

55th Annual

BANK & CAPITAL MARKETS TAX INSTITUTE

S Corp Update

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INTRODUCTIONS



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OBJECTIVES

- Identify the provisions within the CARES Act that apply to financial institutions including the relief measures and options for consideration
- What does the M&A landscape look like in 2020 and beyond?
- What does the ever-changing political environment mean to your S-Corp Bank?



AGENDA

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2020 Legislative update

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M&A Activity

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C Corp Conversions

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Opportunity Zones

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The Future



2020 LEGISLATIVE UPDATE

Coronavirus Aid, Relief and Economic Security (CARES) Act

- Employee retention credits
- Bonus depreciation on Qualified Improvement Property (QIP)
- FICA suspensions
- Section 163(j) changes
- Other non-CARES act updates
- Acceleration of refundable AMT credits
- NOL carrybacks



2020 LEGISLATIVE UPDATE

Employee Retention Credit

- “Eligible Employers” eligible for a credit equal to 50% of the first \$10,000 of “Qualified Wages”
- Eligible Employer:
 - Fully or partially suspend operation during any calendar quarter in 2020 due to orders from an appropriate governmental authority limiting commerce, travel, or group due to COVID-19; or
 - Experience a significant decline in gross receipts during the calendar quarter.
- Qualified Wages:
 - More than 100 full-time employees in 2019, wages paid to an employee for time that the employee is not providing services due to an economic hardship, either
 - (1) a full or partial suspension of operations by order of a governmental authority due to COVID-19, or
 - (2) a significant decline in gross receipts.
 - Average 100 or fewer full-time employees in 2019, wages paid to any employee during any period of economic hardship described in (1) or (2) above.



2020 LEGISLATIVE UPDATE

Employee Retention Credit - FAQs

- FAQ 30: An employer that operates an essential business is not considered to have a full or partial suspension of operations if the governmental order allows the employer's operations to remain open. However, an employer that operates an essential business may be considered to have a partial suspension of operations if, under the facts and circumstances, more than a nominal portion of its business operations are suspended by a governmental order.
- FAQ 34: If an employer's workplace is closed by a governmental order for certain purposes, but the employer's workplace may remain open for other purposes or the employer is able to continue certain operations remotely, the employer's operations would be considered to be partially suspended. However, if all of an employer's business operations may continue, even if subject to modification (for example, to satisfy distancing requirements), such a modification of operations is not considered to be a partial suspension of business operations due to a governmental order, unless the modification required by the governmental order has more than a nominal effect on the business operations under the facts and circumstances.



2020 LEGISLATIVE UPDATE

FICA Tax Suspension

- Employee
 - President Trump made an executive order in August of 2020 giving employer the option to suspend withholdings of FICA for Employer portion
 - Very few employers adopted this
- Employer Deferral of Payment
 - Tax due between March 27, 2020 and December 31, 2020 can be deferred until December 31, 2021 and December 31, 2022
 - 50% due in both 2021 and 2022
 - Employer portion deductible upon payment



2020 LEGISLATIVE UPDATE

PPP Loan Fee Recognition

- Processing fee and taxable when received?
- OID and eligible for deferral?
- What if the bank is already cash basis for loan fees?
- Announcement 2020-12 – No information reporting required on Form 1099-C for forgiven PPP loans under Sec. 1106 of CARES Act



2020 LEGISLATIVE UPDATE

Qualified Improvement Property (QIP)

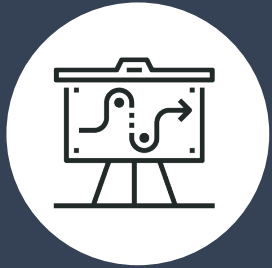
- CARES Act fixed TCJA
 - QIP had to be depreciated over 39 years with TCJA rather than the standard 15 years
 - With QIP being depreciated over 15 years again, bonus depreciation is allowed
- Filing Form 3115 – Application for Change in Accounting Method
- Example
- State conformity differs



2020 LEGISLATIVE UPDATE

163(j) Final Regulations & CARES act

- For banks, the impact mostly related to any K-1 adjustments
- Final regulations apply to all taxable years beginning on or after November 13, 2020 (but may be applied to earlier years)
- CARES act increased limitation of deductible interest from 30% of ATI to 50%. Partnerships do not recognize this increase until 2020, while corporations recognized this in 2019 filings
 - For partners receiving K-1s, 50% of the excess business interest expense from 2019 can be treated as deductible in 2020



2020 LEGISLATIVE UPDATE

2020 Tax form changes

- The number of shares will now be reported on item G of the K-1
- Any loans from shareholder to the company will be reported on item H (likely does not impact banks)

G	Shareholder's number of shares		
	Beginning of tax year		_____
	End of tax year		_____
H	Loans from shareholder		
	Beginning of tax year	\$	_____
	End of tax year	\$	_____



2020 LEGISLATIVE UPDATE

State Nexus and Withholding Requirements

- Some employees may have temporary changes in work location
- Employers should consider withholding requirements of both former and current work state to determine if there is a conflict in the two states' approaches to telecommuting during the pandemic
- Some states have released guidance saying they will not require out of state employers to change their income tax withholding
 - Alabama, Georgia, Indiana, Iowa, Kentucky, Nebraska, New Jersey, North Dakota, Pennsylvania, Rhode Island
- Illinois will require withholding if employees are working more than 30 days in Illinois.



