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Crowe Financial Services Tax Insights™ offers up-to-date information on tax issues affecting financial institutions. In each issue of this electronic publication from Crowe Horwath LLP, you will find articles written by tax specialists who have in-depth knowledge of financial institutions.

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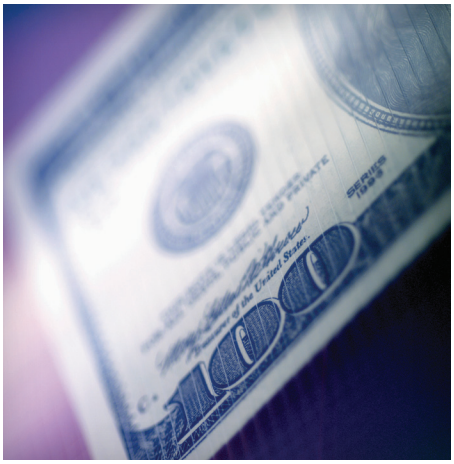
Death Benefit Only Plans: Taxation, Withholding, and Reporting Issues

By Tyler P. Johnson and Thomas J. Tyler, CPA

Financial institutions looking for a way to attract and retain top talent or to enhance employee benefits for important employees should consider establishing a death benefit only (DBO) plan. DBO plans – a type of nonqualified deferred compensation plan – are easy to implement and administer and will provide benefits to the beneficiaries of the covered employee if the employee was employed by the financial institution at the time of his or her death.



DBO Plans in a Nutshell

A DBO plan provides specified death benefits to one or more beneficiaries of a deceased employee, provided the employee was employed or retired from the sponsoring financial institution at the time of his or her death. Payments to beneficiaries can be made as a one-time lump sum or as periodic payments over a number of years. Typically the payment is calculated as a multiple or a percentage of the employee's annual salary.

Life insurance commonly is used to finance the payment of benefits, but is not required. The sponsoring employer purchases one or more life insurance policies on plan participants so that the death benefits can match the expected survivor benefits to be paid or be sufficient to cover both the survivor benefits and recover the employer-paid insurance premiums.

An employer's DBO plan should be in writing and clearly define who is entitled to benefits (surviving spouse or children), eligibility standards (for example, the decedent must have been an employee at the time of death), the timing of plan payments, and the amount of payments and how they are calculated (such as via final salary, average salary, and/or using a multiple for years of service).

Advantages of DBO Plans

Employers are attracted to DBO plans because they offer several advantages over other deferred compensation plans. DBO plans are easy to implement and administer, and no advance approval is required from the IRS or the Department of Labor. Because DBO plans aren't qualified plans, they don't need to follow the nondiscrimination rules that qualified plans must follow. The plans could be considered as an alternative to split-dollar life insurance plans when the premium or economic benefit cost to the employee is prohibitive. In addition, they provide a benefit post-death, rather than a benefit during the life of the employee.

Employer Tax Consequences

If an employer funds a DBO plan with life insurance, the premiums it pays are not tax deductible. When a covered employee dies and the death benefits are paid to the employer, the death benefits are tax-free provided the employer-owned life insurance requirements are met. These requirements include the employer notifying and obtaining consent from the insured employee before the purchase of the life insurance. Note, however, that the death benefits are required to be included in the calculation of the alternative minimum tax (AMT) and may be subject to tax if the AMT liability exceeds the regular tax liability. The employer can take a deduction for the payment of benefits to the beneficiaries provided that the payments represent reasonable compensation for the covered employee's services.

If the payments are made pursuant to an eligible DBO plan, the death benefit payments are exempt from *Federal Insurance Contributions Act* (FICA) and *Federal Unemployment Tax Act* (FUTA) taxes, so employers need not withhold for those taxes. The applicability of federal income tax withholding to the payments remains a gray area, though. IRC Section 3401(a), which defines wages for purposes of federal income tax withholding, does not contain a specific exception for death benefits as found in the FICA and FUTA provisions. The conservative approach for employers is to withhold for federal income tax purposes.

Employee and Beneficiary Tax Consequences

A properly structured DBO plan will not generate taxable income to the employee during his or her lifetime. For those individuals who are concerned about possible estate tax consequences, the value of the survivor benefit may be excluded from the employee's estate provided the employee's rights in the plan are limited. For example, the plan should specify the eligible beneficiaries by class or type (such as surviving spouse), instead of names, and allow payments of benefits only to the eligible beneficiaries. Furthermore, the employee should not control the plan or any life insurance policies held by the plan, and, as such, should not be allowed to change the plan terms or force the plan to surrender the life insurance policy.

