Deferred Income Taxes

GAAP and Regulatory Considerations

Paul Jordan
Senior Team Leader
Federal Reserve Bank of Chicago

Principal Guidance

- GAAP
  - Topic 740 - *Income Taxes*, which cross references to FAS No. 109, *Accounting for Income Taxes*
  - **http://www.fasb.org/pdf/aop_FAS109.pdf**
- Regulatory reporting
  - instructions for Schedule HC-R, Regulatory Capital, line item 9(b), disallowed deferred tax assets
  - **http://www.federalreserve.gov/reportforms/forms/FR_Y-9C20090930_i.pdf**

GAAP Updates

ACCOUNTING STANDARDS UPDATE

No. 2009-06
September 2009

Income Taxes (Topic 740)

Creating Deferred Income Taxes

- Temporary differences
  - **deductible temporary differences** reduce taxable income in future periods and create <u>deferred tax assets</u>
    - » example - the provision for loan and lease losses is deducted for tax purposes when the loans are actually charged-off
    - » example - other than temporary impairment of debt securities is deducted for tax purposes when securities are sold
  - **taxable temporary differences** result in additional taxable income in future periods and create <u>deferred tax liabilities</u>
    - » example - goodwill is deductible for tax purposes, but not for book purposes unless impaired. Treated as a temporary difference
- Net operating loss carryforwards also create <u>deferred tax assets</u>

Valuation and Presentation

- The realizability of all deferred tax assets must be evaluated each period
  - a valuation allowance must be recorded, if needed, to reduce deferred tax assets to an amount that is more likely than not (greater than 50 percent likelihood) to be realized
  - consider all available evidence, both positive and negative, in assessing the need for a valuation allowance
  - realization of deferred tax assets depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period
- On the balance sheet, report net amount of deferred tax assets (less any valuation allowance) and deferred tax liabilities separately for each tax jurisdiction (e.g., federal, state, and local)

Regulatory Capital Treatment

- Net deferred tax assets/liabilities shown in regulatory reports is equal to net deferred tax assets/liabilities shown under GAAP
- However, regulatory capital standards limit the amount of net deferred tax assets that can be included in Tier 1 capital
  - on schedule HC-R Regulatory Capital, line 9(b), institutions must indicate any disallowed deferred income taxes
  - instructions for line 9(b) contains a worksheet for the calculation of disallowed deferred tax assets

Regulatory Capital Treatment (Cont'd)

- There is no limit on deferred tax assets that can be realized from taxes paid in prior carryback years and from reversals of existing taxable temporary differences
  - amount institution could recover if the bank holding company's temporary differences (both deductible and taxable) that fully reverse at the report date
  - any "unlimited" amounts are excluded before determining deferred tax assets that are dependent on future taxable income
- Deferred tax assets that are <u>dependent on future taxable income</u> are limited to the lesser of …
  - amount expected to be realized within one year of the calendar quarter end date, OR
  - 10 percent of the amount of Tier 1 capital

Regulatory Capital Treatment (Cont’d)

“Projected future taxable income”

- Should not include net operating loss carryforwards to be used within one year or existing temporary differences expected to reverse within one year
- May include estimated effect of tax planning strategies that are expected to be implemented to realize tax carryforwards that will otherwise expire during that year
- Supervisory expectations are that the projections should be consistent with the approach the institution uses for its other projections (e.g., growth, performance) and should give greater weight to taxable income reported on tax returns for recent periods with appropriate adjustments for changes in the institution's operations (e.g., shrinking asset base, reduced yields, etc.)
- A bank holding company may use its future taxable income projection for its current fiscal year (adjusted for significant changes that have or are expected to occur) at an interim quarter-end date rather than preparing a new projection each quarter

	Disallowed Deferred Tax Assets Calculation	
(a)	Enter the amount from Schedule HC-R, item 8	Total Tier 1
(b)	Enter 10% of the amount in (a) above	10% of Tier 1
(c)	Enter the amount of deferred tax assets reported in Schedule HC-F, item 2	Net DTA
(d)	Enter the amount of taxes previously paid that the bank holding company could recover through loss carrybacks if the bank holding company's temporary differences (both deductible and taxable) fully reverse at the report date	Carryback potential … assume temporary differences fully reverse
(e)	Amount of deferred tax assets that is dependent upon future taxable income: subtract (d) from (c); enter -0- if the result is a negative amount	(c) minus (d)
(f)	Enter the portion of (e) that the bank could realize within the next 12 months based on its projected future taxable income (Future taxable income should not include net operating loss carryforwards to be used during the next 12 months or existing temporary differences that are expected to reverse over the next 12 months)	Calculate and then enter the lesser of the amount calculated or (e)
(g)	Enter the lesser of (b) and (f)	Lesser of (b) and (f)
(h)	Disallowed net deferred tax assets - subtract (g) from (e); enter 0 if the result is a negative amount	(e) minus (g)

