additional funding is earmarked for expanded enforcement
  - The IRS may hire up to an estimated 87,000 new employees
- The Congressional Budget Office ("CBO") revenue scoring estimates this funding will raise over $200 billion of additional tax revenue (presumably through audits)
- It is possible the banking industry may see an increased frequency of IRS audits in the coming years under this expansion

Energy Tax Credit Provisions

- Expansion of certain energy tax credits and extension of phase-out provisions
- General impact on solar / wind tax credits
  - Credit percentage is 26% if construction began after 12/31/2019 and the property was placed into service before 1/1/2022
  - Property placed into service after 12/31/2021 qualifies for a 6% base credit plus a 5x multiplier (to 30%) if the project meets certain “prevailing wage” and “apprenticeship” requirements, once those requirements are provided in forthcoming Treasury regulations
  - Projects on which construction begins before 60 days after such regulations are issued, but after 12/31/2021, automatically qualify for the 5x multiplier (30%)



Energy Tax Credit Provisions

- New provision allows for transfers (i.e., sales) of energy tax credits (for cash)
  - Penalty provisions apply to the buyer / transferee if the tax credit claimed exceeds what is ultimately determined to be available with respect to the energy credit property
  - So, such sales will undoubtedly require certifications, due diligence, legal opinions, tax opinions, indemnifications, etc.
- Electric vehicle tax credits of up to $7,500 per qualifying vehicle

What <u>is not</u> Included in the New Tax Law?

- Corporate tax rate increase
- Individual tax rate increase
- Relief from the $10,000 cap on individual deductions of state and local taxes
  - Will continue to see state enactment of PTET statutes
- Modification of the long-term capital gain rate benefit on “carried interest” income
- International tax provisions
- Expanded information reporting for banks
- Extension of existing tax rules to digital currency transactions (i.e., short sale and wash sale rules)
- Relief from 2022 R&D cost capitalization

Will a Corporate Tax Rate Increase be Enacted Anytime Soon?

- Depends on the balance of power in Congress
- Democrats currently lack the votes in the Senate to enact a corporate rate increase because at least one Democratic Senator opposes it, but the margin is very thin
- House Ways and Means Committee Chair Richard Neal (D-MA) recently indicated it is still on the Democratic party agenda
- Very unlikely for the remainder of President Biden's current presidential term if Republicans gain control of at least one chamber of Congress in the 2022 mid-term elections

What Tax Planning Strategies Still Work in a Low Tax Rate Environment?

Permanent savings that drive down the ETR

- Increased investment in tax-exempt municipals
- Increased investment in bank-owned life insurance (“BOLI”)
  - Value of these benefits are diminished by a lower federal tax rate
- Increased investment in tax credit programs
  - Value of this benefit <u>is not</u> impacted by a lower tax rate
- SALT strategies that offer permanent savings
  - Value of this benefit is <u>enhanced</u> by a lower federal tax rate

What Tax Planning Strategies Still Work in a Low Tax Rate Environment?

Tax deferral strategies

- Focuses on the timing of taxable income recognition by accelerating deductions and deferring income
  - No effective tax rate benefit in a constant tax rate environment
- Temporary savings provide a cash flow benefit measured by the time value of money (which increases as interest rates rise)
- Can have a favorable impact on regulatory capital by reducing net deferred tax assets
- Examples: fixed asset depreciation acceleration, loan cost and prepaid expense deduction acceleration

Tax Matters Pertaining to Non-Traditional Financial Institutions and Emerging Market Practices

Fintech Lenders

- Generally, refers to non-bank technology-enabled lenders
- These entities do not require FDIC deposit insurance and can therefore be organized as partnerships (or LLCs taxed as partnerships)
  - Acquisitions of partnerships (or LLCs taxed as partnerships) are often treated as asset purchases for tax purposes, which can provide benefits to the acquiror in the form of deductible premium amortization
- However, certain tax precautions are also needed when acquiring the equity interests of the partnership (tax allocation agreement needed)

Fintech Lenders

- However, these entities also can have several tax disadvantages compared to traditional banks
  - Losses on debt securities held for investment are capital losses and may be limited
  - Does not qualify to maintain the same tax-deductible bad debt reserve that a small bank does
  - Interest expense allocations to tax-exempt municipal holdings may result in a higher deduction disallowance, if directly traced into those investments

