FINANCIAL INSTITUTIONS ACCOUNTING AND TAX UPDATE

Key 2022 year-end accounting and tax issues for financial institutions

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Agenda

- Introduction and overview
- Industry economic update
- Accounting update
- Tax update
- Q&A

INDUSTRY
ECONOMIC UPDATE

US economy: Growth, inflation and geopolitical tensions

Economic themes

- Growth slowing
- Hiring remains strong but moderating; capital expenditure boom possible after recession
- Inflation becoming sticky; rising interest rates
- Fed rate increases to continue, include balance sheet runoff

Core economic fundamentals

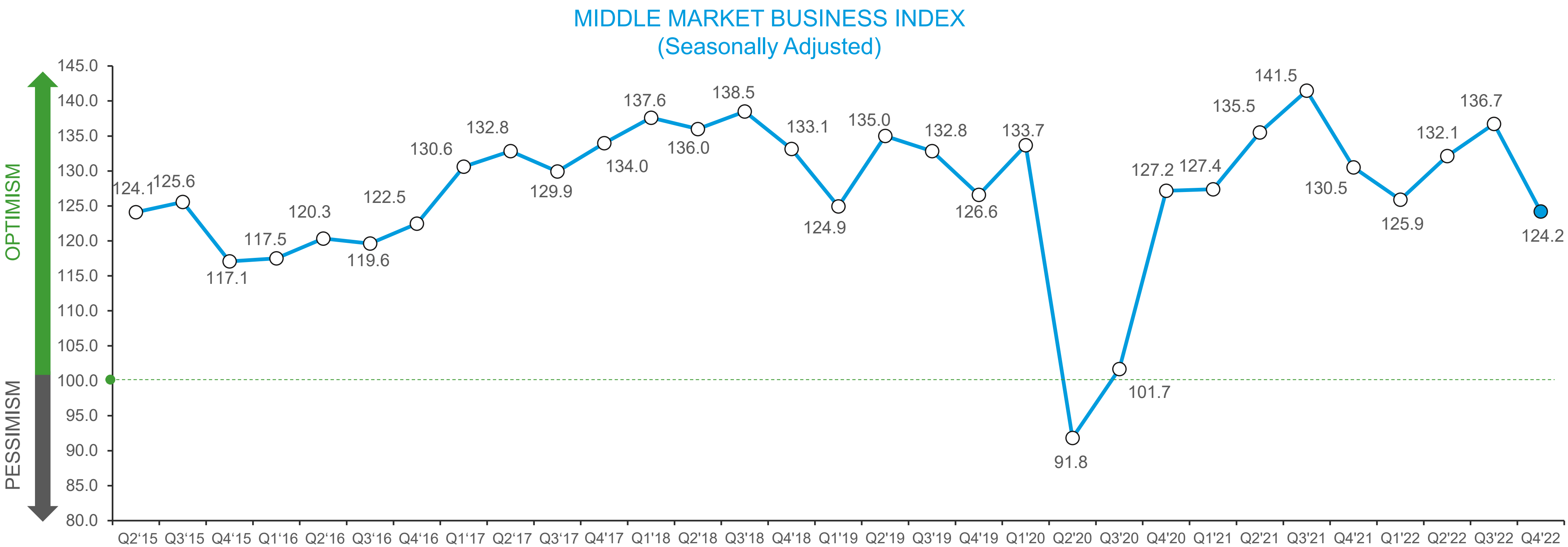
- Unemployment to increase to 3.8% by end of 2022; 4.6% 2023
- $1.4 trillion in excess savings versus pre-pandemic (down from more than $2 in July)
- Low unemployment, strong household balance sheets
- Steady corporate profits, low debt

Stubborn inflation

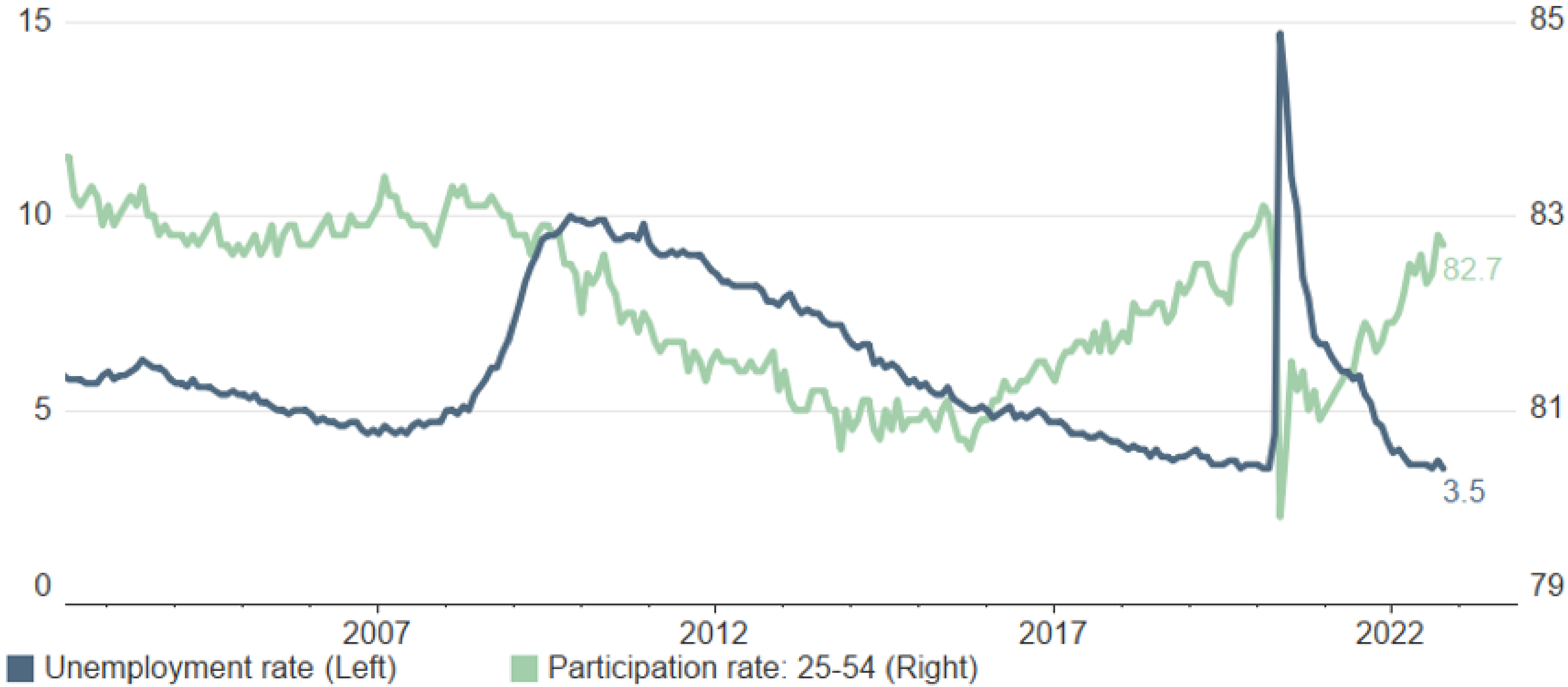
- Supply chain constraints will last into 2023
- Core inflation remains sticky, while top line all-items inflation will fall markedly
- Wage pressures at lower end of income ladder

