

Recent GAAP/Tax Reporting Developments

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Circular 230 Disclosure

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

Agenda

- Fin 48 – Accounting for Uncertain Tax Positions (UTP's)
- FAS 123(R) – Share Based Payments
- Accounting for Split Dollar Life Insurance Arrangements
- Proposed Regulation Under 1221(a)(4)
- Final Regulation 1.6045 - Reporting on Attorney Payments
- Other current developments

FIN 48 – Accounting for Uncertain Tax Positions (UTP's)

- Effective for fiscal years beginning after 12/15/06
- Provisions apply to all tax positions upon initial adoption
- Cumulative effect of applying Interpretation are reported as an adjustment to opening balance of retained earnings
 - Change in retained earnings from cumulative effect of adoption must be disclosed in the year of adoption
- Provisions apply to timing differences as well as permanent differences

FIN 48 – Recognition/Measurement Threshold

- More likely than not threshold (> 50%)
 - Must be based on the technical merits derived from sources of authority (legislation and statutes, legislative intent, regulations, rulings and case law) and examination by the tax authority is presumed
 - Limited exception for “administrative practices and precedents” – **How useful will this exception be?**
- Each UTP must be separately evaluated
- Unit of Account
 - must be considered for determining an individual tax position and whether or not the more likely than not standard has been reached - example of Unit of Account related to R&D credit is included in A5 – A8 of the Interpretation
- Measurement
 - amount determined to be the maximum amount that is cumulatively more-likely-than-not of being sustained

FIN 48 – Required Disclosures

- Tabular Reconciliation of total amount of unrecognized tax benefits at beginning and end of period and to include:
 - Gross amounts of increases or decrease as a result of positions taken during current period
 - Gross amounts of increases or decrease as a result of positions taken during a prior period
 - Decreases in unrecognized benefits resulting from settlements
 - Decreases in unrecognized benefits resulting from lapse in the statute of limitations
- Total unrecognized benefits affecting the effective tax rate
- Total interest and penalties recognized in P&L and on BS
- Open tax years by major jurisdiction
- Where it is reasonably possible the amount of unrecognized benefit would significantly increase or decrease within next 12 months additional disclosure is required

FIN 48 – Implications and Next Steps

- Less flexibility in determining tax reserves vs. existing practices
- Greater income statement volatility as assessments change over time
- Need for enhancements to Internal Controls including management's processes to identify, assess, and continuously monitor UTP's
- Increased interaction and coordination between accounting, financial reporting and tax personnel
- Increased attention by senior management and governance bodies (e.g., Audit Committee)
- Increased interaction between management and its external auditors

Documentation Implications of FIN 48

- Each UTP needs to be assessed for benefit recognition and measurement
- Documentation should consider the appropriate level of evidential matter to support management's conclusions
- Documentation will depend on the level of materiality and complexity of the UTP
- In some cases, while not required, consideration should be given to the following:
 - Obtaining opinion from qualified external tax advisers
 - Updating tax opinions for significant unsettled UTP's that may be several years old

Internal Control Implications of FIN 48

- Establish controls and processes at both entity-level and transaction processing level over the following:
 - Determination of the proper unit of account
 - Identification and communication of UTPs – completeness and accuracy
 - Monitoring of changes in facts and circumstances – completeness and accuracy
 - Assessment of the probability of potential outcomes
 - Measurement assessments – analyses and calculations
 - Timing of recognition and derecognition at each reporting date

Internal Control Implications of FIN 48

- Communication between financial reporting, tax and other internal functions and outside experts
- Proper review and approval of key judgments and estimates including, if necessary, review by senior management and the audit committee
- Financial statement presentation and disclosures
- Automated processes and spreadsheets
- Assessment of design and operating effectiveness of internal control over financial reporting (SOX 404)
- Identify qualified resources to update internal controls and related documentation to address FIN 48
- Provide adequate and appropriate training for the individuals tasked with the execution and review of any new process or controls

FIN 48 – Mortgage Banking Issues (Federal)