2020 LEGISLATIVE UPDATE

State Nexus and Withholding Requirements

- 45 states and the District of Columbia impose an income tax.
- Telecommuting employees can potentially create nexus in a new state
- States that have addressed telecommuting and provided temporary relief from nexus creation due to out of state taxpayers whose only activity is telecommuting employees during the pandemic
 - Alabama, California, District of Columbia, Georgia, Indiana, Iowa, Maryland, Massachusetts, Minnesota, Mississippi, New Jersey, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina
- Kentucky has said it will review nexus determinations on a case-by-case basis



2020 LEGISLATIVE UPDATE

Other state considerations

- In consolidated states, the activity of other members of the group can cause state filings for the consolidated group.
- Alabama Transitions the FIET from a “post-payment system” to a “pre-payment system” by imposing quarterly estimated FIET payment requirements effective for tax years beginning after December 31, 2019
- Connecticut made several changes to Pass-Through Entity Tax
 - Pass-Through Entity tax credit reduced from 93.01% to 87.5%
 - Pass-Through Entity can make an annual election to remit composite income tax on behalf of nonresident individual members.
- Kentucky imposes an income tax effective in 2021 – need to consider non-resident withholding and election to be included in composite filing.
- Michigan - for tax years beginning after 2020, financial institutions tax base is determined as of the close of the tax year instead of using a five-year average.



M&A ACTIVITY

Selling to Credit Unions

- Always an asset purchase
- The projection of gain on sale is the challenge. Often done months in advance of closing
- S-Corporations don't experience the same double taxation that occurs when a credit union buys a C-Corporation
- Make sure you consider any potential BIG tax if you have not been an S-Corp longer than 5 years.
- Most gain should be capital and therefore under current law at a preferential rate



M&A ACTIVITY

Buying Credit Unions

- Credit Union may revoke exemption status immediately prior to the transaction
- This results in a step up in basis to members – no tax paid
- Members are paid for the purchase
- The proceeds on sale are not taxable to members because their basis was stepped up upon the conversion to a taxable entity



M&A ACTIVITY

Selling to a C-Corp

- There are three typical scenarios
 - Purchase stock of holding company
 - Shareholders recognize capital gain on difference between their basis and proceeds
 - Asset purchase of bank
 - Gain is recognized on the S-Corporation return and passed through to shareholders
 - Shareholders basis increases by the amount of gain recognized and any cash is distributed
 - Sale of branches
 - Stock purchase with Section 338(h)(10) election
 - Similar to an asset purchase, but in this case the assets are a deemed sale
 - S-Corporation is liquidated upon sale
- Tax free Merger



M&A ACTIVITY

199A – Passthrough entity deduction considerations

- Timing of transactions
 - Only applies to ordinary income on gain on sale of assets
 - W-2 wages matter in calculation
 - If too early in the year, there won't be enough wages to get the full deduction
- Importance of keeping separate books and records



C CORP CONVERSION

S Corporations

- Owners pay tax on income regardless of whether it was distributed
 - Undistributed income increases basis
- Because income was already taxed, distributions avoid double taxation
- May use cash basis



C CORP CONVERSION

C Corporations

- C Corp earnings distributed to shareholders are typically subject to double taxation
- Stock basis remains static
- More flexible structure for raising capital
- No shareholder limits
- Various classes of stock
- No limitation on state tax deduction
 - Will this matter under Biden presidency? Will he remove the state tax deduction limitation?



C CORP CONVERSION

Impact of converting to C-Corp

- Top corporate rate is currently 21% compared to 29.6% for individuals (with 20% QBI deduction)
 - Will this last? There is potential for Biden undoing the corporate tax cuts from TCJA
 - QBI scheduled to sunset 1/1/2026
 - Biden's plan is to phase out the QBI deduction for AGI > \$400k
- Some cash method S Corp would recognize income post conversion from switching to accrual method
- S Corp shareholders no longer adjust their stock basis for earnings
- Tax filing burden shifts from shareholders to the corporation
- Once the S election is revoked, another cannot be made for 5 years



OPPORTUNITY ZONES

Creating Funds

- An Opportunity Zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment
- Opportunity Zones are officially designated low-income census tracts eligible for favorable capital gains tax treatment
- Added to tax code by Tax Cuts and Jobs Act (TCJA) on December 22, 2017
- 8,764 opportunity zones have been identified in all 50 states, the District of Columbia & five U.S. territories (including Puerto Rico)
- This place-based incentive program provides several capital gains tax incentive for investors who reinvest capital gains in Opportunity Zones



OPPORTUNITY ZONES

Tax Benefits

- Defer
 - Temporary deferral of capital gains until the investment is sold, or December 31, 2026, whichever comes first
 - If investment is not sold before December 31, 2026, any remaining deferred gain is recognized at that time
- Reduce
 - Taxpayer's initial basis in investment is \$0
 - Investment held less than five years result in 100% deferred gain recognition
 - Investment held > five years < than seven years result in recognition of 90% deferred gain
 - Investment held > seven years results in 85% deferred gain recognition
- Considerations
 - December 31, 2019, deadline to obtain full 15% reduction
 - December 31, 2021, deadline to obtain 10% reduction



