FINANCIAL INSTITUTIONS

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Electronic Funds Transfer Act

Time to Prepare for the Opt-In Requirements

OVERVIEW

The traditional ways of banking are rapidly becoming a thing of the past. Consumers paid overdraft fees when their accounts became overdrawn, and rightfully so. Overdrafts are unsecured loans. The changes to Regulation E give consumers the right to opt-in to the payment of ATM and one-time debit card transactions. This applies whether or not the financial institution offers and promotes a discretionary overdraft service.

The revisions to the Electronic Fund Transfer Act limit the ability of a financial institution to assess overdraft fees for paying automated teller machine (ATM) and one-time debit card transactions that overdraw a consumer's account, unless the consumer affirmatively consents, or opts-in, to the institution's payment of overdrafts for these transactions.

The opt-in notice must be provided in writing and describe the institution's overdraft services, provide reasonable opportunity for the consumer to affirmatively consent to the service, obtain the consumer's affirmative consent, and provide the consumer with confirmation of their consent in writing. The financial institution may provide the opt-in notice to the consumer by mail, telephone, in person or electronically. The model form provided in the final rule can be located at www.federalreserve.gov/newsevents.

The financial institution must provide consumers who do not affirmatively consent to the institution's overdraft service for these types of transactions the same account terms, conditions and features it provides consumers who affirmatively consent.

The notice and opt-in requirements do not apply to an institution that has a policy and practice of declining to authorize and pay ATM or one-time debit card transactions when the institution has a reasonable belief, at the time of transaction authorization, that the consumer does not have sufficient funds available. That sounds simple; do not authorize the ATM and one-time debit card transaction when funds are not available, and there will never be issues. Not so fast. Some merchants may not verify availability of the full dollar amount of the transaction. Or, the authorization may be approved today and settled with the financial institution at a later date, after other transactions have cleared and the funds are not available. Unless the consumer has affirmatively consented to the opt-in of the payment of ATM and one-time debit card transactions, the financial institution cannot charge an overdraft fee or any other charge associated with that overdraft.

For existing accounts opened prior to July 1, 2010, the financial institution may not assess any fees or charges on a consumers account on or after August 15, 2010, unless they have affirmatively opt-in to the payment of the ATM and one-time debit card transactions. Compliance for new accounts is mandatory on July 1, 2010. The entire Regulation E revisions can be found at www.federalreserve.gov/newsevents.

On February 19, 2010, the Federal Reserve issued a proposed rule that would amend the revisions of Regulation E. The intent of the proposed amendment is to clarify certain aspects of the final rule published on November 12, 2009. Unfortunately, the mandatory compliance date will not change as a result of this issuance. We will have to wait and see what changes occur, if any.

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CPAs & BUSINESS ADVISORS

The S Corporation Election: Still an Advantage for Community Banks

OVERVIEW

This article reviews the advantages of the S Corporation election for community banks.

In our previous article in the January issue of *Possibilities*, Distressed Banks: Reevaluate S Corporation Election, we discussed distressed community banks, and how factors, such as thinning capital levels, rising debt-to-equity ratios and tight holding company cash-flow, may cause a community bank to reevaluate its S Corporation election for income tax purposes.

These challenges exist for many community banks in today's economic environment. Although earnings may or may not be leaner than prior years, a viable course of cash flow still exists for S Corporation shareholders, and the benefits that have been realized by community bankers since Congress made the S election available to them, beginning with the 1997 tax year, still exist.

Although earnings may or may not be leaner than prior years, a viable course of cash flow still exists for S Corporation shareholders, and the benefits that have been realized by community bankers since Congress made the S election available to them, beginning with the 1997 tax year, still exist.

Many current S Corporation bank shareholders, and shareholders of C Corporation banks considering the election, question whether these benefits will still exist in our current environment of rising individual tax rates. The top two marginal brackets are scheduled to increase after 2010. The 33 percent bracket moves to 36 percent, the current top bracket of 35 percent moves to 39.6 percent. These increases go back to the level of tax rates that were in effect in 1997, when community banks were first allowed to make the S Corporation election.

