

# Bank Notes

A timely information and idea statement

November/December 2010

## Year-End Tax Concerns for Financial Institutions

As the year comes to a close and institutions begin to prepare to file financial and regulatory statements, there have been several impactful developments that could have consequences to your tax picture for 2010. From the Dodd-Frank Act to considerations regarding FDIC-assisted transactions, the tax landscape for many financial institutions has changed. This article is intended to “take a trip around your balance sheet” to identify some things that you might want to be aware of as you finalize your year-end tax position.

### Investments

The small issuer exception has recently been expanded, so your institution may want to consider a review of whether any of your tax-exempt obligations qualify. This should provide you with enhanced after-tax yield as a smaller portion of your allocated interest expense will be subject to disallowance.

The Dodd-Frank Act will have an impact on Trust Preferred Securities (TPS) in terms of Tier 1 regulatory capital treatment for Bank Holding Companies, depending on the size of the institution. These changes will not directly affect the previously accorded tax treatment which means that they should still generally be treated as debt instruments by the issuer of the TPS; however, depending on the form of ownership, they could in some cases be considered equity for the holder.

If you hold trust preferred instruments where interest is currently not being paid, you may still have taxable income due to the original issue discount (OID) rules. Similarly, the issuer may have the ability to deduct the interest it currently is not able to pay.

Other Than Temporary Impairment (OTTI) is a continuing tax issue in 2010, as it relates to losses on mortgage backed (MBS), other similar loan related securities as well as equity securities. If the charge-off has to do with credit risk, it is likely deductible as a partial or full bad debt. If the charge-off is market based, then it will generally not currently be deductible though there

may be some opportunities under the tax mark-to-market rules. The tax loss for MBS or other securities will generally be based on the difference between the tax basis of the asset, including accrued interest, if any, and the gross cash realizable from the obligor.

Even if not currently deductible, such losses should allow for the recognition of a deferred tax asset (DTA), although regulatory and GAAP limitations on the amount of a DTA asset could apply. Similarly, if the character of the loss is capital rather than ordinary, this may present other tax and recognition issues beyond the scope of this article.

### Loans

For bad debts, Treasury regulations and other authorities require consideration of all pertinent evidence and provide that a deduction is warranted if the surrounding circumstances indicate that the debt is uncollectible. Factors that could lead to worthlessness (or partial worthlessness) include bankruptcy, insolvency, lack of assets or abandonment of the business. Some factors against worthlessness are availability of collateral or third party guarantees, payment of interest or a creditor's failure to press for payment.

For banks, there are two conclusive presumptions of worthlessness under current regulations: historical presumption and the conformity election. If criteria are met under either election, bad debts are conclusively presumed to be worthless and deductible in the year of worthlessness. Wholly or partially worthless debt is deducted either through the direct charge-off method or reserve methods.

The conformity election is designed to provide a bank with greater certainty in the tax treatment of its bad debts by providing for a conclusive presumption of worthlessness based on the application of a single set of standards for both regulatory and tax purposes. Debt will be conclusively presumed to be worthless in whole or in part if it is charged

[Year-End Tax Concerns, continued on page 3](#)

# Bank Notes

## The SAFE Act Introduces Federal Registration System for Mortgage Loan Originators

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Farm Credit Administration and the National Credit Union Administration, published a final rule on July 28, 2010 to implement the SAFE Mortgage Licensing Act of 2008.

The act requires the regulatory agencies to jointly develop and maintain a federal registration system for individuals who engage in residential mortgage loan originations. The requirements apply to individuals employed by banks, thrifts, credit unions and Farm Credit System institutions. Mortgage loan originators must be registered with the Nationwide Mortgage Licensing System and Registry, a database established by the American Association of Residential Mortgage Regulators and the Conference of State Bank Supervisors. Mortgage loan originators must furnish background information and fingerprints for a background check to the registry as part of the registration process. The SAFE Act prohibits employees of agency-regulated institutions from originating residential mortgage loans without being registered.

