P&G Banking
ADVISOR
Summer 2019

P&G Associates

www.pandgassociates.com 877.651.1700

OPPORTUNITY ZONES: CAN YOUR BANK BENEFIT?

The Opportunity Zone program, created by the Tax Cuts and Jobs Act of 2017, provides investors with a powerful tax incentive to make long-term investments in state-designated economically distressed communities. The U.S. Treasury Department has certified approximately 9,000 Qualified Opportunity Zones (QOZs) in urban and rural areas across the country. Investors with capital gains can defer and, in some cases, exclude those gains from income by reinvesting them into an opportunity zone.

THE BENEFITS

What are the potential benefits for community banks? It's unlikely that many banks will invest directly in opportunity zone projects, but some are creating funds to make equity investments in these projects.

But perhaps the most significant benefit for community banks is the opportunity to make loans in connection with development projects that might otherwise not be economically feasible — absent the tax breaks available in opportunity zones. And these loans may also help a bank meet Community Reinvestment Act requirements. (See "CRA compliance matters" on page 3.)

IT'S UNLIKELY THAT MANY BANKS WILL INVEST DIRECTLY IN OPPORTUNITY ZONE PROJECTS, BUT SOME ARE CREATING FUNDS TO MAKE EQUITY INVESTMENTS IN THESE PROJECTS.

THE WAY IT WORKS

It's important to recognize that, to enjoy the tax benefits offered by the program, investors can't simply write a check to the developer of a project in a QOZ. First, the investor must show recognized capital gains from other investments. Second, the investor must reinvest those gains, within 180 days, in a Qualified Opportunity Fund (QOF), which is a corporation or partnership formed for the purpose of investing in QOZs. Note that special rules apply to capital gains allocated from partnerships and other pass-through entities to their owners. Under those circumstances, investors should consult their tax advisors to determine when the 180-day period starts.

Virtually any individual or organization can create and manage a QOF, with a single investor or many investors. To qualify, at least 90% of the fund's assets must be "QOZ property."

This includes tangible property that's used by a trade or business within a QOZ and meets specific other requirements (QOZ business property). It also includes equity interests in qualifying corporations or partnerships (QOZ businesses), if substantially all of their tangible property is QOZ business property.

The tax benefits for investors in QOFs are attractive. First, the tax on reinvested capital gains is deferred until the end of 2026 or the date the QOF investment is disposed of, whichever comes first. Next, investors enjoy a 10% reduction in the amount of taxable capital gain if they hold the QOF investment for at least five years — and 15% if they hold the investment for at least seven years. Finally, investors who hold their QOF investments for at least 10 years avoid capital gains tax on the appreciation of the QOF investment itself.

AN EXAMPLE

Consider this example: On September 1, 2019, Bill sells his interest in stock, generating $2 million in capital gain. Bill establishes a single-investor QOF for the purpose of acquiring and developing commercial real estate in a QOZ valued at $10 million. On December 1, Bill reinvests his entire $2 million gain into the QOF, which borrows the remaining $8 million needed to acquire the property from a community bank.

Bill holds the QOF investment until December 15, 2029. At the end of 2026, Bill has satisfied the seven-year holding period, so he's taxed on only 85%, or $1.7 million, of the original $2 million gain. Now, suppose that the value of Bill's interest in the QOF has grown to $7 million by the time he disposes of it on December 15, 2029. Because he's met the 10-year holding period, the entire $5 million in appreciation is tax-free.

TIMING IS EVERYTHING

If your bank is exploring ways to take advantage of the Opportunity Zone program, you should start as soon as possible. That's because investors who wish to maximize the available tax benefits must invest in a QOF by the end of this year. Otherwise, they can't meet the seven-year holding period that's required for a 15% gain reduction by year-end 2026. Of course, investors can still enjoy a 10% gain reduction, which requires a five-year holding period. A requirement: They must invest by the end of 2021.

At press time, the IRS was continuing to fine-tune a complex set of proposed regulations on the QOZ program. So be sure to consult your tax advisors before getting involved in QOZ projects. ■

CRA COMPLIANCE MATTERS

One potential benefit of opportunity zones for community banks is that loans in those economically distressed areas may help banks meet their obligations under the Community Reinvestment Act (CRA). The CRA's purpose is to encourage banks to help meet the credit needs of the communities in which they operate, including low- and moderate-income (LMI) neighborhoods. Of course, their activities must be consistent with safe and sound banking operations. In many cases, these LMI neighborhoods are located in, or coincide with, Qualified Opportunity Zones (QOZs) and are eligible for the tax benefits described in the main article.