Source: RSM US LLP

RSM's Middle Market Business Index… recession looming

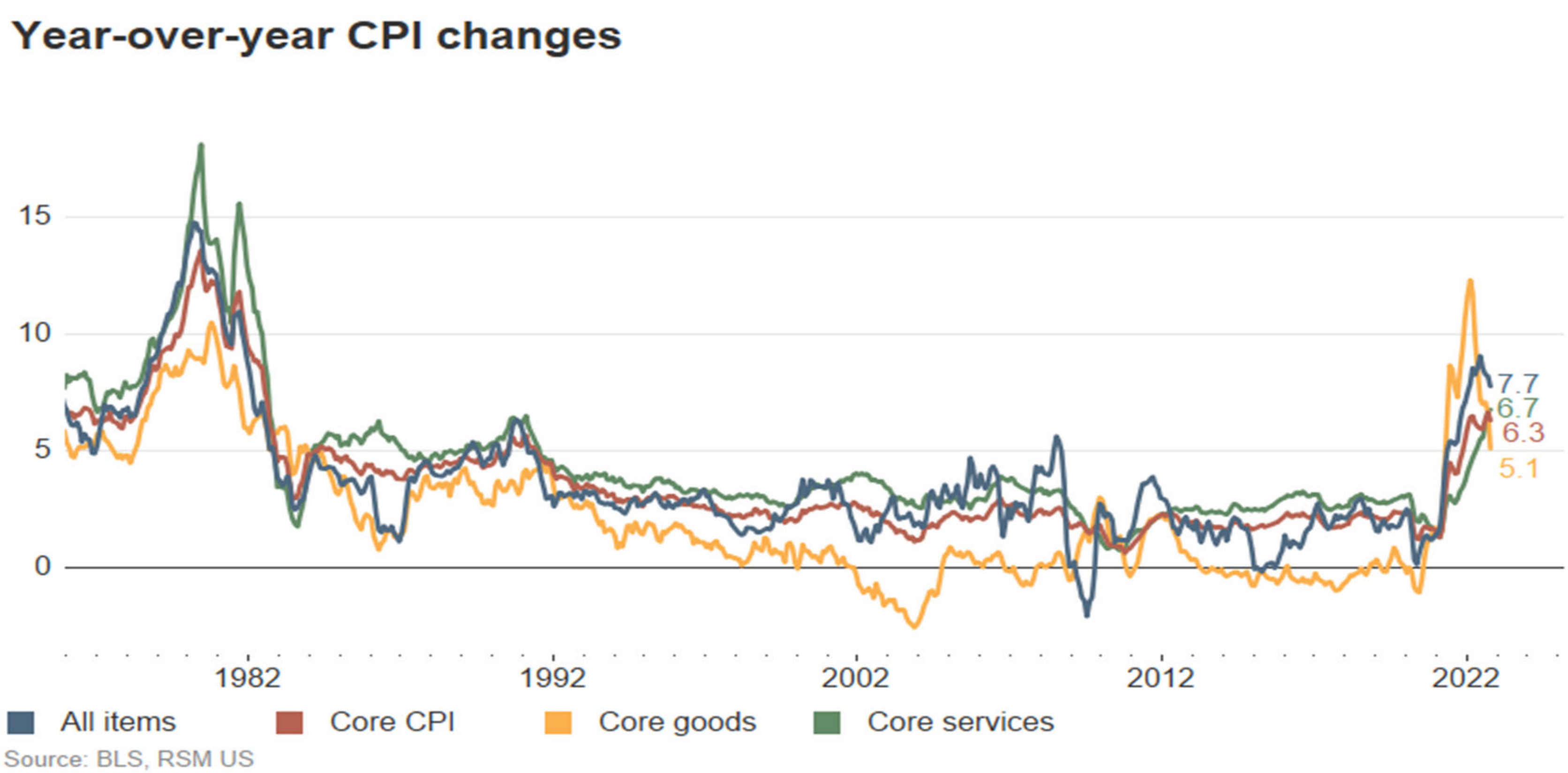


Unemployment and participation rates for prime-age labor (25-54)

