Upcoming Tax and Accounting Updates

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Accounting Update

Learning objectives

- As a result of this presentation, attendees will understand upcoming audit and accounting changes and how they will impact their financial institutions.

Agenda

1. ASU No. 2016-02, Leases
2. ASU No. 2017-04, Intangibles – Goodwill Impairment Test
3. ASU No. 2020-04, Reference Rate Reform
4. ASU No. 2021-07, Stock Compensation
5. ASU No. 2022-01, Derivatives and Hedging
6. ASU No. 2022-02, Financial Instruments, TDR Elimination

ASU No. 2016-02

- Leases (Topic 842)

ASU No. 2016-02, Leases (Topic 842)

1. Effective date, pursuant to ASU No. 2020-05: Fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Public business entities have already adopted this ASU.

2. ASU 2021-09 provides a practical expedient for entities to use a risk-free rate.

ASU No. 2017-04

- Intangibles – Goodwill and Other (Topic 350)
- Simplifying the Test for Goodwill Impairment

ASU No. 2017-04, Intangibles–Goodwill and Other (Topic 350)

Effective for years beginning after December 15, 2020 (PBE) and years beginning after December 15, 2021
for all other entities

- Early adoption permitted

Simplifying test for goodwill impairment

- Step 2 of the goodwill test was eliminated
- Recognize an impairment of goodwill if carrying value exceeds fair value (step 1)

Note: Entity may perform qualitative assessment to determine if quantitative impairment test is necessary

ASU No. 2020-04

- Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting

ASU No. 2020-04, Reference Rate Reform (Topic 848)

- Effective March 12, 2020 through December 31, 2022*
- Contract modification relief
  - Receivables and debt should be accounted for by prospectively adjusting the effective interest rate.
  - Leases should be accounted for as a continuation of the existing contracts with no reassessments of the lease classification and discount rate.
- Hedging relief
  - If specified criteria are met, entities may change certain critical terms of existing hedging relationships that are affected or expected to be affected by reference rate reform.
  - These changes ***would not***, in and of themselves, cause an entity to de-designate the hedging relationship.

** Proposed ASU No. 2022-001 would extend this date to December 31, 2024.*

ASU No. 2021-07

- Compensation – Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards

Example

Newly Issued Share Options

1. Exercise price
2. Expected term
3. Expected volatility of the price of the share underlying the share-option award for the award’s expected term
4. Expected dividends on the share underlying the share-option award for the award’s expected term
5. The risk-free interest rate for the expected term
6. The current share price

Black-Scholes-Merton Model

What’s a reasonable application of a reasonable valuation method?

- The following factors should be considered in a reasonable valuation:
  - The value of the tangible and intangible assets of the entity.
  - The present value of the anticipated future cash flows of the entity.
  - The market value of stock or equity interests in similar entities engaged in trades or businesses substantially similar to those engaged in by the entity for which stock is to be valued.
  - Recent arm’s length transactions involving the sale or transfer of the stock or equity interests of the entity.
  - Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation is used for other purposes that have a material economic effect on the entity, its stockholders, or its creditors.
  - The entity’s consistent use of a valuation method to determine the value of its stock or assets for other purposes.
- The following criteria must be met for the use of a previously calculated value to be considered reasonable:
  - The value is updated for any information available after the date of calculation that may materially affect the value of the entity.
  - The value is calculated no more than 12 months earlier than the date for which the value is being used.

ASU No. 2021-07

Compensation – Stock Compensation (Topic 718)

Treasury Regulations

The same characteristics are used in the Treasury Regulations to describe the reasonable application of a reasonable valuation method for income tax purposes.

Independent Valuation

A reasonable application of a reasonable valuation method for purposes of the practical expedient is not limited to a valuation by independent appraisal. However, it is expected that an independent appraisal will often be the method used by nonpublic entities.