Banking as a Service ("BAAS")

- Generally, refers to a traditional bank partnering with a Fintech to offer banking services to the Fintech's customers
  - May result in dramatic expansion of information reporting requirements (forms 1099, 1098, W-8, W-9, etc.) and backup withholding
  - It is very important for the joint services agreement to specifically identify which party is responsible for filing the information returns
- May result in dramatic expansion of the bank's state and local income tax filing requirements
  - "Economic nexus" can be triggered by generating customer revenue in new and expansive locales

Digital Assets and Cryptocurrencies

- Congress and Treasury are moving quickly to enact / implement tax measures to extend existing tax rules to these assets
- Treasury views these assets as a form of intangible property (see IRS Notice 2014-21)
- Consequently, gain or loss is recognized upon their exchange
  - E.g. – Taxpayer purchases a unit of cryptocurrency for $10,000 and later exchanges it for $15,000 worth of goods and services – a taxable gain of $5,000 results (likely a capital gain)
  - E.g., - Taxpayer purchases a unit of cryptocurrency for $10,000 and later exchanges it for $6,000 worth of goods and services – a taxable loss of $4,000 results (likely a capital loss subject to capital loss deduction limitations)

Digital Assets and Cryptocurrencies

- The 2021 Infrastructure Investment and Jobs Act subjects these assets to the same reporting rules applicable to investment securities and cash
  - Extends the definition of "covered securities" subject to 1099-B broker information / basis / transfer reporting to include digital assets acquired on or after 1/1/2023
  - Treats digital currencies as cash for purposes of $10,000 cash transaction reporting effective for reports required to be filed after 12/31/2023
- The Build Back Better Bill contained provisions expanding securities rules such as short sale and wash sale rules to these assets (but the Bill was never enacted)

Digital Assets and Cryptocurrencies

- The 2021 IRS form 1040 individual income tax return contains this question on page 1 of the form (the question first appeared in 2019):
  - “At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?”
- The draft 2022 IRS form 1040 currently includes a more expansive question regarding these activities

Miscellaneous Developments

Capitalization of R&D Expenses

- The Tax Cuts and Jobs Act enacted in 2017 contains a provision requiring research and development expenses to be capitalized and amortized over 5 years for tax purposes
  - The amortization term is 15 years for foreign R&D expenses
- This new provision is first effective for expenditures incurred in tax years beginning after 12/31/2021
- R&D expenses are defined in IRC section 174 but include all software development costs
- There appears to be bipartisan support to delay or repeal this provision, but to date such attempts have failed

Change in IRS Audit Guidance Pertaining to Acquisition “Milestone Payments”

- On 1/26/2022, the IRS withdrew longstanding audit guidance (LB&I-04-0114-001) pertaining to the treatment of “eligible milestone payments”
  - i.e., non-refundable payments triggered upon the occurrence of a milestone event and credited to an overall success-based investment advisory fee
- Prior to the revocation, the IRS audit guidance permitted these payments to fall within the elective 70% safe harbor deduction provisions of Revenue Procedure 2011-29
- The revocation (re)introduces uncertainty over the deductibility of common milestone payments such as fairness opinion fees

IRS Warns Taxpayers About Third Parties Promoting ERC Claims

- The Employee Retention Credit (“ERC”) is a COVID-era payroll tax credit
- Some consulting firms promote sizeable refund claims by taking aggressive stances on this credit
- Claims for the credit by banks that were designated as “essential business” during COVID lockdown orders may be questionable
- IRS issued a statement (IR-2022-183) on 10/19/2022 warning taxpayers to be wary of promoters offering large ERC refunds based upon aggressive positions and charging contingent fees
- Banks should proceed with caution when evaluating the potential exposure to penalties from filing aggressive ERC claims

ESG Disclosures – Can Information in the Tax Footnote Help?

- As the push for ESG (Environmental, Social and Governance) disclosures grows stronger, keep in mind that the tax footnote may provide useful information to support some ESG disclosures
- Environmental:
  - Does the company invest in renewable energy tax credit projects?
- Social:
  - Does the company invest in: low-income housing tax credit projects, historical rehabilitation tax credit projects, new markets tax credit projects, and / or local municipal funding?

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Thank you