Mortgage loan originators are responsible for registering with the registry and maintaining their registration. Registration must be completed within 180 days from the date the agencies publish a public notice that the registry is accepting registrations. The SAFE Act also requires mortgage loan originators to obtain a unique identifier through the registry that will remain with each originator regardless of changes in employment. The rule requires mortgage loan originators and their respective agency-regulated institutions to provide the unique identifier to consumers upon request, before acting as a mortgage loan originator, and through the originator's initial written communication with the consumer.

Each mortgage loan originator must submit the following categories of information to the registry (not an all-inclusive listing): identifying information, including the originator's name; home address and contact information; principal business location address and business contact information; social security number; gender; date and place of birth; financial services-related employment history for the 10 years prior to the date of registration, including the date the originator became an employee of the agency-regulated institution; convictions of any criminal offense involving dishonesty, breach of trust or money laundering against the originator or organizations controlled by the originator; fingerprints of the originator and any appropriate identifying information for submission to the Federal Bureau of Investigation or other governmental entity authorized

to receive such information in connection with a state and national criminal history background check.

Agency-regulated institutions must submit information to the registry on its own behalf as well, such as its name, main office address and contact information; employer tax identification number; research Statistics Supervision and Discount number issued by the Board of Governors of the Federal Reserve System; identification of its primary Federal regulator; and the name and contact information of the individuals with authority to act as the institution's primary point of contact for the registry. This also is not an all inclusive list.

The rule provides an exception to the requirements for originators who originate a de minimis number of residential mortgage loans. The registration requirement does not apply to employees who have never been registered or licensed through the registry as a mortgage loan originator if during the past 12 months the employee acted as a mortgage loan originator for five or fewer residential mortgage loans.

The final rule provides that an agency-regulated institution must require its employees who are mortgage loan originators to comply with these requirements and specifically prohibits the institution from permitting its employees to act as mortgage loan originators unless registered with the registry. Furthermore, the rule requires agency-regulated institutions to adopt and follow written policies and procedures to assure compliance with the registration requirements.

This final rule was effective on Oct. 1, so policies and procedures should already be established. Because the necessary modifications to the registry have not been completed, agency-regulated institutions and their employees are not required to comply with the final rule's registration requirements at this time. The agencies expect that the registry will be capable of accepting federal registrations in January 2011 at the earliest. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 will transfer the agencies' responsibilities under the SAFE Act to the Bureau of Consumer Financial Protection on a transfer date no earlier than January 2011.

The final rule was published in the Federal Register on July 28, 2010. The Federal Register republished the preamble to the final rule on Aug. 23, 2010 to correct inaccurate footnote numbering.

The final rule can be found at <http://edocket.access.gpo.gov/2010/pdf/2010-18148.pdf>

## Are Your Institution's IT Systems Effectively Managing Risk?

With financial institutions facing a greater amount of internal and external threats as well as increased regulatory scrutiny following the recent financial crisis, the demands on IT systems have never been greater. Data such as social security numbers, bank and credit card information have

become a valued commodity to organized criminals, and your sensitive customer records could be at risk. The efficiency and effectiveness of your framework is currently of the utmost importance, as a single breach could cause considerable financial and reputational damage.

### Year-End Tax Concerns, continued from page 1

off, in whole or in part, pursuant to a specific order of the bank's supervisory authority (fairly rare), or it is classified by the bank as a "loss asset" under applicable bank regulatory standards and an "express determination" letter is obtained from the appropriate regulatory authority. Election is on a bank by bank basis and there is no requirement that all bank members of an affiliated group have to make the election if one does. Making this election also allows for a similar election to be made with respect to non-accrual interest.

#### Other assets

Other Real Estate Owned (OREO) is unfortunately a category of assets that continues to grow for many institutions in the midst of the housing and commercial real estate crisis. Subsequent market adjustments after conversion of collateral are generally not currently deductible for tax. There are several tax considerations to be aware of regarding income and expenses while holding OREO, including pre-acquisition expenses incurred by the owner but paid by the lender should be added to the basis of the property for tax. Further if the property is rented then rental income is includible in taxable income; however, the expenses of operating the property should also be deductible. If the property is not producing income the IRS might challenge the current deductibility of expenses incurred to maintain the property. On the other hand, a strong argument can be made that such expenses are ordinary and necessary expenses for a lender and thus are currently deductible.