Effective Date

Effective prospectively for all qualifying awards granted or modified during the fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

ASU No. 2022-01

- Derivatives and Hedging (Topic 815):
  Fair Value Hedging-Portfolio Layer Method

ASU No. 2022-01 Derivatives and Hedging

- Effective for years beginning after December 15, 2022 (PBE/SEC filers) and years beginning after December 15, 2023 for all other entities

- Early adoption is permitted for entities that have adopted ASU No. 2017-12 – Targeted Improvements to Accounting for Hedging Activities

Portfolio Layer Method

- Previous “last-of-layer” method
- Allows multiple hedged layers to be designated for a single closed portfolio
- Scope expanded to include nonprepayable financial assets
- Allows reclassification of debt securities classified as HTM to AFS

ASU No. 2022-02

- Financial Instruments-Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures

ASU No. 2022-02 Financial Instruments–Credit Losses (Topic 326)

TDR and Vintage Disclosures

- Eliminates current troubled debt restructuring (TDR) accounting guidance
- Loan modifications evaluated to determine whether the modification represents:
  - A new loan
  - Continuation of existing loan
- For PBE, requires disclosure of current period gross writeoffs by year of origination

ASU No. 2022-02 Financial Instruments–Credit Losses (Topic 326)

TDR and Vintage Disclosures

Modification Disclosures

Disclose loan modifications made in the form of:

- Principal forgiveness
- Interest rate reduction
- Other-than-significant payment delay
- Term extension
- Combination of options above

Vintage Disclosures

Public business entities disclose current period gross write-offs by year of origination

Effective Date

Fiscal years beginning after December 15, 2022 for all entities

Early adoption is permitted for entities that have adopted ASU 2016-13

An entity may early adopt the amendments about TDRs and related disclosure changes separately from amendment related to vintage disclosures

Federal & State Tax and Accounting Standards Update

Learning objectives

What you will gain:

- Understanding of the tax implications of new accounting pronouncements / regulatory proposals
- Update on Tax Cuts and Jobs Act provisions that are now in effect / slated to change
- Update on the Inflation Reduction Act
- Update on the State Tax Landscape

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Accounting standards

FASB proposal ASU 2022-004

FASB Proposes to Extend Accounting Rule for Low-Income Housing Tax Credits to Other Similar Investments (Aug. 22, 2022)

- Investments in Tax Equity Projects on the Rise
  - Environmental, Social, and Governance (ESG)-related objectives
  - Community Reinvestment Act goals
- New Markets Tax Credit (NMTC)
- Historic Rehabilitation Tax Credit (HTC)
- Renewable Energy Tax Credit (RETC)

FASB proposal ASU 2022-004

FASB Proposes to Extend Accounting Rule for Low-Income Housing Tax Credits to Other Similar Investments (Aug. 22, 2022)

	Proportional Amortization Method	Cost Method	Equity Method
Subsequent Measurement	Investment's cost basis amortized in proportion to the income tax credits and other income tax benefits received	Investment's cost basis amortized in proportion to only the income tax credits received	Investment's cost basis remeasured consistent with other equity method investments (that is, in proportion to allocable book gains and losses)
Presentation	Cost basis amortization and income tax credit presented net in the income tax expense (benefit) line item	Cost basis amortization presented as other expense Income tax credit presented in the income tax expense (benefit) line item	Cost basis remeasurement presented as other income or expense Income tax credit presented in the income tax expense (benefit) line item

CECL and deferred taxes

Example

- A financial institution has a CECL effective date of January 1, 2023, and a 21% tax rate.
- Pre-CECL (Dec. 31, 2022), the financial institution has $10 million in retained earnings and $1 million in its allowance for loan lease losses (ALLL). Post-CECL (Jan. 1, 2023), the financial institution has $1.2 million in its allowance for credit losses (ACL).
- The financial institution would record an increase to ACL of $200,000, reflecting an offsetting increase in temporary difference deferred tax assets (DTAs) of $42,000, and a reduction in retained earnings of $158,000.
- When reporting the regulatory capital schedule for the FFIEC Call Reports, for each quarterly period of the first year of the 2023 transition period, the financial institution would increase retained earnings and average total consolidated assets by $118,500, decrease temporary difference DTAs by $31,500, and decrease ACL by $150,000.
- For years two and three, regulatory capital schedules would continue to be adjusted based on declining amounts (25% each year).

