

HORNE
BANKERS' FORUM 2010

Tax Update for Financial Institutions

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Agenda of Topics

- Nonperforming Loans and Troubled Debt
- Accounting Method Update
- M&A and Expansion
- Litigation and IRS

What do we know for sure?

- Federal and state income taxes are going up
- Expiration of Bush tax cuts will increase taxes no later than 2011
- Substantial increase in Federal and state enforcement efforts
- Tax policy is a focal point for economic stimulus
- The current economy may be the new normal

Nonperforming Loans and Troubled Debt

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Loan Modifications

- Significant modification – loan is deemed “sold” to the borrower in exchange for the new loan
- Modification – any alteration of the loan
- Significant modification
 - Change in the yield by 0.25% or 5% of the original yield
 - Payments are extended for more than 50% of the original term of the loan
 - Facts and circumstances support significance

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Loan Modifications (cont'd)

- Determination of whether a taxable exchange of the “unmodified” debt for the “modified” debt has occurred (IRC Treas. Reg. Section 1.1001-3)
- Tax consequences
 - Bank will have gain or loss on the “sale” of the loan.
 - The borrower is likely to have discharge of indebtedness income which must be reported on Form 1099-G
 - Accrued interest will be affected.

Tax Accounting for Loan Losses

- Focus of our discussion – the deduction of losses
- Reg. 1.166-2(d)(1) – Presumption that a book charge-off is correct
 - First entered the Regulations in 1959
 - Functionally obsolete
 - Banks no longer wait for the examination to charge off loans
 - Bank examiners don't examine and report on charge-offs between examinations

Tax Accounting for Loan Losses (cont'd)

- Reg. 1.166-2(d)(1) – Presumption continued
 - Experience for the last 15 years or so has been that absent the appearance of abuse, experienced IRS examiners have treated the presumption sort of like an informal conformity election
 - If the bank examiners haven't written up the bank for bad charge-off procedures, and
 - If recoveries are relatively nominal, and remote from the charge-off, then
 - Charge-offs must be correct enough not to warrant detailed examination

Tax Accounting for Loan Losses (cont'd)

- Reg. 1.166-2(d)(1) – Presumption continued
 - The recession has produced such a volume of losses that we are starting to hear of Joint Committee Refund examinations by less experienced examiners
 - We are hearing about extreme positions that without the conformity election, **only** charge-offs ordered by the examiners are allowed
 - Issue – when would these examiners allow a deduction for worthless loans charged off between examinations?

Tax Accounting for Loan Losses (cont'd)

- Regulation 1.166-2(a) – the facts and circumstances test of partial or total loss
 - Still a valid approach to supporting a deduction
 - Not a lot of details in the Regulation on how to support the deduction
 - Bankruptcy of the borrower is an indication of loss
 - Legal action not required if it would be useless

Tax Accounting for Loan Losses (cont'd)

- Regulation 1.166-2(a) – the facts and circumstances test [continued]
- Practical support of loss
 - With hindsight, the loss was not recovered
 - Historically the trump card
 - Bankruptcy of the borrower
 - Foreclosure or other legal action
 - Evidence of borrower's inability to pay
 - Absence of payments
 - Borrower ceases operations
 - Disappearance of the borrower – “skips”

Tax Accounting for Loan Losses (cont'd)

- Regulation 1.166-2(a) – the facts and circumstances test [continued]
 - During the 1980s debt crisis, no problem with the IRS examiners applying this test
 - Then the conformity election came in 1992
 - Industry is starting to learn that some examiners, particularly inexperienced ones, are not patient enough to use the facts and circumstances test
 - May be inexperience
 - May be time pressures from their managers

Tax Accounting for Loan Losses (cont'd)

- Reg. 1.166-2(d)(3) – Conformity Election
 - Loans are conclusively presumed worthless to the extent of the charge-off
 - Requirements
 - An affirmative election by the bank
 - The “express determination letter” from the federal examiners at each examination
 - Effects
 - “Audit protection” of charge-offs
 - Deduction available only if there is a chargeoff

Tax Accounting for Loan Losses (cont'd)