- Character of gains and losses (ordinary vs. capital)
 - Hedges of MSR's – Do hedges of aggregate MSR risk qualify as tax hedges if hedging PMSR or EMSR?
 - Sales of mortgage loans - Prop. Reg. 1221(a)(4) impact
 - Sales of mortgage servicing rights (no clear IRS position)
- Timing of inclusion of hedging termination gain/loss
 - cash method or 1.446-4 clear reflection (mark and spread)
- Timing of amortization of premiums paid for derivatives
- Safe harbour used for commercial mortgage loans
- Bifurcation of PMSR into §197 and Excess asset
- Recovery of Excess on OID method - 1272(a)(6)
- MTM identifications of securities under §475(b)(2)
- MTM on MLHFS – GAAP versus true FMV

FIN 48 – Mortgage Banking Issues (State)

- Combination
- Nexus
 - Economic nexus
 - Affiliate or Agency nexus
 - If no return filed does statute of limitations expire, can reliance be placed on “administrative precedents or practices”
- Apportionment Filing Positions
 - Gross vs. Net Receipts
 - Intercompany Sales/Eliminations
 - Cost of Performance
 - Joyce vs. Finnegan
- Affiliated Entities
 - Intangible Holding Companies (PIC's/Debt)
 - REIT/RIC

FAS 123(AARRRG!) – Shares Based Payments

- Requires book expense for options and stock grants on the income statement based on fair value of equity instrument effective for interim or annual periods beginning after June 15, 2005 or December 15, 2005 for small business issuers.
- Tax expense will be impacted because of the different timing and amount of tax deduction vs. the amount of book expense recognized.
- FSP FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards."

Incentive Stock Options

- No tax deduction until (a) option is exercised and (b) the stock is sold within 12 months of exercise, otherwise referred to as a disqualifying disposition.
- Tax deduction = the excess of the fair value of the stock at exercise less strike price.
- Book expense (option FV) is treated as a nondeductible permanent difference.

Non-Qualified Stock Options

- Tax deduction may be claimed when the NQSO is exercised.
- Amount of the tax deduction = value of stock at exercise less strike price.
- NQSO's are treated as a temporary difference under FAS 109. The tax effect of any difference between the book expense and eventual tax deduction will either be:
 - charged to tax expense (book expense > tax deduction); or
 - credited to APIC (tax deduction > book expense)

Restricted Stock

- Tax deduction amount = value of stock when vested
- IRC Section 83-b exception – employee can elect to be taxed when stock is granted – not a frequent occurrence. Company would receive a current deduction = to employee income recognized for stock granted
- Deferred taxes are generally recognized for book expense until shares are vested and tax deduction determined. A true up entry would be recorded once the stock vests to clear out the DTA with an entry to tax expense or APIC

123-R Other Issues

- Employee Stock Purchase Plan
- APIC Computations
- Prospective or retroactive application
- FASB Staff Position 123(R)-3
- Options issued in business combinations

Accounting for Split \$ Life Insurance Arrangements

- What is Split Dollar Life Insurance Arrangement?
 - These arrangements usually result in the employer sharing the death benefit with the insured, payable to the insured designated beneficiary. The sharing is usually a % of the proceeds, a flat amount, or a multiple of salary.
- How do I know if I have any such arrangements?
 - Almost 50% of banks have BOLI and 80% of those have split dollar arrangements.

BOLI Investments

Bank Information			Financials*		
Company Name	City	State	BOLI Limit (25%)	BOLI Assets	BOLI % of Capital
Bank of America, National Association	Charlotte	NC	17,744,599	13,486,891	19.0
Wachovia Bank, National Association	Charlotte	NC	7,928,000	10,604,000	33.4
JPMorgan Chase Bank, National Association	Columbus	OH	15,500,250	6,941,000	11.2
Wells Fargo Bank, NA	Sioux Falls	SD	6,455,000	3,433,000	13.3
Nevada Savings Institutions		NV	5,840,514	3,359,991	14.4
Washington Mutual Bank	Henderson	NV	5,786,608	3,356,895	14.5
U.S. Bank National Association	Cincinnati	OH	2,989,006	2,950,791	24.7
KeyBank National Association	Cleveland	OH	1,699,368	2,534,318	37.3
Citibank, NA	New York	NY	11,620,000	2,215,000	4.8
Branch Banking & Trust Company	Winston-Salem	NC	1,398,181	2,147,393	38.4