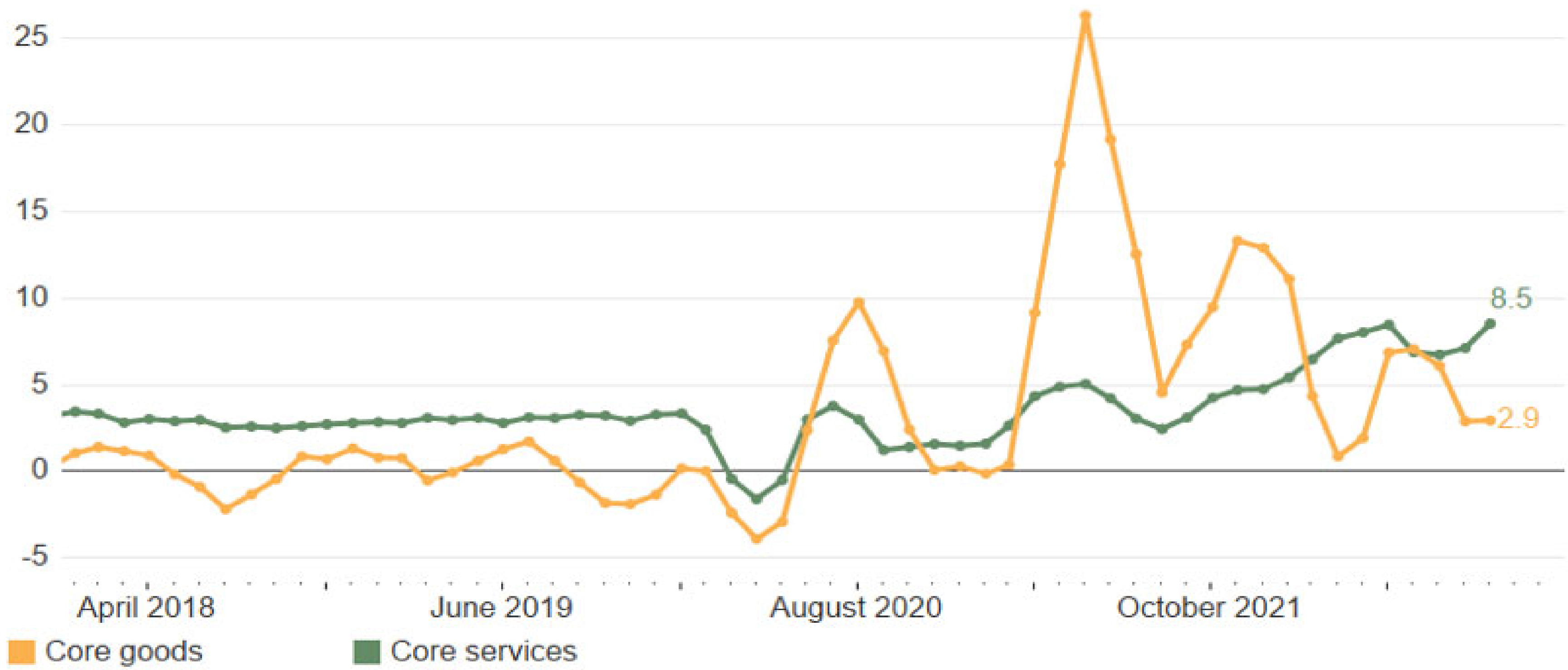


Source: BLS, RSM US

Year-over-year CPI changes

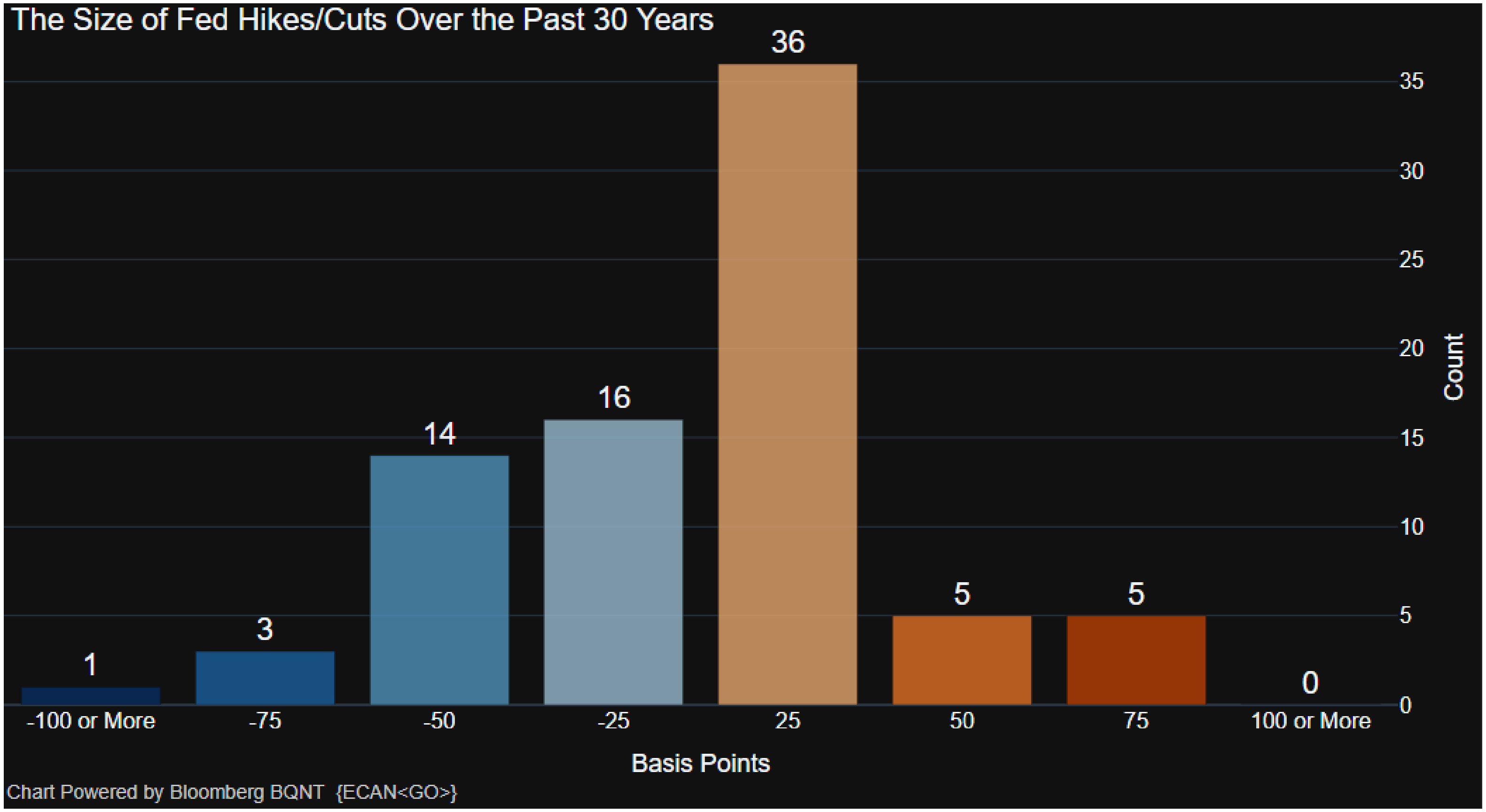


Core goods and services monthly CPI changes, annualized

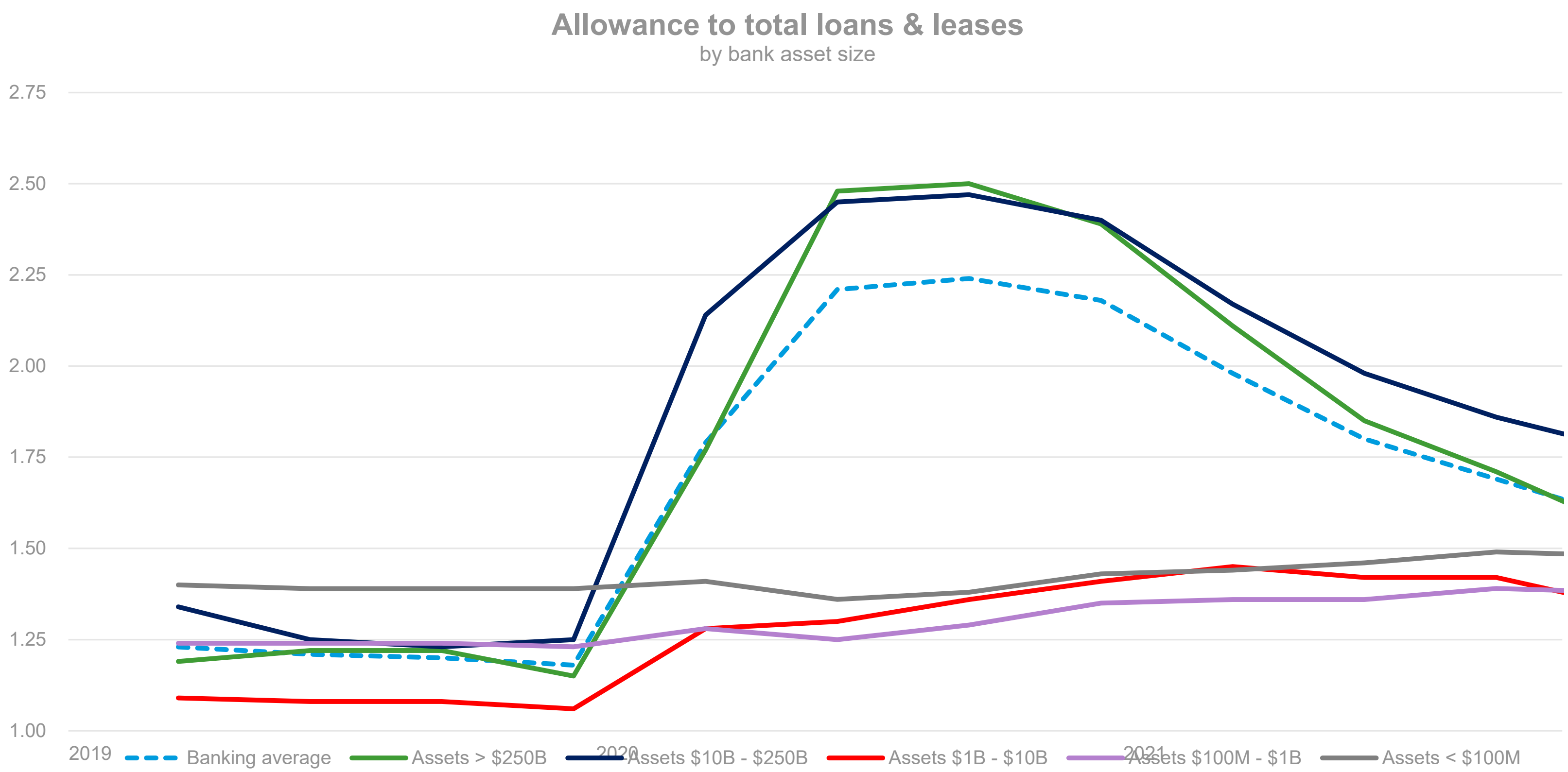


Source: BLS, RSM US