- Making the election
 - Attach Form 3115 to a timely filed return
 - May also revoke the election by filing Form 3115 in a timely filed return
 - Cannot remake the election later without filing Form 3115 with National Office and paying the user fee
 - There is no transition adjustment
- Reason to make the election
 - "Examination insurance" for loan losses
 - May be particularly useful for S corps

Tax Accounting for Loan Losses (cont'd)

- Conformity election [continued]
 - Reasons to not make the election
 - Avoid Rev. Rul. 2007-32 on nonaccrual interest
 - If the bank has in substance foreclosures, will not want to be limited to "book charge-offs"

Nonaccrued Interest

- Revenue Ruling 2007-32
- Revenue Procedure 2007-33
 - Both issued May 4, 2007
- IRS attempt to address the decade long controversy between financial institutions and the IRS regarding this issue

Nonaccrued Interest (cont'd)

- Revenue Ruling 2007-32: Conformity Method Banks
 - Applies only to banks on the conformity method for bad debts
 - Unique in that it extends the conformity election principal to nonaccrual interest
 - The loan becomes nonaccrual for tax purposes when it is placed on nonaccrual status for financial statement purposes
 - All accrued interest is charged-off as a bad debt
 - No reversal against income
 - Accrued Interest on nonaccrual loans is **both**:
 - Recognized in gross income, and
 - Charged-off as a bad debt

Nonaccrued Interest (cont'd)

- Revenue Ruling 2007-32: Conformity Method Banks
 - All subsequent payments must be recognized as recoveries (income) up to the accumulated charge-off
 - Additional payments are charged to principal
 - When is the excess tax principal deducted if not collected?
 - The financial institution is on the conformity election
 - There is no book charge-off for the excess principal; therefore no bad debt
 - Appears to be a "loss" under IRC Section 165 when the loan is settled with the borrower
 - OR when the loan is wholly worthless

Nonaccrued Interest (cont'd)

- Revenue Procedure 2007-33: Safe Harbor Election
 - Available to all accrual method financial institutions
 - Does not require the conformity election
- The recognized interest income for tax purposes is based on a 5 year history of the ratio of collections to payments due:
 - Based on all loans – both performing and nonperforming
 - Reflects all interest accrued - both accrual and nonaccrual
- The recovery ratio equals:
 - Total collections of principal and interest during the 5 preceding years;
 - Divided by total principal and interest payments due during the current and 5 preceding years

Nonaccrued Interest (cont'd)

- Revenue Procedure 2007-33: Safe Harbor Election contd.
 - The recovery percentage multiplied by the total accrued interest earned but not collected at year end (both accrued and nonaccrued per books):
 - Equals the interest earned but not collected included in income during the current fiscal year
- Safe Harbor Election Issues
 - Financial institutions may not know the 5 year payments of principal due or collected
 - How to reconcile accumulated, recognized income to actual income
 - Are payments that become delinquent included in payments due every year, or just once?
 - How does the temporary difference reverse? How to apply subsequent payments on nonaccrual loans?

Nonaccrued Interest (cont'd)

- What about financial institutions that make neither the conformity election for bad debts nor the safe harbor election for nonaccrual interest?
 - Still under the transitional rule
 - MSSP guidance
 - Is the loan uncollectible or merely delinquent?
 - If uncollectible, then nonaccrual status is appropriate
 - If merely delinquent, then accrual should continue for tax purposes
 - Examples – lapse of time; partial charge-offs; sporadic payments; other loans are delinquent

Foreclosed Property

Formal Foreclosures

- Financial Reporting
 - Property is recorded at lower of book value of the loan or fair value of the property
 - Fair Value is net of projected costs – i.e. net realizable value
 - Costs to ready the property for sale
 - Completion or fix up costs
 - Possible environmental studies
 - Costs to sell – i.e. realtor's commissions and closing costs
 - Gain is not recognized

Foreclosed Property (cont'd)

Formal Foreclosures

- Tax Accounting
 - Foreclosure is a taxable "sale" of the loan
 - The property is recorded at fair market value
 - Fair market value of the property is presumed to be the bid price
 - Absent clear and convincing proof
 - Fair market value is the gross projected selling price for the property "as is"
 - Adjusted to contemplate the addition of completion or fix up costs
 - Not adjusted for projected costs to sell
 - Both gain and loss recognized

Foreclosed Property (cont'd)