Accounting for Split \$ Life Insurance Arrangements

- The FASB ratified the position “that for an endorsement split-dollar life insurance arrangement that provides a benefit to an employee that extends to post-retirement periods, an employer should recognize a liability for future benefits in accordance with [FAS 106 or APB 12].”
- What does this mean for a financial institution with postretirement split-dollar benefits? In most cases, it likely will mean that an employer must accrue a liability for something – depending on the benefit that is promised – during the employee’s service period. The EITF proposed two options:
 - (1) the employer must accrue for the present value of the entire promised death benefit (View A); or
 - (2) the employer must accrue for the annual “cost of insurance” required to keep the policy in force during the post-retirement years (View A “prime”).

Accounting for Split \$ Life Insurance Arrangements

- The effective date for this change has been extended to fiscal years beginning after December 15, 2007, although early application is permitted. Employers will be required to apply this new change in one of two ways:
 - (1) employers may make a one-time adjustment to retained earnings or to other components of equity or net assets in their statements of financial position as of the beginning of the year of adoption; or
 - (2) employers may retrospectively apply this change to all prior periods.

Proposed Regulation Under 1221(a)-(4)

- Issued 8/4/06 effective for notes or accounts receivable acquired after the date the final regulations are published
- If adopted as proposed, the regulation would treat gains or losses from sale of mortgage loans as capital gain or loss not ordinary income
- Regulation would reverse the longstanding treatment first enumerated in Burbank Liquidating Corp v. Commissioner, 39 T.C. 999 which held that mortgage loans originated by a savings and loan in the ordinary course of its business were ordinary assets under IRC section 1221(a)(4)
- Would reverse FNMA v. Commissioner, 100 T.C. 541 which held mortgage loans acquired by Agency were ordinary assets
- Hearing to be held on 11/7/06

Proposed Regulation Under 1221(a)-(4)

- Regulation holds that mortgage loans are issued to the borrower in exchange for money, not services
- Potential Impact of Proposed Regulation
 - Gains and losses will be capital, not ordinary for non-bank or non dealer subject to IRC §475
 - Net losses from sale of loans generate capital losses which can only be carried back or forward to offset capital gains
 - Mortgage loans and MBS not held by a bank or dealer subject to §475 become capital assets and cannot be hedged
 - For mortgage servicers stripping servicing from mortgage loans sold into secondary market the regulation raises character issues on treatment of sales of EMSR
 - Increases risk that aggregate hedges of MSR's would fail to qualify as valid hedges for tax purposes and gains or losses from MSR hedges would create capital gain or loss

Final Regulation 1.6045 - Reporting on Attorney Payments

- Final Regulations issued which incorporated MBA's suggested comments which requested an exception for payments made by lenders in real estate transactions.
- MBA's concerns:
 - The MBA opposed the proposed regulation to the extent it required mortgage lenders to report payments (by wire or check) of loan proceeds that were disbursed on behalf of borrowers to attorneys for distribution to the various parties involved in a loan settlement.

Other Current Developments

- Mortgage Servicing Rights
 - Capital versus ordinary?
 - Implications on hedging of MSR's
- Form 1098 reporting proposals (JCT Staff):
 - Breakdown of real estate taxes between regular tax assessments and special benefit assessments (nondeductible User Fees) by either municipalities or mortgage loan servicer
 - Refinancing of mortgage loan reporting of
 - Points paid on refinancing transactions
 - Amount by which the refinanced loan exceeded the outstanding balance of the loan being refinanced.
 - HELOCs > \$100,000
 - Public comments due 12/1/06