Previous rate change decisions



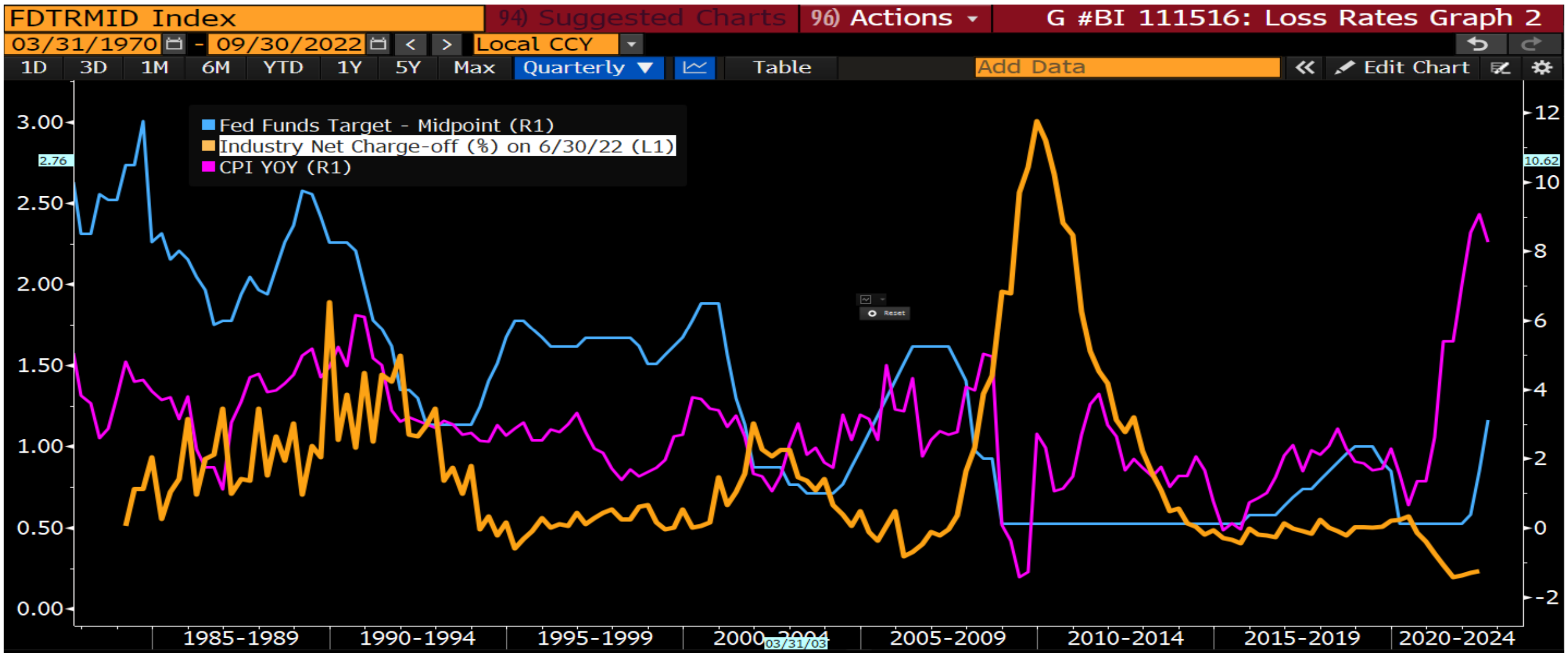
Allowance ratios



Source: FDIC; RSM US

Record low bad debt – could normalize

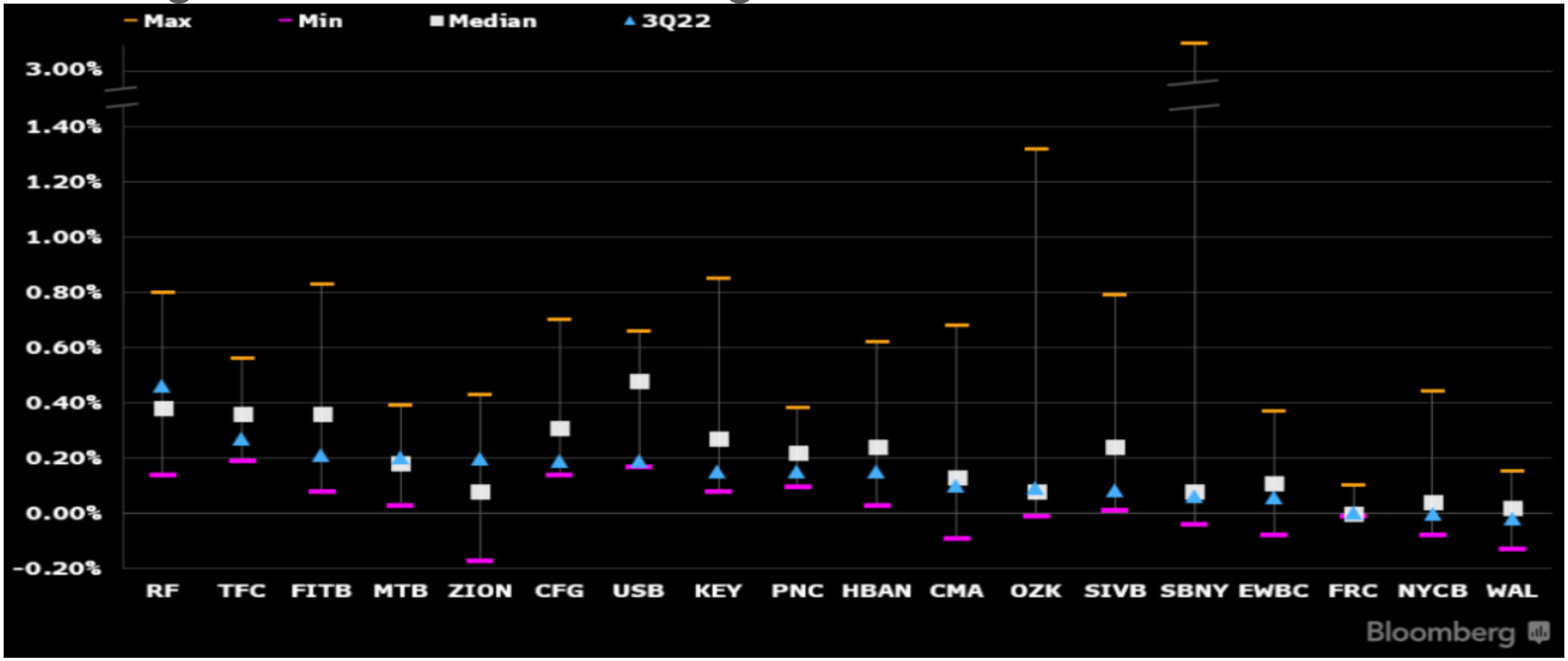
- Fed Funds Rate vs. Charge-offs vs. CPI