Many people feel this increase, or restoration, of higher individual tax rates would cause an S Corporation to lose some of its appeal. Not to be forgotten for S Corporations that have the ability to pay shareholder distributions above and beyond reimbursement for pass-through income tax liabilities, is the fact that preferential rates for qualified dividends are also set to increase after 2010, from 15 percent back to the ordinary income rates. This would cause bank holding companies with the ability to pay shareholder distributions to realize an even greater tax benefit from an S Corporation election than they currently do.

The below table calculates the tax benefit of the "single taxation" structure of an S Corporation using tax rates effective after 2010. As you can see, taking tax-free cash out of the corporation as a shareholder still has its advantages, even with individual interest rates on the rise. The bank retained the same amount of capital ($400,000) in both taxation structures, but shareholders netted more cash as an S Corporation.

Retained corporate earnings	$400,000	$400,000
Shareholder Cash Flow Summary		
Tax distribution from bank	N/A	396,000
Individual tax liability from pass-through earnings (39.6%)	N/A	(396,000)
Additional shareholder dividend/distribution	260,000	204,000
Tax liability on shareholder dividend (39.6% after 2010)	(102,960)	N/A
Net shareholder cash flow	**$157,040**	**$204,000**
Shareholder stock basis effect		
Beginning shareholder stock basis	1	1
Increase in stock basis from retained taxable earnings	N/A	400,000
Ending shareholder stock basis	1	400,001
Future tax benefit of basis increase, using Federal capital gains tax rate effective after 2010 (20%)		**$80,000**

The table does not take into effect some other significant advantages of holding S Corporation stock versus C Corporation stock, such as the state tax advantages. Most states do not tax the interest of qualified U.S. agency bonds, such as FHLB bonds, which creates a substantial tax savings at the state level for many S Corporation bank shareholders.

Also reflected in the table is the effect of the increase in stock basis by undistributed taxable earnings. In this example, you may recall that $400,000 of the year's earnings is retained for capital. You can see that the effect of leaving undistributed taxable earnings of only one year inside the S Corporation still provides shareholders with tax benefits in the future.

There is a much more substantial cumulative effect of this benefit over a five-, ten- or twenty-year period. Thus, it's not just the current cash flow that provides a tax benefit for S Corporation shareholders, but earnings retained by the S Corporation also provide shareholders with a potential tax advantage down the road when they sell or redeem their S Corporation shares.

C Corporation banks that have done their analysis on the cash flow and stock basis benefits still need to consider items discussed in our last article, such as the potential cash crunch if the bank or holding company is unable to distribute any cash to shareholders and there is still taxable earnings passing through to them. However, these prospective S Corporation banks also need to consider that this may be a great time to make an S election, even with rising individual tax rates.

The "built-in gains" tax, which for the first 10 years of an S Corporation's life imposes the C Corporation double-tax on appreciated assets that the bank owned at the date of the S election, can be minimized right now because of generally lower stock values in the industry. This is because the largest "appreciated asset" on a bank's balance sheet has historically been the goodwill inherent (not necessarily booked) on its balance sheet. A bank with $10 million of capital appraised as being worth 1.5 times of book value would have $5 million of "goodwill" inherent at that time.

If the bank made an S Corporation election, as of the appraisal date, this $5 million of goodwill would be subjected to double-taxation if the bank ever sold its assets during the first 10 years of the S election. In the current environment, compressed bank values could potentially lead to minimizing the impact of the built-in gains tax on new S Corporation elections.

Since 1997, many community banks and their shareholders have realized substantial benefits from the S Corporation structure of taxation. These current tough economic conditions may cause some community banks to reevaluate their current or prospective S Corporation elections. S Corporations can still provide a tremendous benefit to their shareholders, even with individual income tax rates on the rise. Many factors determine whether the S election is the most suitable structure for your bank and it is vital for banks to work closely with their tax counsel in making this determination.

S Corporations can still provide a tremendous benefit to their shareholders, even with individual income tax rates on the rise.