The survivor benefits are taxed to the beneficiary as ordinary income in the year received.

Peace of Mind

A DBO plan can help attract and retain valuable employees without burdening an employer with complex benefit rules. Perhaps its greatest benefit is the confidence it provides to employees in knowing that their family has a source of income to help ease the financial blow when the employee dies. If properly structured, the value of the benefit avoids estate tax, further enhancing the value of DBO plans to certain employees.

Contact Information

Tyler Johnson is with Crowe Horwath LLP and can be reached at +1 469 801 4323 or tyler.johnson@crowehorwath.com.

Tom Tyler is a partner with Crowe and can be reached at +1 214 777 5250 or tom.tyler@crowehorwath.com.

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Mergers: The Timing Rules for Compensation Deductions in C-Corporation Acquisitions

By James D. Goeller, CPA, Charlie E. Shureen, CPA, and Howard M. Wagner, CPA

When a C corporation is acquired and joins the acquirer's consolidated group, the target's taxable income for the year between the pre- and post-acquisition periods must be computed under the "end-of-day" and "next-day" rules of U.S. Treasury Regulation Section 1.1502-76(b). Historically, though, guidance was lacking on the application of the end-of-day and next-day rules to the timing of the target's compensation deductions.

On Nov. 30, 2012, the IRS Office of Chief Counsel responded to this gap by issuing General Legal Advice Memorandum 2012-010 (the GLAM). The GLAM addresses the application of the rules to nonqualified stock options and stock appreciation rights held by certain target employees; compensatory deductions (such as investment bankers' success-based fees that are contingent on the closing of the acquisition); and deductions related to the retirement of the target's debt in certain circumstances. Deductions for deferred compensation, however, fall under different rules.

General Rule for the Target's Expenditures

In general, the end-of-day rule provides that a corporation becomes or ceases to be a member of a consolidated group at the end of the day on which its status as a member changes. Thus, items taken into account on the acquisition date generally are reported on the target's stand-alone return for its short tax year ending on the acquisition date.

The next-day rule is an exception to the end-of-day rule. It provides that if a transaction occurs on the acquisition date and is properly allocable to the post-closing portion of the target's day, the transaction is treated for U.S. federal income tax purposes as occurring at the beginning of the day after the acquisition date. A determination as to whether a transaction is properly allocable to the portion of the target's day after the event resulting in the target's change in status will be respected if it is reasonable and consistently applied by all affected persons.

The reasonableness of an allocation under the next-day rule depends on several factors, including:

- Whether income, gain, deduction, loss, and credit are allocated inconsistently
- Whether the allocation reflects ownership of the stock before or after the event (if the item is from a transaction in the subsidiary's stock)
- Whether the allocation is inconsistent with other requirements under the IRC
- Whether other facts exist that indicate that the transaction is not properly allocable to the portion of the day after the change event

The next-day rule was intended to prevent sellers from bearing tax liability for post-closing events that are under the buyer's control (and of which the seller may be unaware).

The GLAM Guidance

In the GLAM, the IRS concluded that, under the end-of-day rule, stock options, stock appreciation rights, and success-based fee deductions should be taken in the target's pre-acquisition taxable year. The agency reasoned that the compensation expenses become fixed and determinable on the day of the acquisition, and, under the end-of-day rule, these deductions ordinarily would be taken in the target's pre-acquisition taxable year.

The next-day rule, which arguably might shift these deductions into the target's post-acquisition taxable year, applies only to transactions involving the target or its subsidiaries that survive the transaction and join the buyer's consolidated return group. The IRS held that deductions for stock options, stock appreciation rights, and success-based fees are deductions from services provided to the target before the acquisition. Therefore, the next-day rule is inapplicable, and the deduction must be taken in the target's pre-acquisition taxable year.

The GLAM provides some valuable insight into current IRS thinking on application of the end-of-day and next-day rules, but guidance still is lacking on many other types of compensatory payments that are triggered as a result of a change in control. Transactions such as payouts of previously deferred compensation and vesting of restricted stock are outside the scope of the GLAM, leaving taxpayers to seek guidance under the general rules for the timing of tax deductions for compensation.