Source: Bloomberg

Loan charge-off rates bounce off cycle lows

- Net charge-offs: Q1 2014 through Q3 2022



Source: Bloomberg

Leveraged loan price index

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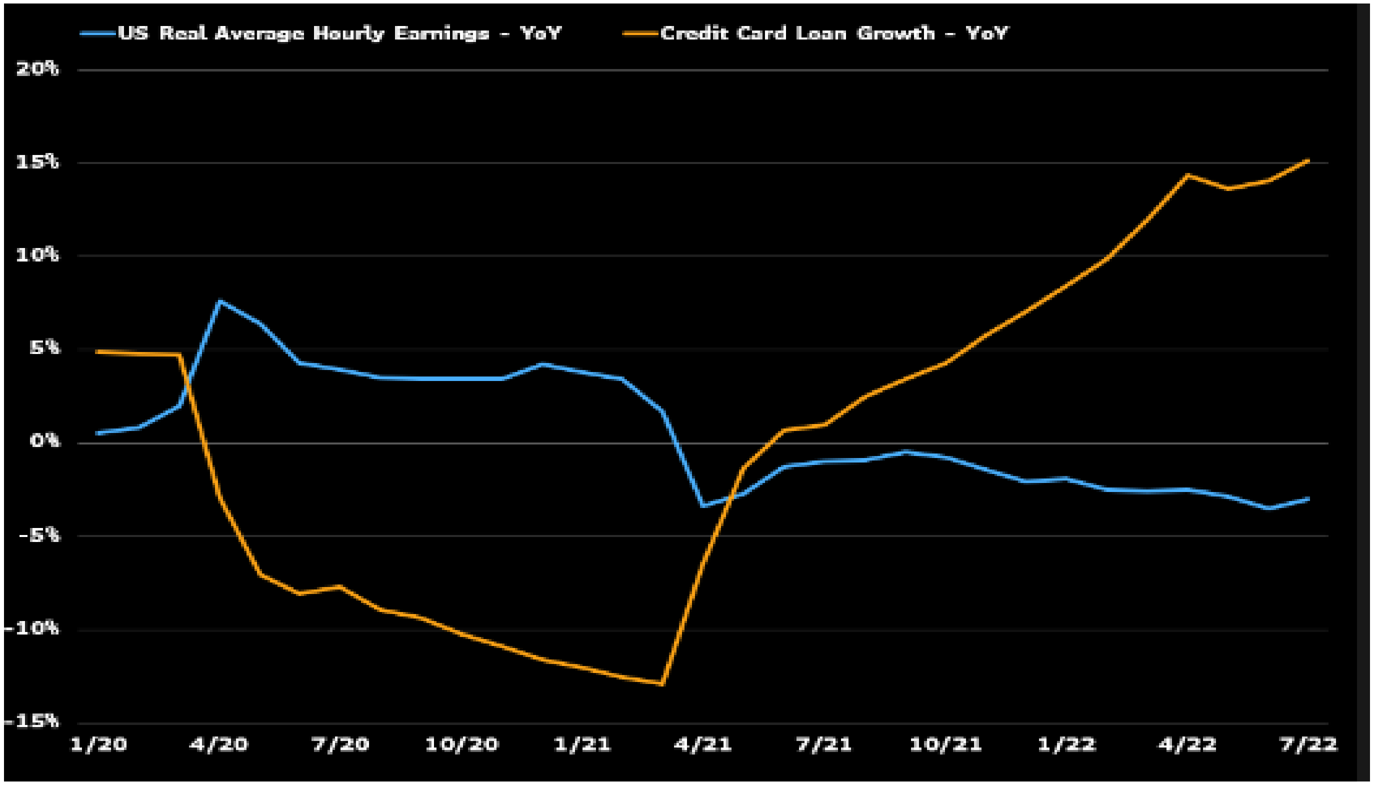
Watching the consumer as conditions continue to tighten

- Real wage growth vs. Credit card growth



ACCOUNTING UPDATE

ACCOUNTING UPDATE: ASU 2022-02

Troubled Debt Restructurings and Vintage Disclosures

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ASU 2022-02: TDR recognition and measurement guidance

- TDRs will no longer exist
- Account for all modifications in accordance with ASC 310-20, requiring determination at modification if a modification represents a new loan or a continuation of an existing loan
  - A modification would represent a new loan:
    - If the terms of the modification are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risk; and
    - The modification of the terms of the original loan are more than minor (i.e., if the present value of the cash flows after modification are at least 10% different than under the original receivable)

ASU 2022-02: Modification-related disclosures

- Expansion of certain existing disclosures and new disclosure requirements
  - Examples include types of modifications and financial effect, subsequent receivable performance and how factored into the allowance
- To include all certain modifications to borrowers experiencing financial difficulty (types of modifications listed on next slide)
  - Guidance to determine if a borrower is experiencing financial difficulty is the same as it was under TDR guidance

REFER TO ASU 2022-02 FOR COMPLETE DISCUSSION

ASU 2022-02 modification

- Modifications requiring disclosure include:

Principal forgiveness → Reduced interest rate → Other-than-insignificant payment delay → Extended term

Note: Covenant waivers and modifications of contingent acceleration clauses are not considered term extensions

ASU 2022-02 modification-related disclosures - Example

Loan Modifications Made to Borrowers Experiencing Financial Difficulty

	Interest Rate Reduction	
	Amortized Cost Basis at 12/31/20X1	**% of Total Class of Financing Receivable**
Loan Type		
Real Estate—Commercial	$ 40,000	2.0%
Real Estate—Residential	-	0.0
Consumer	10,000	0.2
Total	**$ 50,000**	

	Term Extension	
	Amortized Cost Basis at 12/31/20X1	**% of Total Class of Financing Receivable**
Loan Type		
Real Estate—Commercial	$ -	0.0%
Real Estate—Residential	-	0.0
Consumer	22,000	0.4
Total	**$ 22,000**	

ASU 2022-02 modification-related disclosures – Combination example

	Combination—Term Extension and Interest Rate Reduction	
	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Loan Type		
Real Estate—Commercial	$ -	0.0%
Real Estate—Residential	5,000	0.8
Consumer	-	0.0
Total	**$ 5,000**	

ASU 2022-02 modification-related disclosures – Impact example

Interest Rate Reduction

Loan Type	Financial Effect
Real Estate—Commercial	Reduced weighted-average contractual interest rate from 6% to 3%.
Real Estate—Residential	Reduced weighted-average contractual interest rate from 8% to 5%.
Consumer	Reduced weighted-average contractual interest rate from 4% to 1.5%.

