Financial Institution Tax Provision Calculations

Michael J. Rowe, CPA
August 18, 2015
Before we get started…

• Today’s presentation slides can be downloaded at www.wolfandco.com/webinars/2015.

• The session will last about an hour, and we’ll have time for Q & A throughout the presentation.

• Our audience will be muted during the session.

• Please send your questions in using the “Questions Box” located on the webinar’s control panel.
About Wolf & Company, P.C.

• Established in 1911
• Offers Audit, Tax, and Risk Management services
• Offices located in:
  – Boston, Massachusetts
  – Springfield, Massachusetts
  – Albany, NY
  – Livingston, NJ
• Nearly 200 professionals

As a leading regional firm founded in 1911, we provide our clients with specialized industry expertise and responsive service.
Financial Institution Expertise

• Provide services to over 250 financial institutions:
  – Approximately 50 FIs with assets > $1B
  – Approximately 30 publicly traded FIs
  – Constant regulatory review of our deliverables

• Over 45 Risk Management Professionals:
  – IT Assurance Services Group
  – Internal Audit Services Group
  – Regulatory Compliance Services Group
  – WolfPAC® Solutions Group

• Provide Risk Management Services in 27 states and 2 U.S. territories
Meet Our Presenter

Michael J. Rowe, CPA
Principal
617-428-5437
mrowe@wolfandco.com
Today’s Agenda

• Corporate Tax Overview
• Permanent and Temporary Differences
• Overview of ASC 740 (formerly SFAS 109)
• Understanding of the tax provision calculation
• Valuation Allowance
• Tax Footnotes and Disclosures
• Other Issues
• Questions
Corporate Tax Overview

• Corporate (FI) Income Tax rates
  • Federal
    - 34% of Federal Taxable Income if less than $10m and 35% if greater than $10m
    - Surtax exemption
  • State
    - Massachusetts - depends on the type of entity
      - Bank – 9%
      - Security Corporation – 1.32% of gross income (if classified as a security corp. by the MA DOR)
      - Holding Company – same as bank (9%) unless it has requested security corp. status from the DOR. In that case, .33% of gross income
Corporate Tax Overview

• Corporate (FI) Income Tax rates
  • State (cont’d)
    - Connecticut – 7.5% (plus 1.5% surtax, if applicable)
    - Maine – 1% of apportioned book net income plus.008% of apportioned assets
    - New Hampshire – 8.5%
    - New York – 6.5%
    - Pennsylvania – 11.5% (mutual banks)
    - Rhode Island – 9%
Corporate Tax Overview

• Book vs. Tax Accounting
  • In many instances, tax laws and financial standards differ in the recognition and measurement of assets, liabilities, revenues, expenses, gains and losses

• Differences arise in two ways
  - Differences between income or expenses
  - Differences in tax basis and book basis of an asset or liability
Corporate Tax Overview

• Two types of differences
  • Permanent differences – generally never taxable or deductible (do not reverse)
    - Bank Owned Life Insurance (BOLI)
    - Tax-exempt municipal bond / loan income
    - Dividends received deduction
    - Meals and entertainment / country club dues
• Two types of differences (cont’d)
  • Temporary differences – reverse over time (items are recognized in different periods for book and tax). Common financial institution temporary differences:
    - Accrued Pension/SERP/Other post-retirement benefits
    - Accrued expenses/bonuses
    - Allowance for Loan Loss
    - Non-accrual interest
    - Depreciation
    - Mortgage servicing rights
History lesson – “Old” APB 11 format currently used by many for monthly tax expense

State Tax:

- Pre-tax book income: 2,000
- BOLI: (250)
- Meals & Entertainment: 50
- State income: 1,800
- State tax rate: 9%
- State tax: 162
Overview of Tax Provision (ASC 740)

- **Federal Tax:**
  - Pre-tax book income: 2,000
  - BOLI: (250)
  - Net Municipal Income: (300)
  - Meals & Entertainment: 50
  - State tax: (162)
  - Federal income: 1,338
  - Federal rate: 34%
  - Federal tax provision: 455

  Total Federal and State provision: 617
Overview of Tax Provision (ASC 740)

- Total tax expense = a company’s current tax expense/(benefit) plus its deferred tax expense/(benefit)

- Current tax expense / benefit
  - Tax per “tax returns” - Federal and state

- Deferred tax expense / benefit
  - The change in the net deferred tax asset or liability from prior year to the current year – excluding the portion of the change recorded directly to capital (AOCI)
Overview of Tax Provision (ASC 740)