Compensatory Transfers of Property and Deferred Compensation

The fact that the GLAM addressed the timing of deductions for nonqualified stock options and stock appreciation rights might lead taxpayers to believe that all compensation triggered in the event of a change in control of a target is subject to the same rules. However, the language in the next-day rule in the consolidated return regulations interplays with the wording of IRC Section 83(h) and Section 404(a)(5).

Section 83 governs compensatory transfers of property, such as compensation in the form of stock. Under Section 83(a), in the case of a transfer of property in connection with the performance of services, the employee must include in income the fair market value of the property at the first time that the property is no longer subject to substantial risk of forfeiture. If the property is not subject to substantial risk of forfeiture at the time it is transferred to the employee, the employer takes a deduction under its normal method of accounting. If the property is subject to a substantial risk of forfeiture, as is the case with restricted stock, the employer then obtains a corresponding deduction under Section 83(h) in the employer's year that includes the employee's year-end in which the amount is includible in the employee's income.

As a result of the interplay between Section 83(h) and the consolidated return rules, an employer corporation that becomes a member of the acquiring group can claim the deduction for restricted stock in the post-acquisition period, provided the employee's tax year ends on the same date as the employer corporation's tax year or ends sometime during the employer corporation's post-closing tax year.

Section 404(a) presents a rule similar to Section 83(h), but for payments of deferred compensation. This regulation establishes the same timing rule for deferred compensation deductions as for compensatory transfers of property deductions under Section 83(h) – namely, that the deduction is allowable for the target's post-acquisition tax year ending on Dec. 31.

In the acquisition of a C-corporation target, items that constitute deferred compensation (for example, pure deferred compensation and restricted stock) fall under the rules of Section 83(h) and Section 404(a), rather than Treasury Regulation Section 1.1502-76(b). The timing of such deductions is deferred until the tax year in which the recipient records the income on his or her personal tax return. Thus, in a carryover basis reorganization transaction, the tax attributes related to the employer's timing of the tax deduction carries over to the successor entity and be recognized in the year that the recipient recognizes them (generally in the return that ends on Dec. 31).

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Contact Information

James Goeller is a partner with Crowe Horwath LLP and can be reached at +1 415 946 7448 or james.goeller@crowehorwath.com.

Charlie Shureen is with Crowe and can be reached at +1 415 946 7454 or charlie.shureen@crowehorwath.com.

Howard Wagner is a director with Crowe and can be reached at +1 502 420 4567 or howard.wagner@crowehorwath.com.

This treatment is true not only for deductions governed by Section 83(h) that are triggered as a result of a change in control but also for all payments of deferred compensation under Section 404(a) and all vesting of restricted stock, regardless of whether the payments and vesting are directly related to the reorganization transaction. As a result of the application of the "in which or with which ends" rules of Section 83(h) and Section 404(a) in an acquisition context, compensation deductions subject to the timing rule generally will be pushed into the acquiring company's return.

Different Timing Rules for Different Types of Compensation

It's important to realize that no single set of timing rules applies to all types of compensation deductions that can arise in a C-corporation acquisition. Proper tax planning requires an accurate understanding of which rules apply to which compensation.

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Passive vs. Active: Net Investment Income Tax Implications for S-Corporation Bank Shareholders

By David J. Silagi, CPA

Shareholders in S-corporation financial institutions increasingly have been faced with the net investment income tax (NIIT) created by the *Patient Protection and Affordable Care Act*. Yet many of these shareholders remain unaware of the applicable rules, documentation issues, and planning opportunities. In particular, S-corp shareholders need to understand how the treatment of pass-through income and loss can affect their NIIT liability.

The Interplay Between Passive Activities and the NIIT

The NIIT, which first took effect for the 2013 tax year, is a 3.8 percent tax on net investment income. Net investment income generally includes investment income – such as capital gains, interest, dividends, rent, and royalties – unless it's derived in the ordinary course of a trade or business that isn't passive under IRC Section 469. Any income from a passive trade or business activity is net investment income. Thus, an S-corp shareholder generally will include all income from the corporation in his or her net investment income if the corporation is a passive activity for the shareholder.