Term Extension

Loan Type	Financial Effect
Real Estate—Residential	Added a weighted-average 2.4 years to the life of loans, which reduced monthly payment amounts for the borrowers.
Consumer	Provided six-month payment deferrals to borrowers through our standard deferral program. The six monthly payments were added to the end of the original loan terms of these borrowers.

ASU 2022-02: Vintage disclosures

- Only applicable to public business entities
- Required to disclose current-period gross charge-offs by year of origination (not recoveries)

	Term Loans Amortized Cost Basis by Origination Year								
As of December 31, 20X5	20X5	20X4	20X3	20X2	20X1	Prior	Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term Loans Amortized Cost Basis	Total
Residential mortgage:									
Risk rating:									
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total residential mortgage loans	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Residential mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

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ACCOUNTING UPDATE: AVAILABLE-FOR-SALE DEBT SECURITIES

ASC 326-30

AFS debt securities under ASC 326-30

- Continues to apply to individual securities with fair value less than amortized cost basis
- Recognize credit losses through an allowance (not a direct write down) when one of the following applies:
  1. The entity intends to sell the security;
  2. More likely than not would be required to sell it before it recovered; or
  3. The entity does not expect to recover the amortized cost basis
     - Revisions to criteria allowed to consider on next slides
- Once an allowance has been recorded, favorable and unfavorable changes in expected cash flows are recognized immediately through an adjustment to the allowance and credit loss expense

Amended considerations in determining if a credit loss exists

The ~~length of time and~~ extent to which fair value is < amortized cost	Adverse conditions related to the security (e.g., deterioration in issuers or underlying obligors' financial condition, deterioration in collateral values), industry or geographic area	~~**Historical and implied fair value volatility**~~	Payment structure and ability of issuer being able to make payments that increase in the future
Failure of the issuer to make scheduled payments	Changes in the rating of the security	~~**Post balance sheet recoveries or additional declines in fair value**~~	Other

Expected that loss recognition may be accelerated.

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ACCOUNTING UPDATE

Other ASC 326 matters

FASB project updates – PCD financial assets

February 2022

FASB undertakes project to explore adjustments to accounting for PCD financial assets

October 2022

FASB makes certain tentative decisions

1) PCD financial assets concepts will now apply to “purchased financial assets” (PFA)

2) Seasoning principles based, with bright line of 90 days

3) HELOCs, credit cards, trade AR in scope

Future

FASB to continue deliberations at future meetings

Resources

- RSM Thought Leadership
  - Financial Reporting Resource Center: Financial Institutions
    - http://rsmus.com/what-we-do/services/assurance/financial-reporting-resource-center/financial-reporting-resource-center-financial-institutions.html

    (navigate to Topic -> CECL)
    - Includes links to white papers and other resources
      - Implementation and audit readiness for lenders ASC-326
- FASB Accounting Standards Update
  - https://fasb.org/jsp/FASB/Page/SectionPage&cid=1176156316498
  - Lists Accounting Standards Updates Issued by year
- Interagency Joint Statements on CECL
  - https://www.fdic.gov/news/financial-institution-letters/2020/fil20054.html
  - See Related Topics section as bottom for links to series of joint statements

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ACCOUNTING UPDATE: CRYPTOCURRENCY

Troubled Debt Restructurings and Vintage Disclosures

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Crypto-assets safeguarding

- SEC Staff Accounting Bulletin No. 121 released effective April 11, 2022
  - If an entity is responsible for safeguarding the crypto-assets held for its platform users, including maintaining the cryptographic key information necessary to access the crypto-assets, the entity should present a liability on its balance sheet to reflect its obligation to safeguard the crypto-assets held for its platform users
  - The SEC staff believes it would be appropriate to measure this safeguarding liability at initial recognition and each reporting date at the fair value of the crypto-assets the entity is responsible for holding for its platform users
- The AICPA has published an FAQ related to SAB 121 as Appendix B to the Accounting for and Auditing of Digital Assets practice aid
- FASB has agreed to include a project on accounting for and disclosure of crypto assets on its agenda

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FASB project updates - Crypto assets

- Existing model is that crypto assets are treated as intangible assets (recorded at cost, subsequent write-downs for impairment)
- At the October 2022 FASB meeting, FASB concluded that crypto assets should be measured at fair value (ASC 820)
  - Subsequent increases and decreases in fair value would be recorded in comprehensive income
  - Certain costs to acquire crypto assets (e.g., commissions) expensed as incurred
- Presentation and disclosure to be discussed at later meeting
- Keep an eye out for further updates and a formal exposure draft

TAX UPDATE

Introduction

- Agenda
  - Inflation Reduction Act of 2022
  - Miscellaneous tax updates on previous tax legislation
  - Current legislative climate
    - Possible tax legislation
  - State tax matters

Inflation Reduction Act of 2022 - Tax update

- Tax provisions
  - Excise Tax on repurchases of corporate Stock
    - Imposes 1% excise tax on the repurchase of corporate stock based upon the fair market value of the stock
  - Corporate alternative minimum tax
    - Impose 15% tax on the “adjusted financial statement income” of certain corporations and corporate groups that meet a $1 billion average annual adjusted financial statement income test- based on a 3-year average
    - Very limited applicability to most community banks –
    - May have impact on the larger regional banks
  - Energy credit incentives – ability to sell credits on open market
  - $80 billion in funding for the IRS

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Inflation Reduction Act of 2022 - Tax update (cont.)

- Stock Buy-Backs
  - 1% excise tax on stock repurchases
  - Applies to stock purchased after December 31, 2022
  - Not an income tax - most likely will be capitalized to treasury stock for GAAP purposes
  - Nondeductible for tax purposes
  - Taxable repurchases are reduced by the FMV of any new shares issued during the year, including stock option exercises
  - Excise tax generally does not apply if < $1 million in FMV of stock is purchased in a year

Inflation Reduction Act of 2022 - Tax update (cont.)

- Stock Buy-Backs (cont.)
  - There are several exceptions to the excise tax, including:
    - Where the buyback is part of a tax-free reorganization where no gain or loss is recognized
    - Where the repurchased stock or its value is then contributed to an employee pension plan, ESOP or similar plan
    - Where the total value of the stock buyback during the year does not exceed $1 million
    - Where the purchaser is a dealer in securities in the ordinary course of business
    - Where the purchaser is a RIC or REIT
    - Where the buyback is treated as a dividend

Inflation Reduction Act of 2022 - Tax update (cont.)