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Mark Your Calendar

Save these dates for our 2010 Bankers Seminars:

Thursday, October 28
Mankato, Minnesota

Thursday, November 4
Fargo, North Dakota

Thursday, November 18
Sioux Falls, South Dakota

Weathering the Storm—Why 2010 (and beyond) is the Golden Age for Bank-Owned Life Insurance

OVERVIEW

This article explains how Bank-Owned Life Insurance (BOLI) can be used to increase a bank's operating margin, before providing an update on the state of the BOLI in the marketplace today. While most asset classes have suffered as a result of the economic turmoil, BOLI has proven resilient. Now is the time for banks to conduct detailed product reviews, consider yield upgrades and improve the risk profile of existing BOLI investments.

BOLI products have evolved with the industry and the products currently available can be excellent strategic tools for banks to use to attain their financial goals.

Feeling the Squeeze

According to the FDIC's quarterly banking profile report for Q4 2008, 56 percent of all insured institutions reported lower net interest margins than a year earlier. While interest rates continue to remain at low levels, depositors are increasingly sensitive to reductions in rates, leaving many banks with a dilemma—maintain deposit rates and squeeze margins still tighter as investment returns fall, or reduce them and suffer capital outflow. Continued margin compression is a very real threat in 2010 and beyond.

A Spread Investment

When a bank implements a BOLI plan, it becomes the owner and beneficiary of life insurance contracts on a select group of employees. The bank pays the premiums and the policies become assets of the bank. The cash surrender value of the policies is invested in low risk fixed-income securities and all cash value growth accumulates on a tax-deferred basis. Banks enjoy advantages in the form of credit enhancements to the underlying investments and minimum yield guarantees from the policies. An important analogy should be drawn between the banking business and the BOLI asset. Protecting the bank's income and protecting a BOLI investment can be reduced to sensible spread risk management.

There have been a small number of high profile cases in which banks recently lost money on BOLI policies. In each case, this was a result of excessive investment risk in the BOLI portfolio. During the boom years, some banks decided that their BOLI investments should be made in leveraged hedge funds and sub-prime investments. Their fate mirrors banks that made similar decisions with their non-BOLI assets. BOLI is not a place to hide risk, it is a tax advantaged investment vehicle, through which banks can benefit from the tax status of insurance and earn a spread relative to their cost of funds.

Every Cloud has a Silver Lining

Banks inherent nervousness about all investment activity has led to demands for total transparency and simplicity. In the BOLI space, these have been met. Notably, many of the new Hybrid Account BOLI products have evolved to provide all of the benefits of the other two BOLI structures (General Account and Private Placement Variable Universal Life "PPVUL" / Separate Account), while removing the less desirable features of each. The economics of the transaction are simple; the bank is paid the greater of the bond equivalent yield earned in the policy portfolio, or a yield floor. Credit risk is mitigated by an "asset replacement feature" that pledges to replace any asset which suffers an event of default, with one of similar quality prior to the event.

Funds are held in a segregated account and are not subject to the creditors of the insurance carrier if there is deterioration in its financial position. From a regulatory standpoint, Hybrid Account was built with the inter-agency guidance OCC 2004-56 on BOLI best practice in mind. The transparency and risk reduction features inherent in these next-generation products are a tremendous improvement.

A New Era for BOLI

Banks that wish to generate additional spread income, either with a new allocation to BOLI or an upgrade of existing policies, are finding that there has never been a better time to do so. Products are more transparent, with lower risk and costs than ever before. Funds are segregated, carrier credit ratings remain high and the bank's operating margin can be significantly increased. In reviewing your bank's BOLI needs, ensure that you select an independent, objective consultant that has access to many competing carrier's products. This way, you can achieve the best deal for your bank with confidence in fulfilling your fiduciary responsibilities.

RAMP Review Process

RAMP (Review and Analyze to Maximize Performance) is a formalized BOLI review program for banks that may or may not currently own BOLI. The RAMP process includes a detailed report with specific recommendations for your bank that can be used to implement any necessary or desired changes.