Other Regulatory Considerations

Certain Amounts Are Not Limited

- As already mentioned, the amount of taxes previously paid that the bank holding company could recover through loss carrybacks and from reversals of existing taxable temporary differences
- Deferred taxes (assets or liabilities) arising from unrealized holding gains or losses on available for sale securities
  - for deferred tax asset limitation purposes, a bank holding company may, but is not required to, adjust its deferred tax assets for any deferred tax assets and liabilities related to AFS securities. <u>The bank holding company must consistently follow its chosen approach</u>

Other Regulatory Considerations (Cont'd)

- For certain assets deducted from Tier 1 capital, deduction may be made net of associated deferred tax liability
  - disallowed mortgage and nonmortgage servicing assets
  - intangible assets acquired in nontaxable business combinations
  - goodwill acquired in taxable business combinations
  - disallowed credit-enhancing interest-only strips
  - deducted nonfinancial equity investments
- Any deferred tax liability netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets dependent upon future taxable income and the disallowed amount of deferred tax assets, if any, for regulatory capital purposes

SEPARATE ENTITY APPROACH

- SR Letter 98-38, Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure
- For a bank subsidiary of a holding company, if parent does not have the financial capability to reimburse the bank for the tax benefit of the bank's carryback of net operating losses or tax credits, the bank should limit the carryback potential available for realization of its deferred tax assets to the amount which the bank could reasonably expect to have refunded by its parent

Example 1

(a) Tier 1 capital of $2,700 (Goodwill is deducted net of DTL)

(c) Assume net deferred tax assets on balance sheet include the following components:

… DTA – $ 60 AFS debt securities [to be excluded]

… DTA – $314 Other deductible temporary differences

… DTL –($ 24) Goodwill [being netted against goodwill]

… DTL –($ 10) Other taxable temporary differences

… NET – $ 340 Deferred tax assets on Schedule HC-F, item 2

For taxes, $300 goodwill has been amortized $20 per year for four years. Goodwill on tax balance sheet is $220. Deferred tax liability is $220 x 30% = $24.

If bank holding company chooses to exclude the deferred tax effect of its net unrealized loss on AFS debt securities and to net the deferred tax liability associated with goodwill, the adjusted amount of deferred taxes to be reported on line (c) in the deferred tax assets calculation worksheet is $340 - $60 + $24 = 304.

(d) Taxes paid in 2008 is $40 and in 2007 is $30. $70 carryback potential is "supported" by $304 assumed to fully reverse at report date.

(f) Calculate amount realizable over next 12 months

… Projected 2009 taxable income is $260

… Assume $240 of $304 expected to reverse

… No loss carryforward included in projected 2009 to add back

Add income from reversing temporary differences $240/30%=$800 to projection of $260 and multiply by tax rate. $1,060 x 30% = $318. Enter lesser of $318 or (e).

	Disallowed Deferred Tax Assets Calculation	
(a)	Enter the amount from Schedule HC-R, item 8	2,700
(b)	Enter 10% of the amount in (a) above	270
(c)	Enter the amount of deferred tax assets reported in Schedule HC-F, item 2	304
(d)	Enter the amount of taxes previously paid that the bank holding company could recover through loss carrybacks if the bank holding company's temporary differences (both deductible and taxable) fully reverse at the report date	70
(e)	Amount of deferred tax assets that is dependent upon future taxable income: subtract (d) from (c); enter -0- if the result is a negative amount	234
(f)	Enter the portion of (e) that the bank could realize within the next 12 months based on its projected future taxable income. (Future taxable income should not include net operating loss carryforwards to be used during the next 12 months or existing temporary differences that are expected to reverse over the next 12 months)	234
(g)	Enter the lesser of (b) and (f)	234
(h)	Disallowed net deferred tax assets - subtract (g) from (e); enter 0 if the result is a negative amount	0

Example 2

(a) Tier 1 capital of $2,700 (Goodwill is deducted net of DTL)

(c) Assume net deferred tax assets on balance sheet include the following components:

… DTA – $ 60 AFS debt securities [to be excluded]

… DTA – $314 Other deductible temporary differences

… DTL –($ 24) Goodwill [being netted against goodwill]

… DTL –($ 10) Other taxable temporary differences

… NET – $ 340 Deferred tax assets on Schedule HC-F, item 2

For taxes, $300 goodwill has been amortized $20 per year for four years. Goodwill on tax balance sheet is $220. Deferred tax liability is $220 x 30% = $24.