OPPORTUNITY ZONES

Tax Benefits

- Permanent exclusion of post-investment gain after 10 years
 - After 10 years, upon sale of the assets, post-investment appreciation is tax free. (If it's sold earlier, it can be rolled into another QOF & remain tax free)
 - This exclusion only applies to gains accrued after an investment in an QOF
- Considerations
 - Current income from the QOF is subject to tax
 - States conformity



THE FUTURE

New Administration

- What potential changes will a Biden Administration make to tax law?
 - QBI deduction phase out for families with income over \$400,000
 - Social Security tax on income above \$400,000 (full 12.4%) creating a “donut hole”
 - Increase the corporate tax rate from 21% to 28% along with a 15% minimum tax on companies with book income greater than \$100 million.
 - We don't know the status of 100% bonus depreciation



THE FUTURE

What does a Biden presidency mean for you?

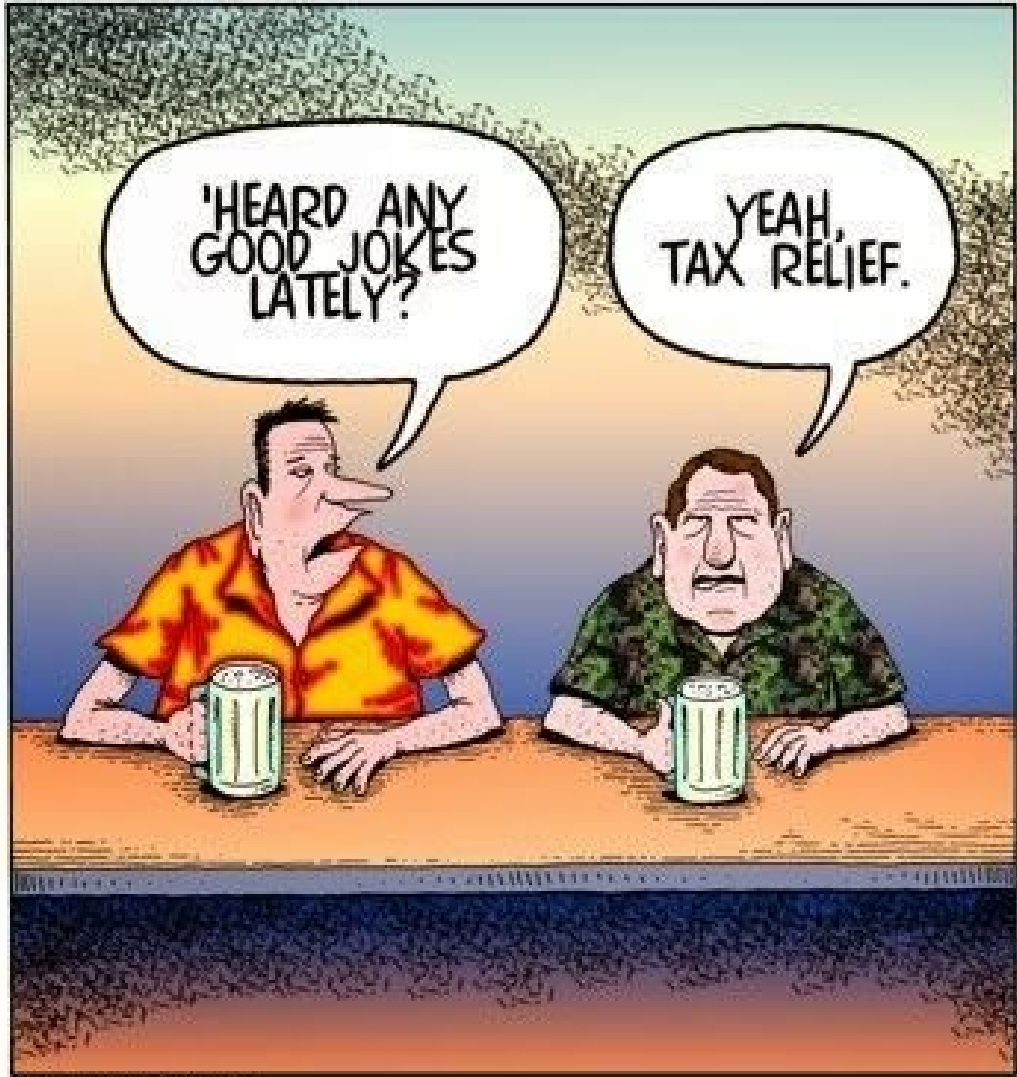
- Consider potential tax rate changes
 - Should you accelerate or defer income?
 - Conversion to a C Corp?



THE FUTURE

Additional COVID Relief Packages

- McConnell has indicated another relief package is a top priority item
- Will the House and Senate be able to agree?
- What could we see come out of a relief package?
- Will they fix the taxability of the PPP funds?



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Questions?



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Thank You!