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ICBA Preferred SERVICE PROVIDER

First Quarter 2012

THE BOTTOM LINE
EXECUTIVE AND DIRECTOR BENEFITS AND BOLI

Legislative Proposals
President's 2013 Budget

In President Obama's 2012 State of the Union address, and later in his 2013 Budget, he proposed a number of changes in individual income tax law. The proposals are outlined in the Budget but remain to be fleshed out by legislative language. The proposed changes are summarized here:

Individual Tax Proposals

- Extend the reduced 4.2 percent Social Security payroll tax rate for individuals until end of 2012 (the reduced rate was extended by Congress and the President in February 2012)
- Households making over $1 million/year to pay a minimum effective tax rate of at least 30 percent
- Reduce value of itemized tax deductions for those families making over $250,000/year (married, filing jointly) to 28 percent
- Make permanent a tax credit that provides up to $10,000 for tuition over four years of college
- Extend Bush tax cuts for those families with incomes under $250,000 (married, filing jointly)

Outlook for Proposals/ Meaning for 2013 Deferral Elections

Most professional prognosticators see almost no chance for any movement on tax proposals prior to the November Presidential election and many see little chance for any movement during the lame duck session of Congress after the elections. If the prognosticators are correct, this will mean that all Bush tax cuts will end December 31, 2012. If so, the value of deferred compensation for years 2013 and beyond will increase. This could be a significant factor in deferral elections to be made at the end of this year. We will, of course, be keeping close tabs on developments in this area.

Featured Articles

- Legislative Proposals: President's 2013 Budget
- The President's Framework for Business Tax Reform
- Assessing the Impact of Low Interest Rates on Life Insurance Products
- A Utilitarian Solution to Disappearing Margins: A Potential Remedy to Burdensome Regulations and Low Interest Rates
- M Benefit Solutions - Bank Strategies Adds to Lineup of Community Bank Consultants

The President's Framework for Business Tax Reform

On February 22, 2012, the White House and the Treasury Department jointly released The President's Framework for Business Tax Reform (the "President's Framework"). The President's Framework would reduce the corporate tax rate and eliminate dozens of tax expenditures and reform the business tax base with the intent of reducing distortions that hurt productivity and growth.

Specifically, the President's Framework would:

Reduce the Corporate Tax Rate from 35 Percent to 28 Percent. The reduction in the rate is intended to put the United States in line with other advanced countries and help encourage greater investment in the United States.

Eliminate Dozens of Business Tax Loopholes and Tax Expenditures. The President's Framework starts from a presumption that all tax expenditures for specific industries should be eliminated, with a few exceptions critical to broader growth or fairness. Examples of specific reductions in tax expenditures and loophole closers:

- **Eliminate "Last in First Out" Accounting.** The President's Framework would end LIFO accounting, bringing the Code in line with international standards and simplifying the tax system.
- **Eliminate Oil and Gas Tax Preferences.** The Code currently subsidizes oil and gas production through tax expenditures that provide preferences for these industries over others. The President's Framework would repeal tax preferences available for fossil fuels. This includes, for instance, repealing the expensing of intangible drilling costs and percentage depletion for oil and natural gas wells.
- **Reform Treatment of Insurance Industry and Products.** The President's Framework would not allow company interest deductions allowable to life insurance policies unless the contract is on a person who owns at least 20 percent of the business. Currently, no interest deductions are lost due to ownership of life insurance policies if the insureds are employees, officers, directors, or 20-percent or greater owners. The Framework would also make a number of other reforms to the treatment of insurance companies and products to improve information reporting, simplify tax treatment, and close loopholes.
- **Taxing Carried (Profits) Interests as Ordinary Income.** Currently, many hedge fund managers, private equity partners, and other managers in partnerships are able to pay a 15 percent capital gains rate on their labor income (on income that is known as "carried interest"). The President's Framework finds this loophole inappropriate as it permits these financial managers to pay a lower tax rate on their income than other workers. The President's Framework would eliminate the loophole for managers in investment services partnerships and tax carried interest at ordinary income rates.
- **Eliminate Special Depreciation Rules for Corporate Purchases of Aircraft.** This would eliminate the special depreciation rules that allow owners of non-commercial aircraft to depreciate their aircraft more quickly (over five years) than commercial aircraft (seven years).
- **Depreciation Schedules.** Current depreciation schedules generally overstate the true economic depreciation of assets. In an increasingly global economy, accelerated depreciation may be a less effective way to increase investment and job creation than reducing tax rates.
- **Reducing the Bias Toward Debt Financing.** A lower corporate tax rate reduces but does not eliminate the bias toward debt financing. The President's Framework suggests reducing the deductibility of interest for corporations should be considered as part of any reform plan.