Deed in Lieu of Foreclosure

- Book accounting is identical to foreclosure
 - Record the property at fair value
 - Recognize losses but not gains
- Tax accounting
 - A taxable disposition of the loan for the collateral
 - Proceeds equal the “fair market value” of the collateral (without recognizing disposition costs)
 - Both gain and loss are recognized

Foreclosed Property (cont'd)

In Substance Foreclosures

- The lender takes control of the collateral without formal ownership
- Book accounting is the same as for formal foreclosures
- No comparable tax concept
 - The loan remains outstanding
 - No tax event upon obtaining control – no gain/loss
 - Further charge-offs of the loan are deductible when the collateral is “written down” for book purposes
- Costs are either an additional loan or credit expense

Foreclosed Property (cont'd)

Post Foreclosure Accounting

- Financial reporting
 - Additional losses are recorded as declines in the fair value of the collateral are identified
- Tax reporting
 - Once the property is reduced to ownership, no further adjustments are made until the collateral is disposed of in a taxable transaction

Foreclosed Property (cont'd)

Post Foreclosure Accounting

- Is gain or loss on disposition of Other Real Estate ordinary or capital?
 - Revenue Ruling 75-159: Where property has not been operated or rented and is held for sale, gain or loss is ordinary
 - The MSSP states that gain and loss are ordinary
 - Effect of *Arkansas Best* decision if the property has been held for investment?

Accounting Method Update

Prepaid FDIC Premium

- Sept. 2009: Deposit Insurance Restoration Plan
 - DIF cash and marketable securities had declined from \$55 billion to \$22 billion
 - Plan required banks to prepay on Dec. 30, their estimated quarterly risk-based assessments for the 4th quarter of 2009, and all of 2010, 2011, and 2012
 - Estimated funding of \$45 billion
 - Prepayment to be offset on a quarterly basis
 - If not exhausted by December 31, 2014, excess refunded

Prepaid FDIC Premium (cont'd)

Applicable Law

- Section 461
 - Liability incurred and taken into account when fixed and determinable, and economic performance (payment) has occurred
- Section 263(a)
 - Reg. sec. 1.263(a)-4(d)(3) generally requires the capitalization of prepaid expenses where the benefit extends beyond the end of the tax year in which incurred
 - A prepaid expense is not required to be capitalized if the benefit does not extend beyond the earlier of 12 months from the date the benefit begins, and the end of the tax year following the year incurred. See Reg. sec. 1.263(a)-4(f)

Prepaid FDIC Premium (cont'd)

Application of Law

- Multi-year prepayment on Dec. 30, 2009, fixed the liability for all 3 years even though subject to contingent refund (See Rev. Rul. 2007-3)
- Economic performance requirement was satisfied for all 3 years by prepayment
- The benefit from the 2010 premium does not extend beyond the earlier of 12 months from the date the benefit begins or the end of 2010
- Does the separate invoice cause the 2010 liability to satisfy the 12-month rule?

Prepaid FDIC Premium (cont'd)

Example (1) of Reg. sec. 1.263(a)-4(f)(8)

On December 1, 2005, N corporation pays a \$10,000 insurance premium to obtain a property insurance policy (with no cash value) with a 1-year term that begins on February 1, 2006. The amount paid by N is a prepaid expense described in paragraph (d)(3) of this section and not paragraph (d)(2) of this section. Because the right or benefit attributable to the \$10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12-month rule provided by this paragraph (f) does not apply.

N must capitalize the \$10,000 payment.

Prepaid FDIC Premium (cont'd)

- Inquiry by American Bankers Association to IRS
- IRS
 - Declined to issue a formal ruling on the issue but made it clear that it will not permit financial institutions to apply the "12-month rule" to the FDIC prepayments
 - Based decision on FDIC's decision to present one invoice with 13 quarters of assessments listed
- Result:
 - 4th qtr 2009 allocation is deductible for 2009
 - Subsequent years deductions will be realized as obligation accrues
 - Book and tax treatment should be parallel