- Stock Buy-Backs (cont.)
  - “Stock” is not defined currently in the bill. Thus, for now we must assume that this includes all stock (i.e. common, preferred, etc.).
  - “Established Securities Market” is broadly defined and generally includes:
    - A national securities exchange (under section 6 of the Securities Exchange Act of 1934)
    - A national securities exchange exempt from registration due to low volume of trades
    - A foreign securities exchange which satisfies regulatory requirements in the local jurisdiction similar to the 1934 Act
    - A regional or local exchange
    - An interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers
  - “Repurchase” may include leveraged buyout transactions and / or other constructive redemptions.
  - The tax is assessed on the “Fair Market Value” of the stock repurchased. However, no guidance has been provided as to when such FMV should be determined.

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Inflation Reduction Act of 2022 - Tax update (cont.)

- Corporate alternative minimum tax
  - The corporate alternative minimum tax would impose a 15% tax on the "adjusted financial statement income" of certain corporations and corporate groups that meet a $1 billion average annual adjusted financial statement income test- based on a 3-year average).
  - The limit is reduced to 100 million in the case of foreign-parented corporations.
  - This test is computed upon the net income or loss provided on a taxpayer's financial statement with certain adjustments.
  - Limited exceptions – certain corporations that are involved in certain manufacturing and as well as corporate subsidiaries of private equity firms.
- Effective for years beginning after 2022

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Inflation Reduction Act of 2022 - Tax update (cont.)

- The "Inflation Reduction Act includes an $80 billion appropriation in additional IRS funding that is projected to increase federal tax receipts by $204 billion over 10 years.
  - Potential to hire over 87,000 employees
  - The Act appropriates an increase in IRS funding over 10 years as follows:
    - $45.6 billion for enforcement activities, including: determining and collecting owed taxes, providing legal and litigation support, conducting criminal investigations (including investigative technology), providing digital asset monitoring and compliance activities, and enforcing criminal statutes related to violations of internal revenue laws and other financial crimes
    - $25.3 billion for operations support for taxpayer services and enforcement programs, including information technology development, enhancement, operations, maintenance, and security
    - $4.8 billion for business systems modernization, including development of callback technology and other technology to provide a more personalized customer service
    - $3.2 billion for taxpayer services, including pre-filing assistance and education, filing and account services, and taxpayer advocacy services

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Inflation Reduction Act of 2022 - Tax update (cont.)

- Notable Items that were missing from the 2022 tax legislation
  - No corporate tax rate increase (21% to 28%)
  - No individual income tax rate increase
  - No SALT relief (i.e., $10K state & local tax deduction cap)
  - No expanded information reporting for banks

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Miscellaneous tax updates on previous tax legislation

- The Tax Cuts and Jobs Act (“TCJA”), The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) and the Families First Coronavirus Response Act (FFCRA),), all enacted in prior years, provided for several benefits to financial institutions. For the 2022 tax compliance season, we’d like to highlight some lingering tax provisions of interest to financial institutions:
  - The 80% NOL carry-forward limitation is back for 2021/2022 (The CARES Act)
  - Update for 2022:
    - The 80% limitation on utilization of NOL carry-forwards, temporarily suspended by the Cares Act, was reinstated for 2021 (and forward)
    - Losses generated in 2021 (and forward) will continue to have no expiration period

Miscellaneous tax updates on previous tax legislation (cont.)

- IRC 163(j) Interest Expense Limitations: The CARES Act provided for certain changes to interest expense limitations under IRC 163(j) for 2020
  - Favorable increase to the inclusion of Adjusted Taxable Income ("ATI") from 30 to 50% in the computation of interest expense limitations
  - Favorable changes to the definition of "interest expense"
  - Generally, not applicable to the banking industry
- Update for 2022:
  - Add-back of Depreciation & Amortization expenses no longer allowed in the computation of ATI for 2022
  - ATI is multiplied by 30% (instead of 50%) when computing interest expense limitation

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Miscellaneous tax updates on previous tax legislation (cont.)

- Employee Retention Credit – Cares Act
- The ERC is a refundable payroll tax credit claimed quarterly on Form 941.
- The partial or total government-ordered shutdown or the applicable decline in gross receipts tests still apply (decreased to 20% from 50% in 2021).
- The definition of a “large employer” changed from 100 to 500 employees in 2021.
- For wages paid between March 13 and December 31, 2020, employers who qualify may claim a credit for 50% of wages paid, capped at $10,000 per employee annually. The limitation on taxpayers who obtained PPP loans was retroactively removed (however, wages used for PPP loan forgiveness cannot be used for the ERC credit).
- For wages paid between January 1, 2021, and September 30, 2021, the available credit was increased to 70% of wages paid, generally capped at $7,000 per employee **per quarter**.
- The statute of limitations was extended from 3 to 5 years for any credits claimed in Q3 of ’21. Wages used in Q3 of ‘21 for (i) PPP loan forgiveness, (ii) the shuttered venue operators grant or (iii) the restaurant revitalization grant cannot also be used for ERTC purposes.
- Note – generally the IRS requires an amended return for the respective year the 941 is amended.
  - Filing an amended tax return is still a viable option to get this credit

Miscellaneous tax updates on previous tax legislation (cont.)

- Calendar year companies are now **required to capitalize certain** research and experimental expenditures under section 174. The capitalization requirement, included as part of the Tax Cuts and Jobs Act (TCJA), is effective for tax years beginning after December 31, 2021.
- Section 174 requires that companies capitalize and amortize domestic research and experimental expenditures over five years and foreign expenditures over 15 years.
- In addition to requiring capitalization, the TCJA also codified that self-developed software costs are now section 174 expenditures.
  - Prior to the TJCA, the IRS had indicated in Rev. Proc. 2000-50 that such costs so closely resembled research and experimental costs to warrant similar treatment but had not specifically required companies to treat such costs section 174 costs.
- Federal legislation has previously been proposed and may be considered in the future to either delay the onset of, or fully repeal, the new section 174 capitalization rules.
- While there has been ample time since the enactment of TCJA for most states to fully conform to the treatment of R&D expenses under section 174 for the 2022 tax year, there are some states that still do not conform to these provisions of the TCJA (e.g., California and Wisconsin).

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Miscellaneous tax updates on previous tax legislation (cont.)

- Tax Cuts and Jobs Act (TCJA), other sunset provisions of interest:
  - Bonus Depreciation – begins to phase out after 2022:
    - 100% in 2022
    - 80% in 2023
    - 60% in 2024
    - 40% in 2025
    - 20% in 2026
    - 0% after 2026…
  - Individual tax rates are set to sunset after 2025
    - Highest individual tax rates to revert to 2017 levels in 2026 – highest rate 39.6% (from current 37%)
    - Indexed to inflation (i.e., impact on tax brackets)
  - Other items set to sunset after 2025
    - SALT cap of $10,000
    - Reduction to standard deduction (cut by almost half)
    - Reduction in child tax credit
    - Elimination of Section 199A – 20% qualified business income deduction (QBI) for pass-through entities

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Miscellaneous tax updates on previous tax legislation (cont.)

- Tax Cuts and Jobs Act (TCJA), other sunset provisions of interest (cont.):
  - Lifetime gift exemption – will sunset for years beginning January 1st, 2026 – to approximately $6.4 million per person ($12.8 for a married couple)
  - Currently in 2023 - $ 12.92 million per person ($25.84 for a married couple).

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Miscellaneous tax updates on previous tax legislation (cont.)

