DEFERRED TAX ASSETS

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Edmund S. Pooler
Atlanta Regional Accountant
Division of Risk Management Supervision
FDIC

Deferred Tax Assets

- How do deferred tax assets (DTAs) arise?
- How do you account for DTAs under GAAP?
- When is a valuation allowance recorded?
- How are DTAs treated for regulatory capital purposes?

Deferred Tax Assets

Applicable Accounting Standard:

ASC 740 *Income Taxes* (previously FASB Statement No. 109, *Accounting for Income Taxes*).

- Two basic principles related to accounting for income taxes, each of which considers uncertainty through the application of recognition and measurement criteria:

  a. To recognize the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset

  b. To recognize a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards.

Deferred Tax Assets

A **deferred tax liability** or **asset** represents the increase or decrease in taxes payable or refundable in future years as a result of "temporary differences" and net operating loss or tax credit carryforwards that exist at the reporting date.

Deferred Tax Assets

- Temporary differences arise when events are recognized in one period on a bank's books but are recognized in another period on its tax return
- Deductible temporary differences reduce taxable income in future periods and create deferred tax assets
- Net operating loss carryforwards also create deferred tax assets

Deferred Tax Assets

Examples of temporary differences:

- Provision for Loan and Lease Losses
- Writedowns of ORE
- Recognition of loan origination fees
- Other postemployment benefits expense

Deferred Tax Assets

Calculate deferred tax assets and liabilities by multiplying applicable tax rate times amount of the temporary difference or carryforward

Deferred Tax Assets

- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that are not expected to be realized.
- The realizability of all deferred tax assets must be evaluated each period
- A Valuation Allowance should be established for the portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.

Deferred Tax Assets

- All available evidence, both positive and negative, shall be considered to determine whether a valuation allowance is needed
- A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome
- Realization of deferred tax assets depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period

Deferred Tax Assets

- Regulatory capital standards limit the amount of deferred tax assets that can be included in Tier 1 capital
  - Limit applies to deferred tax assets that are <u>dependent on future taxable income</u>:
    - Deferred tax assets arising from deductible temporary differences that exceed taxes previously paid that could be recovered through loss carrybacks if all temporary differences (both deductible and taxable) <u>fully reverse at the report date</u>
    - Deferred tax assets arising from operating loss and tax credit carryforwards

Deferred Tax Assets

- Determination of deferred tax assets “dependent on future taxable income”
  - May exclude deferred tax effects of unrealized holding gains and losses on available-for-sale debt securities
    - If excluded, follow this treatment consistently
  - For a bank subsidiary of a holding company, if parent does not have financial capability to reimburse bank for tax benefit of bank’s carryback of net operating losses or tax credits, bank should limit the carryback potential available for realization of its deferred tax assets to the amount which it could reasonably expect to have refunded by its parent

Deferred Tax Assets

- Deduct from Tier 1 capital the amount by which deferred tax assets dependent on future taxable income exceed the lesser of
  - Amount of deferred tax assets the bank expects to realize within one year based on <u>projected future taxable income</u> or
  - 10% of the bank's Tier 1 capital before deducting certain disallowed assets

Deferred Tax Assets

- "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 <u>expected to be implemented</u> to realize tax carryforwards that will otherwise expire during that year
    - Differs from tax planning strategies in ASC 740 (FAS 109) for determining need for and amount of any valuation allowance against deferred tax assets

Deferred Tax Assets

- Bank should calculate one overall limit on deferred tax assets that covers all tax jurisdictions rather than a separate limit for each tax jurisdiction
- See Call Report Schedule RC-R, item 9.b
  - Disallowed Deferred Tax Assets

Disallowed Deferred Tax Assets Calculation

(a) Enter the amount from Schedule RC-R, item 8 ________

(b) Enter 10% of the amount in (a) above ________

(c1) Enter the amount of deferred tax assets reported in Schedule RC-F, item 2 ________

(c2) Enter adjustments to the amount of deferred tax assets in (c1) above for:
(1) the deferred tax effects of certain items reported in Schedule RC, item 26.b, "Accumulated other comprehensive income" (AOCI), that are excluded from regulatory capital (i.e., unrealized holding gains and losses on available-for-sale debt securities, other-than-temporary impairment losses on debt securities, and defined benefit postretirement plan amounts reported in AOCI),[1] and
(2) any deferred tax liabilities the bank has netted against assets deducted from Tier 1 capital[2] (i.e., 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, and deducted nonfinancial equity investments) ________

(c3) Subtotal: (c1) plus or minus (c2), as appropriate ________

Disallowed Deferred Tax Assets Calculation

(d) Enter the amount of taxes previously paid that the bank could recover through loss carrybacks if the bank's temporary differences (both deductible and taxable) fully reverse at the report date ________

(e) Amount of deferred tax assets that is dependent upon future taxable income: subtract (d) from (c3); enter 0 if the result is a negative amount ________

(f) Enter the portion of (e) that the bank could realize within the next 12 months based on the estimated taxes payable 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. ________

(g) Enter the lesser of (b) and (f) ________

(h) Disallowed net deferred tax assets - subtract (g) from (e); enter 0 if the result is a negative amount ________

Deferred Tax Assets

- Deferred tax assets dependent upon future taxable income
  - Example: As of June 30, 2011:
    Estimated tax payments paid for 2011 = \$10
    Taxes paid for 2010 = \$40
    Taxes paid for 2009 = \$30
    Total taxes paid that could be recovered = \$80
  - If net deferred tax assets (Schedule RC-F, item 2) $\leq$ \$80, then deferred tax assets dependent upon future taxable income = 0
  - If net deferred tax assets (Schedule RC-F, item 2) > \$80, then deferred tax assets dependent upon future taxable income = Schedule RC-F, item 2, minus \$80

Deferred Tax Assets

- In contrast, if bank is in a net operating loss carryforward position
  - Bank has no carryback potential, i.e., there are no taxes previously paid that are recoverable
  - Entire amount of deferred tax assets is dependent upon future taxable income
  - Exception: Bank has made estimated tax payments for the current year, which are recoverable

Deferred Tax Assets

- Deferred tax assets related to available-for-sale (AFS) debt securities
  - Net unrealized holding gains and losses on AFS debt securities
    - Reported in “accumulated other comprehensive income” component of equity capital
    - Excluded from regulatory capital
  - For deferred tax asset limitation purposes, a bank may, but is not required to, adjust its deferred tax assets for any deferred tax assets and liabilities related to AFS securities
    - Bank must consistently follow its chosen approach

Deferred Tax Assets

- Deferred tax assets related to available-for-sale (AFS) debt securities
  - Example:

Amortized cost of AFS debt securities	1,000
Fair value of AFS debt securities	880
Net unrealized loss on AFS securities	120*
Applicable tax rate (30%)	36**
Net unrealized loss, net of tax effect	84#

* Deductible temporary difference

** Deferred tax asset (assume no valuation allowance)

\# Amount included in AOCI

Deferred Tax Assets

– Example (continued)
– Assume net deferred tax assets on balance sheet include the following components:

DTA – AFS debt securities	36
DTA – Other deductible temporary differences	124
DTL – All taxable temporary differences	(35)
Net deferred tax assets (Schedule RC-F, item 2)	125

If bank chooses to exclude the deferred tax effect of its net unrealized loss on AFS debt securities, the adjusted amount of deferred taxes to be reported on line (c3) in the deferred tax asset calculation worksheet = 125 - 36 = 89

Questions?

ATLConferenceCall@fdic.gov

Contact Information

- Ed Pooler epooler@fdic.gov
  404-267-5439 or 413-386-9499