Credit Losses on Securities

- Debt Securities vs. Equity Securities
 - A credit loss on debt securities is a bad debt under IRC Section 582(a) and 166; not a loss under IRC Section 165
 - Section 582 does not apply to equities
 - The “credit loss” concept is not applicable to an equity security
- Is an OTTI charge-off a “credit loss” or a “market loss”?
 - If a credit loss, a deductible “bad debt” equal to the lesser of
 - (i) the “loss asset” or
 - (ii) the amount charged off
 - If a market loss, not deductible
- Most OTTI adjustments are probably a combination of both

Credit Losses on Securities (cont'd)

- Distinguish between a credit loss and a market loss
 - A credit loss is the amount of principal that the creditor is not expected to pay (the same analysis as for a loan)
 - Cash on cash comparison
 - The projected future cash flow can be reduced by the risk of it not materializing
 - The “bad debt” cannot include the loss of future income
 - Projected future cash flow cannot be present valued
 - A market loss is the amount that a third party is expected to be willing to pay the lender to purchase the security
 - A market loss will include a discount for the “yield” to the buyer based on the projected cash flow

Credit Losses on Securities (cont'd)

- Example:
 - Principal amount of security - \$5,000,000
 - Anticipated cash collections (principal and interest - \$4,000,000
 - Present value of the anticipated cash collections discounted at 5% compounded semi-annually - \$2,896,000
 - Book OTTI - \$2,104,000
 - Deductible bad debt - \$1,000,000

Credit Losses on Securities (cont'd)

- What if the financial institution has made the "conformity" election?
 - Consider charging the credit loss to the reserve for losses
 - Results in a charge-off to "conform with"
 - A subsequent increase in the bad debt should also be charged to the reserve, with offsetting "gain" assuming that the whole OTTI has not become larger
 - The financial institution will recognize and charge-off interest income on the "nonaccrual asset"
 - The financial institution will recognize part of the subsequent cash receipts as a recovery of nonaccrual interest under Revenue Ruling 2007-32

Credit Losses on Securities (cont'd)

- After the OTTI adjustment:
- Books – may or may not accrue 5% interest on \$2,896,000 depending upon the reliability of the cash flow and subsequent performance
- Tax – a nonaccrual asset
- Based on court decisions, the OTTI adjustment should be a charge-off; the asset is removed from the books
- If the credit loss is determined later to be larger, another bad debt should be deductible based on the \$2,104,000 charge-off that was not deducted

Losses on Trust Preferred Investments

- Many banks have invested in Trust Preferred Securities, which are now in “deferral” and also have serious OTTI impairments
 - Most bank purchases have been offerings from trust preferred pools assembled by investment banks
- Are the Trust Preferreds debt or equity securities?
 - If a debt security, can the investor determine the amount of the credit loss?
- The pools commonly have a four layer structure

Losses on Trust Preferred Investments (cont'd)

- The “equity” element is between the Sub-Trusts and the Pool
 - The Sub -Trusts issue Capital Securities to the Pool
- The “loan” from the Sub-Trust to the issuer is debt, and gain on forgiveness of it might be eligible for deferral
- The “notes” issued by the Pool to the Investors should also be debt
 - If so, partial worthlessness should be a bad debt

Losses on Trust Preferred Investments (cont'd)

- CCA 200932049 (Chief Counsel Advice)
 - Facts considered by IRS
 - BHC creates grantor trust; contributes funds in exchange for trust's common securities
 - Trust sells preferred securities (“TPS”) to public and invests proceeds in unsecured junior sub notes issued by BHC
 - Rate of interest on BHC pays trust equals rate on TPS
 - TPS are considered capital for regulatory purposes and BHC sub notes are treated as debt for tax

Losses on Trust Preferred Investments (cont'd)

- **IRS Analysis**
 - Notice 94-47 – 8 factor test for debt vs equity analysis
 - TPS reviewed had many factors favoring equity treatment
 - Extended term to maturity
 - Option to defer interest payments
 - BHC's strong financial position was decisive factor
 - Well capitalized and strong dividend history
 - Debt to equity ratio within industry norms
 - Sufficient facts to justify assertion interest payments would not be deferred
 - IRS characterized TPS as debt for tax purposes
 - Debt treatment not guaranteed
 - Current economic conditions warrant close review of facts and circumstances

Tax Litigation and IRS Update

Tax Litigation

- **Seventh Circuit Reverses Tax Court, Holds Interest Incurred by QSub Bank Not Subject to §291(a)(3) Cutback**
 - In, *Vainisi v. Comm’r*, 599 F.3d 567 (7th Cir., 2010), rev’g, 132 TC No. 1 (2009), the Seventh Circuit held that the Vainisis, owners of an S corporation holding company (“Holdco”) that owned all of the stock of First Forest Park National Bank (FFP), a QSub national bank, were not subject to the 20% interest expense limitation of §291(a)(3), for tax years following the third tax year after Holdco converted from C to S status.