- Taxpayer Certainty and Disaster Tax Relief updated
  - Extended the Work Opportunity Tax Credit for five years (through 12/31/25)
    - The WOTC is a federal income tax credit ranging from $2,400 to $9,600 for each qualified newly hired employee.
  - Extended the New Markets Tax Credit for five years (through 12/31/25)
    - The NMTC program was created to encourage investment in low-income communities (LICs) and grow businesses, create jobs and sustain healthy local economies through federal tax incentives.

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Miscellaneous tax updates on previous tax legislation (cont.)

- American Rescue Plan Act" – tax update
  - Signed into law on March 11, 2021:
    - Changed and expanded the definition of "covered employees" under IRC 162(m)
    - Section 162(m) generally limits the deductibility of compensation paid by a publicly held corporation to "Covered Employees" to $1 million per year
    - Under ARPA, the term "Covered Employees" has been expanded from at least five officers to at least 10 officers and employees (seemingly whether officers or not). This expands the current group of the three highest paid officers and the CEO and CFO
    - The new group of five will be covered employees for the years they are in the highly compensated group, but the law does not include them in the forever-covered provision that applies to the other officers
    - This provision takes effect for tax years beginning after December 31, 2026
    - **This could have an issue with any DTA's being set up for stock compensation plans**
      - **Need to evaluate recoverability**

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Miscellaneous tax updates on previous tax legislation (cont.)

- Miscellaneous items of interest
  - Congress provided a temporary exception to the 50% the business deduction for certain business meals under the Taxpayer Certainty and Disaster Relief Act of 2020 (the Act).
  - The temporary exception under the Act allows a 100% deduction for business meals if the food or beverages are provided by restaurants after Dec. 31, 2020, and before Jan. 1, 2023.

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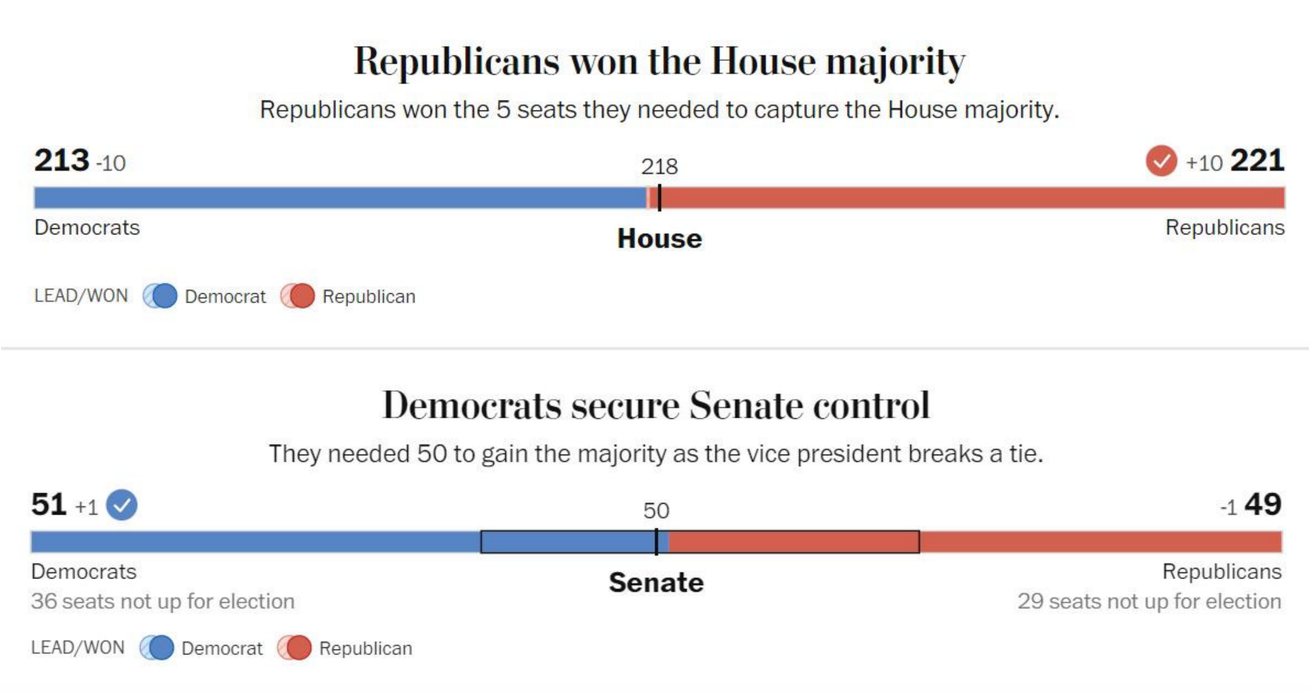
Miscellaneous tax updates on previous tax legislation (cont.)

- Miscellaneous Items of interest
  - Transition to LIBOR
    - Treasury released proposed regulations under 1.1001-6 which provide a broad safe harbor which generally exempts the modification of debt instruments and derivatives solely to modify the LIBOR reference rate from the debt modification rules.
  - This replacement rate must meet certain requirements in order to fall within such safe harbor. Generally:
    - Must be one of the rates within Reg 1.1001-6(b)(1) or referenced to such rate
    - The FMV of the modified instrument must be relatively close (w/in 25 basis points) to the instrument immediately prior to the modification
    - The replacement rate should be negotiated between unrelated parties, and they agree the rate is substantially equivalent
    - The replacement rate must be conducted in the same currency
    - Should allow taxpayers avoid having a debt modification result in a taxable event

Post-Election - General climate



Source: The Washington Post
Updated as of 12/08/2022

Post-Election - General climate (cont.)

- Looks like there will be gridlock with little movement on the legislation front
- Small margins in the House and Senate will require negotiation and compromise across the aisle if anything is to get accomplished
- Continuing resolution and other must pass measures to keep the government funded
- Possible tax legislation
  - R&D capitalization back to current expensing
  - Modification to the Interest Expense deduction limitation
  - Modification to the current bonus depreciation provisions
  - Modification to a more favorable child care tax credits

State considerations

- Several states (29+) have adopted PTE provisions to address the $10,000 limitation of state & local tax deductions at the shareholder/partner level
- State Nexus – Work from Home during COVID-19 Pandemic
  - Employee temporarily working from home can create tax nexus for a business with no other nexus-creating presence
  - In response to COVID-19, several states have been addressing whether income/franchise tax nexus is created for a business by its employees temporarily teleworking in a state during the pandemic, in situations where the business has no other nexus-creating presence or activities within the state.
  - Without official state guidance to the contrary, the presence of an employee working in a state is typically sufficient presence to create corporate income tax nexus in that state.
  - Several states had provided for reciprocity but have now indicated that this would no longer apply

State considerations (cont.)

- Banks with national lending/leasing platforms should continue to consider the following:
  - IRC conformity date
  - State decoupling from Federal provisions
  - Treatment of disregarded entities
  - Separate / Combined / Consolidated return changes
  - Tax elections & Accounting Methods
  - NOL carry-back / carry-forward rules
  - Financial statement impact
  - Regulatory filing / Call Report Impact

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THANK YOU FOR YOUR TIME AND ATTENTION

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QUESTIONS AND ANSWERS

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