The Material Participation Issue

The regulations for Section 469 generally provide that an activity isn't passive if the taxpayer "materially participates" in the activity on a regular, continuous, and substantial basis. A taxpayer can establish material participation under any of the following seven tests:

1. Does the taxpayer or spouse work more than 500 hours per year in the business?
2. Does the taxpayer do most of the work?
3. Does the taxpayer work more than 100 hours per year and no one (including nonowners or employees) works more hours?

4. Does the taxpayer have several passive activities in which he or she participates 100-500 hours each, and the total time is more than 500 hours annually?
5. Did the taxpayer materially participate in the activity for any five of the 10 preceding years?
6. Did the taxpayer materially participate in a personal service activity for any of the three prior years?
7. Do the facts and circumstances indicate the taxpayer is materially participating?

The latter, subjective test does not apply unless the taxpayer worked more than 100 hours per year. It also does not apply if any person other than the taxpayer received compensation for managing the activity, or if any person spent more hours than the taxpayer managing the activity.

The test related to material participation in five of the previous 10 years is particularly important when a bank is being sold. Even if a shareholder isn't participating materially in the bank when the sale occurs, the gain from the sale won't be subject to the NIIT if the shareholder materially participated in any five of the preceding 10 years. Proper planning is critical to avoid the NIIT in this situation.

Disqualified Activities

Certain "disqualified activities" cannot be counted toward material participation. Work not customarily performed by owners is disallowed if the principal purpose of the work is to meet the material participation rules (for example, having a spouse work as a receptionist solely to increase the hours of participation).

Investor activities also are disallowed unless the taxpayer is directly involved in day-to-day management or operations. Investor activities include:

- Studying and reviewing financial statements or reports on activity operations
- Preparing or compiling summaries or analyses of finances or operations for the individual's own use
- Monitoring finances or operations in a nonmanagerial capacity

Grouping Activities and Regrouping Election

Section 469 offers taxpayers the ability to treat one or more trade or business activities as a single activity if the activities are an "appropriate economic unit" based on all relevant facts and circumstances. Consideration of these detailed rules are beyond the scope of this article, but should be evaluated further to determine the appropriate course of action.

Tax Distribution Considerations

If an S corporation intends for its tax distributions to shareholders to cover the NIIT, it should first review the shareholder agreements to determine if this is permissible. Assuming the agreements allow NIIT distributions, disproportionate distributions still are not allowed. Therefore, even shareholders who aren't subject to the NIIT on S-corp income must receive the increased tax distribution amount.

Plan Carefully, and Document, Document, Document

The interaction of the passive activity rules and the NIIT offers a number of challenges for shareholders in S corporations (especially if a sale is contemplated) that add yet another layer to S corporations' tax planning. Documentation detailing day-to-day activities is critical in substantiating a position taken in a tax return. Do not assume that the details of such activities will be easy to recall two to three years after the fact.

Contact Information

Dave Silagi is a director with Crowe Horwath LLP and can be reached at +1 630 586 5106 or dave.silagi@crowehorwath.com.

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Avoiding the Personal Holding Company Tax

By Avani Shah, CPA, and David A. Thornton, CPA

The personal holding company (PHC) tax is a federal 20 percent penalty tax assessed on certain types of undistributed passive income, including interest and dividend income, earned by a closely held C-corporation. Although the disparity between individual and corporate tax rates that prompted the enactment of the PHC tax largely has been eliminated, the tax remains a trap for unwary corporations and can result in a substantial tax liability. Special care and planning are necessary to avoid structures that expose a corporation to the PHC tax and, once exposed, to operate the corporation in a manner that eliminates the PHC tax liability. This is especially true for banking organizations, as special PHC rules apply to banks and certain other lenders.

Applicability of the PHC Tax

The PHC tax is a concern for a C-corporation when three conditions are satisfied:

1. More than 50 percent of the value of the corporation's stock is owned by five or fewer individuals at any time during the last half of the corporation's tax year
2. At least 60 percent of the corporation's gross income is from certain identified passive sources
3. Corporate distributions to shareholders for the year are insufficient to eliminate the PHC tax

Special attribution rules apply for purposes of determining stock ownership. The primary sources of passive income include interest, dividends, rents, and royalties. For purposes of measuring the 60 percent threshold, gross income is modified by removing U.S. government interest and certain expenses directly associated with the production of rental income.