CECL and deferred taxes

In Thousands	Transitional Amounts	Transitional Amounts Applicable During Each Year of the Transition Period		
		Year 1 – 75%	Year 2 – 50%	Year 3 – 25%
Increase retained earnings and average total consolidated assets by the CECL transitional amount	$158,000	$118,500	$79,000	$39,500
Decrease temporary difference DTAs by the DTA transitional amount	$42,000	$31,500	$21,000	$10,500
Decrease AACL by the ACL transitional amount	$200,000	$150,000	$100,000	$50,000

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Federal tax updates

Tax Cuts & Jobs Act

Sunsetting Bonus Depreciation

Placed-in-Service Year	Bonus Depreciation Percentage
9/28/2017 – 12/31/2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027	None
2028 and thereafter	None

Tax Cuts & Jobs Act

IRC Sec. 174 – Research & Experimental Expenditures

The 2017 tax reform act amended Section 174, effective for amounts paid or incurred in tax years beginning after December 31, 2021, to eliminate these options and require taxpayers to charge their R&E expenditures and software development costs (collectively, R&E expenditures) to a capital account. Capitalized costs are required to be amortized over five years (15 years for expenditures attributable to foreign research).

Tax Cuts & Jobs Act

IRC Sec. 174 – Research & Experimental Expenditures

- Many financial institutions invest significantly in software development and/or enhancement. This may include software to stay up to date with current trends and cybersecurity, development of online and mobile banking applications, or software targeted at automating various processes that once were manual.
- The activities that many financial institutions perform on a day-to-day basis may meet the definition of Research and Experimental Expenditures. These activities include, but are not limited to:
  - Developing a new software application
  - Enhancing an existing application
  - Customizing existing software
  - Testing new technology
  - Integrating disparate software systems

Inflation Reduction Act

15% Minimum Corporate Book Tax

- Imposes a corporate alternative minimum tax (AMT) equal to the excess of 15% of a corporation's adjusted financial statement income (AFSI) over its corporate AMT foreign tax credit. Applies to C corporations which, for a three taxable year period, have average annual AFSI greater than $1 billion
- Adjusted Financial Statement Income (AFSI)
- Starts with net income per financial statements (i.e., Form 10-K)
- Various adjustments – tax depreciation instead of book depreciation

Inflation Reduction Act

Excise Tax on Repurchase of Corporate Stock

- Imposes a non-deductible 1% tax on the fair market value of stock repurchased by a publicly traded U.S. corporation during the taxable year.
  - Reduced by FMV of stock issuances during the taxable year.
- Projected by the Joint Committee on Taxation to raise $74 billion over the following 10 years.
- The measure is seen as increasing the relative appeal of dividends.
- Exceptions:
  - De minimis exclusion – value does not exceed $1M
  - Certain reorganizations

Inflation Reduction Act

IRS Funding for Enforcement and Modernization

- The Inflation Reduction Act increases IRS enforcement funding by $80b over the next 10 years. The additional funds are expected to generate $204b in additional revenue (closing the tax gap), with a net of $142b, that will partially finance $430 billion in climate, energy and healthcare provisions.
- Under the IRA, the increased funding will be allocated as follows:
  - $45.6b for enforcement, which includes examinations, collections, criminal investigations, legal and litigation support, and digital asset monitoring
  - $25.3b for operations support, including legacy information technology systems and telecommunications
  - $4.8b for business systems modernization, including technology to improve customer service
  - $3.2b for taxpayer services, including pre-filing assistance and education, filing and account services, and funding for the Taxpayer Advocate Service

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State tax landscape

State income tax implications

Remote employees

- State income tax filing requirements
- State tax withholding
- Unemployment taxes and workers' compensation
- Personal property and other taxes
- Other considerations

State income tax implications

Lending activities

- Economic Nexus
- Factor Presence (“bright-line” thresholds)
- Sourcing of Loan interest and Fee Income
- Sourcing of Loan Principal Balances

State income tax implications

Services

- Economic Nexus
  - Factor Presence ("bright-line" thresholds)
- Sourcing of Service-Based Revenue
  - Cost of Performance (COP)
    vs. Market-Based Sourcing (MB)

Questions?

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