



MOSS ADAMS BANKING VIEWPOINT

Winter 09

Recent Tax Updates

By Jason Munn, CPA

Effects of the Bailout Bill on Financial Institutions

In October 2008, President Bush signed the Emergency Economic Stabilization Act of 2008 (commonly referred to as the “financial bailout bill”). There were several provisions in the bill specific to financial institutions. The following is a brief summary of those provisions:



- Losses on Freddie Mac (FHLMC) and Fannie Mae (FNMA) preferred stock to be treated as ordinary and not capital losses. This is discussed in more detail below. The stock still must be disposed to recognize the loss.
- For institutions that participate in the Capital Purchase Program (CPP), those institutions:
 - May not deduct executive compensation in excess of \$500,000 for each senior executive, and
 - Are prohibited from entering into new executive employment contracts that include golden parachutes during the time the institution is participating in the program.
 - Must meet certain tax attestation requirements related to the above matters as well compliance with all tax obligations of the institution.

Freddie Mac and Fannie Mae Stock Holdings

The Tax Act provides guidance specific to holdings of FHLMC or FNMA. If your Bank held preferred stock in either of these entities, you likely have recorded an impairment for book purposes against the value of those holdings. The Act included a favorable provision for banks in that the losses upon the disposition of either FHLMC or FNMA stock will be characterized as ordinary as opposed to capital in nature. This is beneficial because capital losses can only be offset by capital gains for corporations, whereas ordinary losses can be deducted to the extent of ordinary income. However, the Act does not allow for a deduction in 2008 before the FHLMC or FNMA stock holdings are sold. Thus, to receive a tax benefit for the decline in the value FHLMC or FNMA stock, the Bank must have sold those shares by December 31, 2008. Otherwise, the deduction will not be available until future years when the stock is sold and any impairment recognized for book purposes in 2008 will be an add-back when computing taxable income.

Quick Refund Reminder

Starting January 2, 2009, if a business meets certain tests with regards to overpayment of estimated taxes for 2008, it may request an early refund of those taxes by completing Form 4466 “Corporation Application for Quick Refund of Overpayment of Estimated Tax”. Instead of requesting the refund when the federal tax return is filed, an institution can file Form 4466 and receive its refund as early as February in many cases. As always, you should first consult with your tax advisor regarding the status of estimated tax payments before making a decision to request a refund.

In this issue:

- = Recent Tax Updates
- = Mortgage Fraud Disguised as Nonperforming Loans
- = Be Proactive with Tax Charge-offs!
- = Bankers Compensation Survey

Mortgage Fraud Disguised as Nonperforming Loans

By Lisa Sanborn, CPA

Nationwide, banks have experienced a decline in the quality of their mortgage portfolios. Most bank managers attribute this trend to the U.S. mortgage crisis; however, mortgage fraud is the root cause in an unknown percentage of cases. The volume of mortgage fraud hidden in nonperforming loans is unclear because these loans are only identified as fraudulent if and when a victim steps forward. Compounding the problem, there is often a 12-month lag between payment default and the filing of a Suspicious Activity Report (SAR). The fact is, mortgage fraud complaints more than doubled in the U.S. from 2003 to 2006, according to the U.S. Treasury Department.¹ And according to the Mortgage Asset Research Institute, mortgage fraud increased by 42% in the first quarter of 2008.²

There are two basic types of mortgage fraud: “fraud for profit” and “fraud for housing.” The first type is perpetrated by someone whose intent is to willfully scam a lender. The second type is a deception, usually overstating income, simply for the purpose of obtaining housing and with no criminal intent. Of the two types, fraud for profit can have a much greater impact on the market and is, therefore, the focus of law enforcement authorities.

Fraudulent Schemes are Always Changing

In one fraud for profit scheme, for example, two individuals claiming to be doctors purchase an apartment building. Soon after, they apply at their local lender for a much larger cash-out refinance loan, with the stated purpose of converting the ground floor into a medical facility. This facility would command a much higher rent than is currently earned from the ground floor apartment tenants, and this is reflected in the appraisal. Once funded, the loan goes into immediate default and the borrowers disappear.