Tax Litigation (cont’d)

- *PSB Holdings v Commissioner*
 - Investment Management Company case –
 - Tax Court decision for the Taxpayer
 - Investment subsidiaries will be honored as separate corporations for purposes of calculating the Section 265(b) interest disallowance
 - The Service did not appeal
 - Amended returns are being filed and paid

Tax Litigation (cont'd)

- *Capital One v. Commissioner*
 - Credit card exchange fees earned may be deferred and recognized as OID
 - Decision for the taxpayer
 - The more major lesson for community banks is that Capital One won the issue but lost the case because they had not obtained a proper change of accounting method

Reporting of Uncertain Tax Positions

- Reporting of Uncertain Tax Positions
 - Announcement 2010-9 (as clarified by Announcement 2010-17) IRS considering requiring certain business taxpayers to disclose their uncertain tax positions with respect to their U.S. federal income tax liability on a schedule that would be attached to their Form 1120 U.S. CIT return, or other return.
 - Focus examination resources on issues of particular interest or of sufficient magnitude
 - Quick and efficient identification of issues

Reporting of Uncertain Tax Positions (cont'd)

- Schedule would require a concise description of each uncertain tax position and for which the taxpayer has recorded a reserve
 - Report all federal income tax positions except those for which the taxpayer has concluded, after applying the two-step process, that are more likely than not to be 100-percent sustained.
 - In addition, taxpayer will be required to report any position for which it or a related entity has not recorded a reserve either because the taxpayer expects to litigate the position (and prevail) or because the taxpayer has determined that the IRS has a general administrative practice not to examine the position (e.g., because of materiality threshold).

Reporting of Uncertain Tax Positions (cont'd)

- Description must include, *inter alia*:
 - The rationale for the position
 - General statement of the reasons that the position is an uncertain tax position.
 - Description of the Code sections implicated
 - Taxable years to which it relates.
 - Schedule will require the taxpayer to disclose the maximum amount of potential federal tax liability attributable to each uncertain tax position, determined without regard to the taxpayer's risk analysis regarding the likelihood of prevailing on the merits.

Reporting of Uncertain Tax Positions (cont'd)

- Proposed regulations (Issued September 7, 2010)
 - Officially authorizes the IRS to require corporations to file a Schedule UTP reporting uncertain tax positions consistent with the forms, instructions, and other appropriate guidance as provided by the IRS.
 - Hearing scheduled for October 10
 - IRS intends to implement its authority by
 - Issuing a schedule and explanatory publication requiring corporations that prepare audited financial statements to file a schedule identifying and describing the uncertain tax positions—as described in FIN 48 and other generally accepted accounting standards (including International Financial Reporting Standards and country-specific generally accepted accounting standards)—that relate to the tax liability reported on the return.

Reporting of Uncertain Tax Positions (cont'd)

- Observations and planning
 - Companies may want to consider proactively resolving potential issues with the IRS
 - IRS Pre-Filing Agreement (PFA) program
 - affords taxpayers greater certainty around their transactions and issues
 - Compliance Assurance Program (CAP)
 - IRS essentially signs off on key tax positions to be taken by a taxpayer before it files its tax returns
 - An item that is agreed in advance with the IRS is, by definition, not uncertain, and therefore would reduce the number of reportable uncertain tax positions

Bank Owned Life Insurance

- **Notice 2009-48**
 - Guidance on employer owned life insurance contracts:
 - What contracts are covered
 - How exceptions apply
 - Notice and consent requirements
 - Requires employers to treat death benefits as taxable income for contracts issued after Aug. 17, 2006 unless the notice and consent provisions are met PRIOR to the policy being issued or substantially modified.
 - The consent from the insured employee is secured on Form 8925 which is then attached to the employer's tax return.