If the first two conditions are satisfied, the corporation is required to attach Schedule PH, "U.S. Personal Holding Company (PHC) Tax," to its federal income tax return unless it is an exempt corporation (defined later). This form indicates to the IRS that the PHC conditions have been satisfied for the year and subjects the corporation to a distribution test to determine the extent of its PHC tax liability.

PHC Tax Liability

A PHC tax liability will result only when the corporation has positive undistributed PHC income for the taxable year.

To determine PHC income, federal taxable income is modified by:

- Adding back the dividends-received deduction
- Limiting the net-operating-loss deduction to the loss generated in the immediately preceding tax year
- Removing net capital gains, net of the federal tax liability on these gains
- Deducting the federal tax liability due on the taxable income after applying the modifications discussed earlier
- Deducting the amount of shareholder distributions paid (or deemed paid) during the year

The resulting figure is the corporation's undistributed PHC income subject to the 20 percent PHC tax. This tax is reported on Form 1120, "U.S. Corporation Income Tax Return," and factors into the corporation's overall federal tax liability.

Risks for Bank Consolidated Groups

The PHC tax generally is determined and applied on a consolidated basis. However, if any affiliate in the consolidated group is an exempt corporation, the PHC rules are applied individually to each corporation in the group. Exempt corporations include banks, thrifts, and nonbank finance companies that meet certain lending tests. Thus, for a consolidated banking group, each of these tests is determined at the affiliate level for each member of the group. This poses particular planning challenges for certain nonbank affiliates within the group, to the extent they are profitable and earn investment income.

For example, a bank-owned investment subsidiary that houses the bank's investment portfolio and generates net investment income will generate a PHC tax liability if the distribution rules are not properly addressed. Likewise, a bank-owned finance company that does not meet the particular lending tests for PHC exemption also could generate a PHC liability if proper planning is not undertaken. Furthermore, a bank holding company that maintains its own investment portfolio and is profitable on a stand-alone basis could generate a PHC tax liability.

Planning Considerations

The PHC planning for bank consolidated groups centers on several IRS rulings addressing the PHC treatment of intercompany distributions when the group contains an exempt member. These rulings provide two fundamental concepts: 1) Dividends received from an exempt member are ignored by the recipient corporation for all PHC purposes; and 2) Dividends received from a nonexempt member are PHC income to a nonexempt recipient member to the extent the distributing member availed itself of a distribution deduction. Applied properly, these rules can offer an escape from the PHC tax for affiliates within a bank consolidated group.

For bank-owned subsidiaries, PHC planning can be structural or operational in nature. From a structural standpoint, closely held banks should be cautious about setting up profitable subsidiaries that will generate the passive sources of income potentially subject to the PHC tax. For example, establishing an investment subsidiary underneath the bank might expose the income of that subsidiary to the PHC tax. If the bank subsidiary is established, the only way to avoid the PHC tax is operational planning.

This involves paying sufficient dividends (or making an election for deemed dividend distributions) annually to the bank parent, eliminating the PHC tax liability of the subsidiary and moving this income into the bank, which is exempt from the PHC tax. If the bank has two or more tiers of subsidiaries, the PHC income must be distributed by each subsidiary until it either reaches the bank or is received by an affiliate with sufficient losses to offset the PHC income distribution received.

Closely held banks might want to avoid establishing a holding company for PHC exposure reasons. If a holding company is established, careful annual planning is necessary to avoid the PHC tax. The holding company must verify that either its PHC income is negative (bank dividends are excluded from this determination) or sufficient dividends are paid to shareholders so the PHC tax is avoided. Establishing an investment portfolio within the bank holding company could be an issue, unless the holding company intends to pay annual shareholder dividends in an amount sufficient to eliminate any PHC tax concerns.

Protect Yourself From the PHC Tax

Neglecting to identify and properly plan for a PHC tax exposure can be an expensive mistake. Although banks are exempt from the PHC tax, many of the affiliates that are commonly established within banking groups are not. For closely held banks, the opportunities for using these other affiliate structures could be limited or require constant and careful planning to navigate through the PHC tax exposure.

Contact Information

Avani Shah is with Crowe Horwath LLP and can be reached at +1 212 572 5578 or avani.shah@crowehorwath.com.

David Thornton is a partner with Crowe and can be reached at +1 212 572 5588 or david.thornton@crowehorwath.com.

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