• Current tax expense / benefit
  • Pre-tax book net income plus or minus
    – The change in cumulative taxable and deductible temporary differences (including carryovers) - based on prior year to current year provision
    – Permanent differences
  • Apply current tax rates
  • Consider tax credits
  • Consider alternative minimum tax (AMT)
Overview of Tax Provision (ASC 740)

- Deferred tax expense / benefit
  - Identify cumulative taxable and deductible temporary differences (including carryovers)
    - Differences between book balance sheet and “tax balance sheet”
  - Compute deferred tax assets and liabilities
    - DTA – tax effect of deductible temporary differences that may be used to reduce a subsequent period’s taxable income
    - DTL – tax effect of taxable temporary differences that will increase a subsequent period’s taxable income
    - Use enacted tax rates that apply to year item is expected to be settled
Overview of Tax Provision (ASC 740)

Example:
Cumulative Temporary Differences:

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>Ending</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Loss</td>
<td>(3,000)</td>
<td>(3,500)</td>
<td>500</td>
</tr>
<tr>
<td>Depreciation</td>
<td>500</td>
<td>750</td>
<td>(250)</td>
</tr>
<tr>
<td>Pension</td>
<td>(1,000)</td>
<td>(1,750)</td>
<td>750</td>
</tr>
<tr>
<td>Non-acc’l int</td>
<td>(600)</td>
<td>(700)</td>
<td>100</td>
</tr>
<tr>
<td>MSRs</td>
<td>800</td>
<td>1,000</td>
<td>(200)</td>
</tr>
<tr>
<td></td>
<td>(3,300)</td>
<td>(4,200)</td>
<td>900</td>
</tr>
</tbody>
</table>
### Overview of Tax Provision (ASC 740)

#### Calculation of Current Tax Provision

**State**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax book income</td>
<td>2,000</td>
</tr>
<tr>
<td>Temporary differences</td>
<td>900</td>
</tr>
<tr>
<td>BOLI</td>
<td>(250)</td>
</tr>
<tr>
<td>Meals &amp; Entertainment</td>
<td>50</td>
</tr>
<tr>
<td>State taxable income</td>
<td>2,700</td>
</tr>
<tr>
<td>State tax rate</td>
<td>9%</td>
</tr>
<tr>
<td>State tax</td>
<td>243</td>
</tr>
</tbody>
</table>
Overview of Tax Provision (ASC 740)

• Calculation of Current Tax Provision
  • Federal

  Pre-tax book income  2,000
  Temporary Differences  900
  BOLI (250)
  Net Municipal Income (300)
  Meals & Entertainment  50
  State tax (243)
  Federal taxable income  2,157
  Federal rate 34%
  Federal tax provision 733

  Total current Federal and State tax 976
Overview of Tax Provision (ASC 740)

• Calculation of Deferred Tax Benefit
  • State:

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>Ending</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temp. Diff</td>
<td>(3,300)</td>
<td>(4,200)</td>
<td>(900)</td>
</tr>
<tr>
<td>State Rate</td>
<td>9%</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>State net DTA</td>
<td>(297)</td>
<td>(378)</td>
<td>(81)</td>
</tr>
</tbody>
</table>
### Calculation of Deferred Tax Benefit

#### Federal:

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>Ending</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temp. Diff</td>
<td>(3,300)</td>
<td>(4,200)</td>
<td>(900)</td>
</tr>
<tr>
<td>State DTA</td>
<td>297</td>
<td>378</td>
<td>81</td>
</tr>
<tr>
<td></td>
<td>(3,003)</td>
<td>(3,822)</td>
<td>(819)</td>
</tr>
<tr>
<td>Federal Rate</td>
<td>34%</td>
<td>34%</td>
<td>34%</td>
</tr>
<tr>
<td>Federal net DTA</td>
<td>(1,021)</td>
<td>(1,299)</td>
<td>(278)</td>
</tr>
<tr>
<td>Total net DTA</td>
<td>(1,318)</td>
<td>(1,677)</td>
<td>(359)</td>
</tr>
</tbody>
</table>
Overview of Tax Provision (ASC 740)

• Summary:

  Current Federal Provision    733
  Deferred Federal Benefit     (278)
  Total Federal Provision      455

  Current State Provision      243
  Deferred State Benefit       (81)
  Total State Provision        162

  Total Provision              617
It is important to determine if a valuation allowance is needed