If bank holding company chooses to exclude the deferred tax effect of its net unrealized loss on AFS debt securities and to net the deferred tax liability associated with goodwill, the adjusted amount of deferred taxes to be reported on line (c) in the deferred tax assets calculation worksheet is $340 - $60 + $24 = 304.

(d) Taxes paid in 2008 is ~~$40~~ $0 and in 2007 is $30. ~~$70~~ $30 carryback potential is "supported" by $304 assumed to fully reverse at report date.

(f) Calculate amount realizable over next 12 months

… Projected 2009 taxable income is ~~$260~~ $250

… Assume $240 of $304 expected to reverse

… ~~No~~ $10 loss carryforward included in projected 2009

Add income from reversing temporary differences $240/30%=$800 and $10 loss carryforward to projection of ~~$260~~ $250 and multiply by tax rate. $1,060 x 30% = $318. Enter lesser of $318 or (e).

	Disallowed Deferred Tax Assets Calculation	
(a)	Enter the amount from Schedule HC-R, item 8	2,700
(b)	Enter 10% of the amount in (a) above	270
(c)	Enter the amount of deferred tax assets reported in Schedule HC-F, item 2	304
(d)	Enter the amount of taxes previously paid that the bank holding company could recover through loss carrybacks if the bank holding company's temporary differences (both deductible and taxable) fully reverse at the report date	30
(e)	Amount of deferred tax assets that is dependent upon future taxable income: subtract (d) from (c); enter -0- if the result is a negative amount	274
(f)	Enter the portion of (e) that the bank could realize within the next 12 months based on its projected future taxable income. (Future taxable income should not include net operating loss carryforwards to be used during the next 12 months or existing temporary differences that are expected to reverse over the next 12 months.)	274
(g)	Enter the lesser of (b) and (f)	270
(h)	Disallowed net deferred tax assets - subtract (g) from (e); enter 0 if the result is a negative amount	4

Example 3

(a) Tier 1 capital of ~~$2,700~~ $2,676 (Goodwill is deducted gross ~~net of DTL~~)

(c) Assume net deferred tax assets on balance sheet include the following components:

… DTA – $ 60 AFS debt securities [NOT to be excluded]

… DTA – $314 Other deductible temporary differences

… DTL –($ 24) Goodwill [NOT being netted against goodwill]

… DTL –($ 10) Other taxable temporary differences

… NET – $ 340 Deferred tax assets on Schedule HC-F, item 2

For taxes, $300 goodwill has been amortized $20 per year for four years. Goodwill on tax balance sheet is $220. Deferred tax liability is $220 x 30% = $24.

~~If bank holding company chooses to exclude the deferred tax effect of its net unrealized loss on AFS debt securities and to net the deferred tax liability associated with goodwill, the adjusted amount of deferred taxes to be reported on line (c) in the deferred tax assets calculation worksheet is $340 – $60 + $24 = 304~~.

(d) Taxes paid in 2008 is ~~$40~~ $0 and in 2007 is $30. ~~$70~~ $30 carryback potential is "supported" by ~~$304~~ $340 assumed to fully reverse at report date.

(f) Calculate amount realizable over next 12 months

… Projected 2009 taxable income is ~~$260~~ $250

… Assume $240 of $340 expected to reverse

… ~~No~~ $10 loss carryforward included in projected 2009

Add income from reversing temporary differences $240/30%=$800 and $10 loss carryforward to projection of ~~$260~~ $250 and multiply by tax rate. $1,060 x 30% = $318. Enter lesser of $318 or (e).

	Disallowed Deferred Tax Assets Calculation	
(a)	Enter the amount from Schedule HC-R, item 8	2,676
(b)	Enter 10% of the amount in (a) above	268
(c)	Enter the amount of deferred tax assets reported in Schedule HC-F, item 2	340
(d)	Enter the amount of taxes previously paid that the bank holding company could recover through loss carrybacks if the bank holding company's temporary differences (both deductible and taxable) fully reverse at the report date	30
(e)	Amount of deferred tax assets that is dependent upon future taxable income: subtract (d) from (c); enter -0- if the result is a negative amount	310
(f)	Enter the portion of (e) that the bank could realize within the next 12 months based on its projected future taxable income. (Future taxable income should not include net operating loss carryforwards to be used during the next 12 months or existing temporary differences that are expected to reverse over the next 12 months)	310
(g)	Enter the lesser of (b) and (f)	268
(h)	Disallowed net deferred tax assets - subtract (g) from (e); enter 0 if the result is a negative amount	42