M&A and Expansion

FDIC - Overview

- The number of failing institutions and continued economic conditions have increased interest in the implications of FDIC-Assisted Transactions
- The FDIC resolution process includes receipt of a Failing Bank Letter and a team of specialists to complete an information package
- After an asset valuation review, the appropriate structure is chosen and an on-site analysis is performed including an asset valuation review
- The FDIC will utilize one of three resolution models:
 - Purchase and Assumption Transaction (P&A)
 - Deposit Payoffs
 - Open Bank Assistance Transactions

Purchase & Assumption (P&A) Transactions

- Most commonly used FDIC resolution method
- Occurs when a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities
- P&As vary depending on assets and liabilities acquired and other factors
 - P&A types can include basic, modified, loan purchase, whole bank, with asset pools and loss sharing

Loss Share Transaction

- Asset acquired include:
 - Virtually all of the bank's assets
 - Option to purchase fixed assets at fair market value
- +
 - Deposit Franchise
 - Substantial asset loss coverage from FDIC
- - Less: Liabilities assumed:
 - Secured liabilities, deposits assumed, unsecured liabilities (if assumed)
- =
 - Equals: FDIC payments to cover difference between liabilities assumed and assets acquired
- =
 - The bid in such a transaction would include 3 components:
 1. Types of liabilities to be acquired
 2. Franchise value bid, submitted as a percentage of deposits
 3. Asset premium (discount) submitted as a dollar amount

P&A Transactions with Loss Share – Potential Tax Implications

- Potential Tax Issues related to P&A transactions with optional loan pools include:
 - Treatment of FDIC cash payment to cover difference between liabilities assumed and assets acquired – IRC Section 597
 - Treatment of Loss Guarantee – IRC Section 597
 - Tax basis of assets acquired
 - Determination of highest guaranteed value
 - Tax consequences if purchase price is less than tax basis of Class I and Class II assets
 - Consideration of specific facts/terms of transaction:
 - Clawback provision
 - Equity appreciation instrument

P&A Transaction with Loss Share – Potential Tax Implications

- Post Day 2 Tax Issues to be addressed:
 - Foreclosure of Property
 - Other Real Estate
 - Market Discount – IRC Sections 1276-1278
 - Nonaccrual Interest – IRC Section 446 and *European American Bank and Trust Company v. United States*
 - Payment Ordering Rules – IRC Section 446
 - Bad Debt Deductions – IRC Section 166

Purchase of Failed Bank's Assets

- Example
 - Purchase price is the sum of:
 - Cash paid, usually zero
 - Buyer's capitalized transaction costs
 - Expensed on the books under FAS 141R
 - Capitalized into the purchase price for tax purposes unless *de minimis under the Sec. 263(a) Regulations*.
 - Liabilities assumed at the closing [i.e. at least the insured deposits, often all of the failed bank's liabilities]

Purchase of Failed Bank's Assets

- **Book allocation among the assets acquired**
 - Record all of the assets acquired, including loans, at fair market value
 - Record the receivable from the FDIC under the loss sharing agreement at estimated collections
 - If the agreement with the FDIC indicates a value for the core deposit intangible, normally recorded as an identified intangible
 - If the assets exceed the purchase price, the excess is negative goodwill recognized in income
 - Not taxable but a temporary difference

Purchase of Failed Bank's Assets

- **Tax allocation among the assets acquired:**
 - Class I – cash, including both the failed bank's cash and due from banks at the closing and cash from the FDIC to balance the closing entry
 - Class II – US Gov't and tax exempt securities and accrued interest on securities
 - Class III – Loans, and accrued interest on loans
 - Class IV – Inventory [banks seldom have any]
 - Class V – All other tangible assets, including prepaid expenses and OREO

Purchase of Failed Bank's Assets

- Tax allocation among the assets acquired:
 - If the sum of Classes I through 5 *exceed the tax* purchase price:
 - Reduce the Class V assets to the extent practical, principally OREO
 - As a practical solution, the balance usually reduces one or more categories of loans even though they are Class III
 - If the sum is *less than the purchase price*:
 - Record core deposit value up to the book value – Class VI
 - The balance is goodwill – Class VII

QUESTIONS?



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