- “More likely than not” criterion
- Using all evidence – positive and negative
- Tax planning strategies – prudent and feasible
- If so, how much?
- Most common reasons for valuation allowances
  - Capital loss carryovers – 5-year expiration
  - OTTI write downs that are capital in nature
  - Contribution carryovers – 5-year expiration
  - State net deferred tax assets not expected to be realized
  - Cumulative losses
Allocation of federal and state income taxes between current and deferred portions is as follows:

Current tax provision:
- Federal: 733
- State: 243
- Total: 976

Deferred tax benefit:
- Federal: (278)
- State: (81)
- Total: (359)

Total tax provision: 617

(Note: footnote is 2-year comparative – 3-year for public companies)
The reasons for the differences between the statutory federal income tax rate and the effective tax rate are summarized as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory rate (2,000 X 34%)</td>
<td>680</td>
<td>34.0%</td>
</tr>
<tr>
<td>State tax (162 X 66%)</td>
<td>107</td>
<td>5.4</td>
</tr>
<tr>
<td>BOLI (250 X 34%)</td>
<td>(85)</td>
<td>(4.3)</td>
</tr>
<tr>
<td>Net Muni Income (300 X 34%)</td>
<td>(102)</td>
<td>(5.1)</td>
</tr>
<tr>
<td>Other (50 X 34%)</td>
<td>17</td>
<td>0.8</td>
</tr>
<tr>
<td></td>
<td>617</td>
<td>30.8%</td>
</tr>
</tbody>
</table>

(Note: footnote is 2-year comparative – 3-year for public companies)
## Tax Footnote

The tax effects of each item that give rise to deferred tax assets (liabilities) are as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Loss Reserve</td>
<td>1,398</td>
<td>1,199</td>
</tr>
<tr>
<td>Accrued Pension</td>
<td>699</td>
<td>399</td>
</tr>
<tr>
<td>Non-accrual interest</td>
<td>280</td>
<td>240</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>2,377</td>
<td>1,838</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(300)</td>
<td>(200)</td>
</tr>
<tr>
<td>Mortgage Servicing Rights</td>
<td>(400)</td>
<td>(320)</td>
</tr>
<tr>
<td>Deferred tax liabilities</td>
<td>(700)</td>
<td>(520)</td>
</tr>
<tr>
<td>Net deferred tax asset</td>
<td>1,677</td>
<td>1,318</td>
</tr>
</tbody>
</table>
Tax Footnote

• Other disclosures
  – Carryovers with expiration dates
  – Thrift tax bad debt reserves subject to recapture
  – Explanation of change in valuation allowance
Tax Provision Analysis

In addition to calculation of current and deferred tax:

• Tax Accounts Roll forward
  • Roll forward of each entity’s accrued and deferred tax accounts in detail
    - Payments
      ▪ Tax payments made during the year
    - Receipts – Outsiders (IRS or State)
      ▪ Refunds received during the audit period
        ‐ Refunds from prior year tax returns
        ‐ Refunds from Form 1139 (carryback of NOLs, capital losses or credits)
        ‐ Refunds from amended returns
    - Intercompany Reimbursements/Payments
    - Provisions
      ▪ Tax expense recorded on the income statement for each entity
    - Reclasses between accounts
    - Other
      ▪ FAS 115/FAS 158 changes
      ▪ Some stock based compensation adjustments
• **Current Reasonableness Test**  
  - Analysis of what the current federal and state tax liabilities should be  
    - Prior year actual  
    - Current year estimated  
  - Compare the actual current and deferred tax accounts after posting the calculated adjustments to the analysis of what the tax accounts should be  
  - Result is a balance sheet overaccrual or underaccrual  
  - Should compare to previous year’s overaccrual or underaccrual and understand the reasons for the change
Other Issues

• FIN 48- Uncertain Tax Positions
  • Identify tax positions (permanent and temporary)
  • Uncertain or certain?
  • Material?
  • Disclosure requirements
    - Only if material, must disclose in tax return if disclosed in financial statements (UTP Schedule)
Other Issues

• Interim Reporting
  • Estimated ANNUAL effective tax rate
  • Applied to interim period pretax income
  • It is not an actual current period tax calculation
  • Exceptions:
    - When there is inability to make reliable estimates
    - When there are significant unusual or extraordinary items that are separately reported
Other Issues

• Basel III – Call Report DTA Limitation:
  • Effective January 1, 2015
  • Two-year look back remains from the old rules
  • One year look out replaced - no limit but is risk weighted at 250% beginning in 2018
  • NOL and tax credit Carry overs not allowed
  • Allocation of deferred tax liabilities – various options
  • AOCI one time election
Questions?

Michael J. Rowe, CPA
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mrowe@wolfandco.com