With respect to "in substance" foreclosures, the loan is generally deemed to be outstanding for tax purposes, thus any costs incurred to maintain the property and any income collected relating to the property is considered to be a net loan to the borrower that may be eligible to be charged off as a loss asset.

With regard to the sale of OREO, many practitioners believe that any gain or loss is ordinary. However, the IRS may

assert that non-income producing OREO is a capital asset, consequently giving rise on disposition to capital gain or loss, which if the latter, could create limitations with respect to current deductibility.

#### FDIC and other acquisitions

If your bank has acquired assets in an FDIC-assisted or non-assisted transaction, there are special tax rules that may need to be considered.

Most FDIC assisted transactions will be treated as taxable asset acquisitions. Because of the significant differences between the specific GAAP and tax rules that apply to these transactions, generally, this will create significant book/tax differences requiring the recording of deferred taxes at the time of the acquisition.

Dependent on several tax factors, opportunities also exist for the deductibility of costs inherent to FDIC-assisted or traditional merger and acquisition transactions, such as legal and accounting fees. Much of it depends on when the costs were incurred relative to the execution of a definitive agreement.

#### Small Business Jobs Act

Although the recently enacted Small Business Jobs Act (SBJA) will generally not have significant implications for banks, one aspect of the act that could impact some is the temporary reduction in the recognition period for S Corporation built in gains tax. The time period where the built in S Corporation gain is forgiven has been reduced in 2010 and further in 2011 which could significantly impact the economics of a merger or acquisition transaction involving such an entity. In addition, the unresolved status of the capital gains tax rate that individual shareholders will be subject to in 2011 will also need to be considered as well, even for entities that are "regular" corporations.



## Bank Notes

November/December 2010

### Year-End Tax Concerns for Financial Institutions

### The SAFE Act Introduces Federal Registration System for Mortgage Loan Originators

### Are Your Institution's IT Systems Effectively Managing Risk?



Members: Carbis Walker Group ■ McGladrey Alliance ■ AICPA Alliance for CPA Firms

5700 Corporate Drive, Suite 650  
Pittsburgh, PA 15237

2599 Wilmington Road  
New Castle, PA 16105

381 Chestnut Street  
Meadville, PA 16335

Address Service Requested

Information provided in this publication has been obtained by Carbis Walker LLP from sources believed to be reliable. However, Carbis Walker LLP guarantees neither the accuracy nor completeness of any information and is not responsible for any errors or omissions or for results obtained by others as a result of reliance upon such information. This publication does not, and is not intended to, provide legal, tax or accounting advice.

McGladrey Alliance is a premier affiliation of independent accounting and consulting firms. McGladrey Alliance member firms maintain their name, autonomy and independence and are responsible for their own client fee arrangements, delivery of services and maintenance of client relationships. McGladrey Alliance is a business of RSM McGladrey, Inc., a leading professional services firm providing tax and consulting services. McGladrey is the brand under which RSM McGladrey, Inc. and McGladrey & Pullen, LLP serve clients' business needs. McGladrey, the McGladrey logo and the McGladrey Alliance signatures are used under license by RSM McGladrey, Inc. and McGladrey & Pullen, LLP.

For additional copies, change of address, or more information contact Carbis Walker LLP's Marketing Department at (724) 658-1565 or (800) 452-3003.

If you have any questions or concerns, please call Brian J. Kassalen, CPA, Partner - Financial Institution Services at (412) 635-6270, or you can e-mail him at [bkassalen@carbis.com](mailto:bkassalen@carbis.com).

Offices throughout western Pennsylvania and eastern Ohio.

Website: [www.carbis.com](http://www.carbis.com)

Bank Notes

November/December 2010

Printed in the U.S.A.

©2010 RSM McGladrey, Inc. All Rights Reserved. Used with Permission.