Another scheme involves a developer/builder who has sold the majority of homes in a development but is left with a few unsold. The developer finds a buyer, but the individual has no down payment. The property, worth \$150,000, is sold to the buyer for \$170,000, and the builder forgives the down payment. The net effects are: the builder receives the value he intended (\$150,000), the buyer pays what the property is worth (approximately \$150,000), the buyer is able to finance the whole transaction (\$150,000) and the lender is left with a loan-to-value of 100%, which the lender had not intended. If the home goes into foreclosure, there is no equity to protect the lender and the resulting losses are disproportionately large.



A third scheme, illegal flipping, involves borrowers who purchase a single-family residence for \$150,000. They collude with a loan officer or mortgage broker to quickly sell the property to a “straw buyer” (usually a person who has no intention of living in the house or making the payments) for \$400,000. The straw buyer is able to obtain a loan above his creditworthiness using falsified documents, with an overstated appraisal. The perpetrators use the proceeds to pay off the existing first mortgage and they keep the balance. The straw buyer then defaults on the payments and the lender is left to foreclose on a property that is worth considerably less than the loan balance. This fraud implicates the buyer, loan officer, appraiser, and often the escrow at an enormous cost to lenders.

Steps to Reduce Fraud Charge-Off Volume

With the risk of non-detection at the forefront of this issue, there are steps that banks can take to decrease the volume of fraud that is charged off in the form of “bad loans.”

- **Prevention** Does the bank have an approved appraiser listing? Appraisers should be heavily scrutinized, including background checks. This approved appraiser listing should be updated often, and include the details of appraisers who were deleted because they failed to meet the bank’s standard qualifications.
- **Early detection** Were loans made that circumvented the bank’s typical underwriting controls and scoring tools? Consider evaluating loan files to ensure complete documentation, which may help the bank’s attorney in more effectively representing the institution’s interest should the loan go into default.

In short, analysts are predicting the housing crisis to continue well into 2009. It is very likely that mortgage fraud cases will continue to rise as lenders become more aware of mortgage fraud. Fraud prevention and early detection techniques will lessen the impact of mortgage fraud imbedded in nonperforming loans, and are essential to protecting an institution’s assets and reputation.

Monitoring a Bank’s Credit Risk

Moss Adams partners with financial institutions in performing any number of risk mitigation services to help identify fraud risk.

- **Loan File Reviews** Our professionals can perform loan file reviews to help ensure that loan officers are complying with the bank’s policies. Complete loan files can often speed up the collection process on foreclosed properties.

- **Internal Control Process Reviews** We provide practical recommendations on the processes surrounding the lending cycle to minimize the occurrence of future fraudulent loans.
- **Fraud Investigation and Testing** Our consultants have experience in quantifying fraud events for a more complete recovery.

These are just a sample of the services Moss Adams provides to our Bank industry clients to help minimize loss exposure. Our breadth and depth of professional experience in the banking industry translates into a focused commitment, with effective results for our clients. Contact us today to discuss building proactive and cost-effective processes for your institution.

References:

- 1 Ivy, Bob. April 26, 2007. Mortgage fraud seen as prolonging U.S. housing slump. *Bloomberg News*
- 2 White, Frayser. August 25, 2008. ChoicePoint affiliate says mortgage fraud reports rose 42% in Q1. *Bank, Thrift & Specialty Lender - Industry News*

Be Proactive with Tax Charge-offs!

By Jason Munn, CPA

A few years ago, it seemed as if a bank could make a loan to virtually anyone and the risk of incurring a charge-off was low. Well, times have changed and across the nation, loan quality has suddenly become a significant concern for many banks. As a result, many institutions dramatically increased the provision for loan losses in 2008, significantly reducing pre-tax book earnings. Much to the chagrin of many bank CFO's, those same book provisions are generally not deductible for income tax purposes (typically only actual loan charge-offs will result in a tax deduction). As a result, taxable income may be significantly higher than book income for 2008. Therefore, even in these troubled financial times for banks, significant cash outflows for income taxes may still have occurred. At a time when many institutions are concerned about capital levels and liquidity, there needs to be a creative manner in which taxable income can be reduced.