For banks that currently own BOLI, RAMP is a comprehensive review and analysis of existing plans and an opportunity to review upgrade

Weathering the Storm—continued on page 8

7th Circuit Court Reverses Tax Court on S Corporation TEFRA Issue

The 7th Circuit court of appeals rendered its opinion in the case of Vainisi v. Commissioner on March 17, 2010. The 7th Circuit court ruled in favor of taxpayer, reversing the Tax Court decision made on January 15, 2009, which had ruled in favor of the Internal Revenue Service.

This case has been the topic of much discussion and debate in the banking industry over the last few years. The general industry position has been that the TEFRA adjustment no longer applied to S Corporation banks after the first three years of their S Corporation election had passed, based on existing language in the Internal Revenue Code. The IRS issued a proposed regulation, effective beginning with the 2007 tax year, that stated their position on this issue. Many S Corporation banks followed the guidelines of the proposed regulation and made the TEFRA adjustment on their 2007 income tax returns, while some S Corporation banks decided to not make this adjustment and awaited the decision of the Tax Court case, which as mentioned earlier, came in January 2009. Thus, many S Corporation banks followed the initial Tax Court decision and made the TEFRA adjustments to their 2008 tax return, as well as to their 2009 tax return, which was due on March 15, 2010, just two days before the 7th Circuit reversal decision.

S Corporation banks and holding companies, and their shareholders, now appear to have a position to not make the TEFRA adjustment to their 2009 tax returns. This may require an amendment of the 2009 S Corporation tax return in many cases. However, taxpayers outside of the 7th Circuit court of appeals jurisdiction should likely disclose this position to protect themselves from potential IRS penalty assessments. The IRS is not bound to follow this decision outside of the 7th Circuit, thus proper disclosure of the position may be advisable. The 7th Circuit court of appeals jurisdiction consists of the states of Wisconsin, Illinois and Indiana.

Also, those S Corporation banks that made the TEFRA adjustment on their prior year returns may also want to consider amending the prior year S Corporation tax returns and applicable shareholder individual tax returns as a result of this ruling.

Taxpayers need to be aware that the three-year statute of limitations closes on April 15, 2010, for shareholders that were affected by the TEFRA adjustment on their 2006 tax returns, so time may be of the essence in those situations. Protective claims may need to be filed by the shareholders in advance of the actual 2006 S Corporation return being amended.

Please contact your Eide Bailly advisor to determine what impact this important Tax Court decision may have on your financial institution.

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The New Rules on Participation Loans

OVERVIEW

Be aware of the details when entering into participation loans. This article reviews some of the complex issues of the new standard.

The following list includes specific items to be aware of when entering into various participation arrangements. This list is not intended to be all inclusive, rather a taste of some of the complexities involved with the new standard.

- Loans meeting sale treatment must be recorded by the buyer at fair market value, with a gain or loss recorded by the seller. For most community banks, the sale of loans will be at par value because of the lack of an active market. If terms of the loan are significantly above or below market conditions, then consider reporting a gain or loss.

- A servicing right asset, or liability, needs to be considered by the selling bank for a participating interest meeting sale treatment. For many smaller institutions, the amount will be immaterial, but calculations will need to be made to document the consideration.

- If there are several participants involved in a participation arrangement, and one of them fails to meet sale treatment, then they all fail to meet sale treatment.

- For operating lines in place prior to January 1, 2010, where the agreement is on a LIFO basis, any advances after December 31, 2009, have to be on a pro rata basis to qualify for sale treatment.

- On operating lines that have daily activity of advances and payments with several participants involved, each transaction does not have to be handled on a pro rata basis; settlement can take place periodically. As a general guideline, settlement on a weekly basis should be sufficient.

- Even if the principal portion of the loans participated out are on a pro rata basis, and are paid on a pro rata basis, the cash flow from interest must also be on a pro rata basis. You cannot distribute the cash flow from interest on any basis other than the percentage of ownership in the financial asset.

- For national-chartered financial institutions, and certain state-chartered banks, they can continue to have LIFO and FIFO participation arrangements after December 31, 2009, and it will not count against the bank for lending limit purposes. However, the bank will have to include the full amount of the loan for capital calculation purposes and for call report purposes.