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- **Improve Transparency and Reduce Accounting Gimmicks.** Corporate tax reform should increase transparency and reduce the gap between book income, reported to shareholders, and taxable income, reported to the IRS. These reforms could include better disclosure of annual corporate income tax payments.
- **Effectively Reduce the Top Corporate Tax Rate on Manufacturing Income to 25 Percent and to an Even Lower Rate for Income From Advanced Manufacturing Activities by Reforming the Domestic Production Activities Deduction**. The President's Framework would reform the current domestic production activities deduction. It would focus the deduction on manufacturing activity, expand the deduction to 10.7 percent, and increase it further for advanced manufacturing.
- **Expand, Simplify and Make Permanent the Research and Experimentation Tax Credit.** The President's Framework would increase the rate to 17 percent, which would make it more attractive and simplify tax filing for businesses. In addition, the credit would be made permanent to increase certainty and effectiveness.
- **Extend, Consolidate, and Enhance Key Tax Incentives to Encourage Investment in Clean Energy.** The President's Framework would make permanent the tax credit for the production of renewable electricity, in order to provide a strong, consistent incentive to encourage investments in renewable energy technologies like wind and solar.
- **Require Companies to Pay a Minimum Tax on Overseas Profits.** Under the President's Framework, income earned by subsidiaries of U.S. corporations operating abroad would be subject to a minimum rate of tax.
- **Remove Tax Deductions for Moving Productions Overseas and Provide New Incentives for Bringing Production Back to the United States.** The tax code currently allows companies moving operations overseas to deduct their moving expenses—and reduce their taxes in the United States as a result. The President's Framework proposes that companies will no longer be allowed to claim tax deductions for moving their operations abroad. At the same time, to help bring jobs home, the President is proposing to give a 20 percent income tax credit for the expenses of moving operations back into the United States.
- **Other Reforms to Reduce Incentives to Shift Income and Assets Overseas.** The Framework would revise the international tax code and reduce incentives and opportunities to shift income and assets overseas. For example, as noted above, U.S. companies may use accounting rules or aggressive transfer pricing to shift profit offshore. This is particularly true in the case of profits associated with intangible assets (assets like intellectual property). The Framework would strengthen the international tax rules by taxing currently the excess profits associated with shifting intangibles to low tax jurisdictions. In addition, under current law, U.S. businesses that borrow money and invest overseas can claim the interest they pay as a business expense and take an immediate deduction to reduce their U.S. taxes, even if they pay little or no U.S. taxes on their overseas investment. The Framework would eliminate this tax advantage by requiring that the deduction for the interest expense attributable to overseas investment be delayed until the related income is taxed in the United States.

Assessing the Impact of Low Interest Rates on Life Insurance Products

Generally speaking, interest rates have been on the decline for more than 30 years. Events of the financial crisis that began in 2008 contributed to this decline include:

1. The Federal Reserve responded to the crisis by suppressing interest rates in order to spur economic growth; and
2. Investor demand for the relative safety of fixed income investments like U.S. Treasury and high-quality corporate bonds has increased, driving prices up and yields down.

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Interest rates have a direct impact on life insurers and the products they issue and manage. Companies generally make profits from the spread between what they earn on their general account portfolios and what they credit as interest on insurance policies. Policyowners are impacted as low interest rates result in lower investment returns credited to policies over time.

Historically low interest rates are likely to remain in the near term. On January 25, 2012, the Federal Reserve announced plans to keep short-term rates very low through 2014. This reinforces the importance of considering the impact of low interest rates on life insurers and their products.

Email shirley.mcmillan@mben.com, to request the M Due Care Bulletin that examines the impact of a low interest rate environment on insurers, the performance and management of in-force products, and pricing of new products.

A Utilitarian Solution to Disappearing Margins

A Potential Remedy to Burdensome Regulations and Low Interest Rates

By John Gagnon, Principal, GW Financial, Advisor Firm to M Benefit Solutions - Bank Strategies and Russell McMillan M Benefit Solutions - Bank Strategies

Many of today's community banks find themselves in a tough spot. The exponential rise in the cost of compliance and the low interest rate environment is adversely impacting banks' bottom-lines. The new regulations are affecting everything from mortgage lending to the viability of owning some of a bank's already limited range of permissible investments. One asset, however, that appears to have come through this regulatory cyclone unscathed, is bank-owned life insurance (BOLI).

Community banks have, in general, withstood the economic turmoil and are preparing themselves to thrive when the economy inevitably recovers. Bankers are waiting for their opportunities while still making careful, profitable loans. However, there are outside influences, beyond their control, eating into their profits: increasing regulatory burdens and the manipulated interest rate environment. BOLI counters both issues with clear, venerable, regulatory guidelines for banks to follow and the enjoyment of tax favored returns that typically exceed after-tax returns of more traditional bank investments by 150 to 300 basis points.

Not Every Banking Activity Needs a New Regulation

Despite recent overtures from federal agencies promising to ease the burden on smaller institutions, bankers remain unconvinced.