Strategies to Reduce Taxable Income

How can this be achieved? The standard approaches include cost segregation, using federal and state tax credits, and performing a general study of tax accounting methodologies to ensure that best practices are being utilized. However, there is one approach not commonly utilized and now is the time to deploy this methodology:



the Substandard Loan Charge-Off Analysis. This formal study evaluates substandard loans in order to potentially charge-off loans for tax purposes before writing off the same loans for regulatory purposes. A thorough analysis of substandard loans can result in a bad debt charge-off for tax purposes for 2008 whereas the book charge-off (if any) does not occur until 2009. This generates a tax deduction one year in advance of when it would have otherwise been recognized – it provides benefit from a time value of money perspective by reducing current year taxable income. Cash is now conserved that might otherwise be paid to federal and state taxing authorities, providing for enhanced liquidity of the bank.

What does the IRS think about this?

Now, you may ask yourself “what does the IRS think about this?” As with many tax positions, there are no “bright-line” tests that indicate when a bad debt arises for tax purposes. However, completing a Substandard Loan Charge-Off Analysis does not stamp a “red flag” on the bank’s tax return – it simply increases bad debt expense. In these trying financial times, large bad debt write-offs on bank tax returns will not necessarily seem unusual to the Internal Revenue Service (IRS). Ultimately, the most important aspect of deploying this methodology is completing a formal study of each potential problem loan. The studies are conducted within the framework of Internal Revenue Code section 166 and the related regulations, providing solid support in the event of an IRS audit. Inquiries are made of the chief credit officer and others familiar with the problem loans. Generally this can be done remotely or in person so as to minimize the interference with the bank’s personnel.

Some of you may also wonder how the “bad debt conformity election” impacts these studies. In times of prosperity, the conformity election served mostly as an insurance policy against the IRS questioning the timing of a charge-off for tax purposes. Now, the election may in fact be detrimental to a bank if opportunities otherwise exist to accelerate charge-offs for tax purposes. The election can be revoked and there are two different ways to do achieve this. Thus, if additional tax deductions are desired and the bank previously made the conformity election, formal revocation may be something the bank should consider.

Studies are Available

If you are interested in the Substandard Loan Charge-Off Analysis (or other strategies mentioned in this article), Moss Adams LLP has the experts that can assist you. We began conducting these studies late 2008/early 2009 as book charge-offs for 2008 were being finalized. Contact Moss Adams today to discuss the potential impact of the study on your business. Call Jason Munn at (800) 888-4065 or send an email to jason.munn@mossadams.com to discuss further.

Bankers Compensation Survey

Compensation packages continue to be a major tool for hiring and retaining employees in today's competitive market.

The Bankers Compensation Survey provides useful information and serves as a guide to banking professionals' career and business planning, with:

- Benchmarks in salary and bonus structures for the Western United States.
- Salary differentials for institution size and geographic location.
- Benefits and salary packaging for the banking community.

Call us today and sign up to receive the 2008 Bankers Compensation Survey Report. You can also receive a copy of the 2007 Survey Report. Call (800) 888-4065 or visit www.mossadams.com.



Benefit and Salary Expenses

The following chart reflects the bank's total benefit expense (medical, dental, retirement, etc.) for executive management as a percent of salary, including annual expense of traditional and incentive benefits. For example, 36% of banks with total assets between \$50-99 million have a benefit expense ratio between 10%-20% of total salary expense.

Why Moss Adams

Founded in 1913, Moss Adams LLP is the 11th largest CPA and consulting firm in the nation, providing specialized audit, tax, and consulting services to Financial Institutions.

Over 300 financial institutions have selected Moss Adams Financial Institutions Group to serve them because of our industry experience and service excellence. We serve clients from the start-up phase and into the growth phase; during public offerings and through the transition of ownership. To provide services that contribute to our clients' success, we focus on their unique needs, situations, and expectations at each stage of their business.

Financial Institutions like yours rely on Moss Adams for valuable, relevant guidance and dedicated service that makes a difference.

www.mossadams.com

Contacting Our Team

For information about Audit, Tax and Business Consulting services provided by the Financial Institutions Group at Moss Adams LLP please contact:

JASON MUNN, CPA

Senior Tax Manager

T (509) 777-0119

jason.munn@mossadams.com

LISA SANBORN, CPA

Senior Audit Manager

T (509) 777-0207

lisa.sanborn@mossadams.com