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10 Best Practices to Increase Board Regulatory Oversight

The role of bank directors has grown in complexity. In addition to selecting and retaining competent management, monitoring operations and overseeing the bank's performance, bank directors are encouraged to be more involved with regulatory oversight. Follow these best practices to enhance board regulatory oversight.

1. Set the tone.
According to Andrew Olszowy, Consumer Compliance Examinations Manager for the Federal Reserve Bank of Boston, "The most effective compliance risk management programs are proactive and driven by the board of directors. By engaging the compliance function, the board establishes the expectation that compliance is a priority, thereby establishing a 'culture of compliance'."

2. Define the board's responsibilities.
Articulate and document the specific responsibilities, scope and duties of the board. They should be consistent with regulatory requirements and risk management policies.

3. Be familiar with regulatory agencies.
Do your homework. Come prepared to board meetings and be fully aware of the regulatory agencies and requirements the bank must satisfy. Understand how regulatory agencies oversee and view the bank.

4. Conduct a board self-assessment.
Evaluate the board performance and effectiveness. Peer review is an important element in achieving board oversight.

5. Understand the bank's lending parameters.
Do research to know which lending parameters currently apply to the bank and how those parameters compare to the bank's competitors.

6. Discuss risks with senior executives.
Develop formal guidelines with management for communicating, reporting and escalating risks. Schedule regular meetings with management and review the bank's risk management policies.

7. Consider creating a risk oversight committee.
Form a risk oversight committee to establish risk as a bank's focus. The formation of this committee does not relieve the directors of their responsibilities, but proactively addresses risk. The decision to form a risk oversight committee may depend on the size and complexity of the bank's operations, the board members' expertise and the number of current board committees.

8. Evaluate directors' skills and competencies.
Document the skill-sets required of the board of directors, which may include financial literacy, knowledge of the banking industry, objectivity and knowledge of the community. In addition, board members may be required to have expertise in risk, or designate a "risk expert."

9. Stay informed.
Follow industry trends and regulatory developments, attend regular meetings, review meeting materials, auditor's findings, recommendations and supervisory communications. The regulatory environment changes rapidly for financial institutions; it's critical that directors stay informed. Seek regular training and education.

10. Understand the bank's risk appetite.
Work closely with compliance management to understand and address risk. When a regulatory issue develops, ask questions: What is the change and why was it adopted? How does it affect our financial institution? What is the risk of noncompliance? What is the cost of compliance? Do we have a plan to implement the change?

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Source: Consumer Compliance Outlook: Third Quarter 2009

OVERVIEW

The board and its members are ultimately responsible for ensuring that a bank operates safely and soundly, and complies with laws and regulations. The following article shares 10 best practices to increase board oversight.

In addition to selecting and retaining competent management, monitoring operations and overseeing the bank's performance, bank directors are encouraged to be more involved with regulatory oversight.

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RETURN SERVICE REQUESTED

Weathering the Storm—continued from page 4

options for BOLI products and insurance carriers. RAMP can also include a review of existing benefit plans to determine if the plans are providing the intended benefits to the recipient and the bank. In addition, the RAMP process can include a review of bank BOLI documentation to determine if it is up to date and in compliance with current regulatory requirements.

For banks that do not currently own BOLI, RAMP is an opportunity to review and analyze possible improvements in yield, income, risk weight, earnings per share, non-interest/interest income ratio's, net interest income, efficiency ratio, capital ratios, return on assets, and return on equity. The current employee benefits offered by most banks will support the addition of BOLI. However, the increased income provided by BOLI can also be used to fund new executive benefit plans to attract and retain key employees.

Banks have utilized life insurance products for many years. BOLI products have evolved with the industry and the products currently available can be excellent strategic tools for banks to use to attain their financial goals.

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Meyer-Chatfield is an independent consulting organization formed in 1992, to assist financial institutions with BOLI products. Over the past 17 years, they have completed more than 1,000 transactions for more than 250 financial institutions and are recognized for their leadership and expertise in BOLI products.