…For the most part, the new regulations are directed at the largest institutions, whose failure would pose the greatest risk to the financial system, or at the lending practices that led to the crisis. Even so, the changes are so sweeping that many industry analysts have questioned whether the overall weight of regulation poses a threat to the future of the community bank model.
– Federal Reserve Board Governor Elizabeth A. Duke at the 2012 Bank Presidents Seminar, California Bankers Association[1]

The massive new regulations are broad and complex which will cause compliance costs to significantly increase. A properly administered BOLI program shouldn't add to this cost, however, as the regulators have provided clear and decisive guidelines to follow via the Interagency Statement on the Purchase and Risk Management of Life Insurance (OCC 2004-56)[2].

The Agencies also solidified their opinion of BOLI in the recent Volcker Rule Proposal[3]. In it, Separate Account BOLI was exempted from the rule and referenced the adequacy of existing, long-standing guidelines. While this is still in proposal form, and there is no guarantee it will make it to the final rule, it re-emphasizes the permissibility, and the utility, of BOLI ownership.

The Low Rate Environment—A Depressant, Not a Stimulant

Economic indicators appear to be pointing toward a recovery. Or do they? What we do know is that the Federal Reserve initially announced they would hold rates down through 2013; strike that, now it's through 2014! The Fed issued a press release stating,

"… (The Committee) anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014."[4]

Well, at least that removes some uncertainty for bankers. Now they're certain they won't make money until 2015. Camden Fine, President/CEO of the Independent Community Bankers of America (ICBA), made this point recently on his blog:

"…But with the Fed setting rates at nearly zero percent and slack credit demand, how are community banks supposed to make a viable spread on their funds? Most community banks are swimming in liquidity. Meanwhile, they're holding short-term investments (encouraged by their field examiners, by the way) under the assumption that rates would begin to rise within the next year or so. Now they are faced with at least two more years of zero interest in a struggling economy."[5]

With the Federal Reserve's promise to keep interest rates low through 2014, coupled with low loan demand and regulatory pressure to keep investment funds in short-term low-to-no yielding securities, banks are challenged to find ways to grow revenue or to make a viable spread. Bank-owned life insurance confronts these challenges by providing higher before- and after-tax returns than most traditional bank investments while reducing risk exposure to sudden rate changes. BOLI carriers mitigate some of the portfolio rate risk by facilitating smooth earnings to the bank due to: assets (and yields) in the portfolio being carried at book value; average duration of portfolio assets being typically shorter than bankers realize; and any gains/losses from purchases/sales being amortized over a long period.

As community banks struggle to generate earnings via their core business, lending, they are being further threatened by considerable new regulations and an extended low interest rate environment. While not a cure all, bank-owned life insurance, with its regulatory certainty and tax favored status, can provide a useful and timely solution for community banks.

[1] See, e.g., Board of the Federal Reserve System Speech ("Opportunities to Reduce Regulatory Burden and Improve Credit Availability") (Jan. 13, 2012) (http://www.federalreserve.gov/newsevents/speech/duke20120113a.htm).

[2] See, e.g., Bank-Owned Life Insurance, Interagency Statement on the Purchase and Risk Management of Life Insurance ("Interagency BOLI Guidance") (Dec. 7, 2004).

[3] See, e.g., Sec__.14, Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds (FRS Docket No. R-1432 & RIN 7100 AD 82; OCC Docket ID OCC-2011-14; FDIC RIN 3064-AD 85; SEC File Number S7-41-11).

[4] See, e.g., Board of the Federal Reserve System Press Release (Jan. 25, 2012) (http://www.federalreserve.gov/newsevents/press/monetary/20120125a.htm).

[5] See, e.g., Independent Community Bankers of America (ICBA) ("Finer Points") (Aug. 15, 2011) (http://camfine.wordpress.com/2011/08/15/backdoor-bailout-for-wall-street-back-of-the-hand-for-main-street/).

GOLDSTEIN FINANCIAL GROUP, LLC

M Benefit Solutions - Bank Strategies Adds to Lineup of Community Bank Consultants

M Benefit Solutions - Bank Strategies is pleased to announce the addition of *Murray Hoyt* of **Goldstein Financial Group** to its lineup of Community Bank Consultants. Murray brings extensive experience working with financial institutions on the strategic use of BOLI to finance employee benefit programs. This addition further enhances our ability to service our bank clients nationwide. Contact information can be found at the end of this newsletter.

Advisor Firms

M Benefit Solutions - Bank Strategies is structured to provide our clients with consistent nationwide coverage. We have identified several Advisors with superior reputations in bank executive and director benefits and BOLI to provide consulting services to clients nationwide.

Distributed throughout the country, these Advisors work interactively with M Benefit Solutions and bank clients to design programs which meet each bank's specific needs and to ensure high quality administrative and compliance services.

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About M Benefit Solutions - Bank Strategies

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