The federal banking agencies periodically evaluate banks' records in meeting their communities' credit needs. And the agencies' performance evaluations and CRA ratings are made available to the public. A positive rating can enhance a bank's reputation in its community. And the agencies take a bank's CRA record into account when considering requests to approve bank mergers or acquisitions, charters, branch openings or deposit facilities. Banks should consider these potential benefits as they evaluate opportunities in QOZs.

FED ISSUES GUIDANCE ON ACCOUNTING FOR LEASED BANK PREMISES

With the effective date of the Financial Accounting Standards Board's new lease accounting standard rapidly approaching for nonpublic companies, most community banks are preparing for the standard's impact on loan covenants and regulatory capital. But it's also important to consider its potential impact on your institution's investment in bank premises, such as office space and retail branch leases.

For banks supervised by the Federal Reserve, adoption of the new standard may trigger certain obligations under Regulation H, which places limits on such investments. Recently, the Fed issued guidance on this subject.

WHEN DO THE NEW RULES TAKE EFFECT?

The new standard — Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)* — is effective for fiscal years starting after December 15, 2019, and for interim periods in fiscal years starting after December 15, 2020. (The standard is already in effect for many public companies.) Banks may adopt the new standard early. But, if they do, they must apply it in its entirety to *all* lease-related transactions.

AFTER A BANK ADOPTS THE STANDARD, IT WILL BE REQUIRED TO RECORD ALL OF ITS OPERATING LEASES (WITH LIMITED EXCEPTIONS) ON ITS BALANCE SHEET.

WHAT'S THE IMPACT ON OPERATING LEASES?

The most significant impact of the new standard will be on operating leases. Under current accounting standards, lessees don't recognize lease assets or liabilities on the balance sheet for operating leases (as opposed to capital leases). But the new standard will require most lessees to record both a right-of-use asset and a lease liability on their balance sheets, based on the present value of minimum payments under the lease (with certain adjustments). After a bank adopts the standard, it will be required to record all of its operating leases (with limited exceptions) on its balance sheet. That includes those entered into before the standard's effective date.

WHAT ARE THE REGULATION H IMPLICATIONS?

Regulation H implements Section 24A of the Federal Reserve Act. One of its provisions prohibits Fed-supervised banks from making aggregate investments in bank premises that exceed the amount of the bank's capital stock, unless they first obtain the Fed's approval. For some banks, adoption of the new lease accounting standard will cause the carrying value of bank premises (which includes leases recorded on the balance sheet) to surpass their capital stock.

The Fed's guidance — found in Supervision and Regulation Letter No. SR 19-7 — clarifies that Fed approval isn't needed when adopting the new standard requires a bank to capitalize premises leased before the standard's effective date. In other words, if a bank's investment in bank premises is less than its capital stock before adopting the standard, but adoption causes that investment to increase to an amount that exceeds the bank's capital stock, it's not necessary to seek the Fed's approval. But prior approval *will* be required for any *post*adoption leases that cause investments in bank premises to exceed capital stock.

WHAT'S YOUR PLAN?

As you plan your bank's transition to the new accounting standard for leases, it's important to evaluate the impact of adopting the standard on your investment in bank premises. Moving existing leases to the balance sheet won't cause you to run afoul of Regulation H. But if you're planning any significant new leases of retail branches or other facilities, be sure to consider the timing of those investments in relation to your planned adoption of the standard. Your financial professional can help you assess the impact. ■

THE BIG PICTURE

Fight money laundering with visual analytics

Money laundering is an insidious and ever-present issue for community banks. Rapidly advancing technology enables criminals to invent new ways of gaming the system. But that same technological progress, in the form of data visualization software, can give your community bank an edge in detecting and preventing money laundering and ensuring your institution's compliance with the Bank Secrecy Act and Anti-Money Laundering (BSA/AML).

COMPLIANCE

Banks that fail to take reasonable steps to detect and prevent money-laundering activity risk government fines. They also may receive severe negative publicity that harms their reputations.

Several developments over the past few years reflect the federal banking agencies' increasing concern about BSA/AML compliance efforts. For one thing, the Financial Crimes Enforcement Network (FinCEN) introduced customer due diligence (CDD) rules that require institutions to incorporate beneficial ownership identification requirements into existing CDD policies and procedures.

In 2016, the Office of the Comptroller of the Currency (OCC) alerted banks to increasing BSA/AML risks associated with technological developments and new product offerings in the banking industry. In addition, regulators increasingly have been scrutinizing automated monitoring systems used by banks to detect suspicious activity to ensure that they're configured properly.

For several years now, regulators haven't limited their heightened scrutiny to larger banks. In fact, some large banks have restricted certain customers' activities or closed their accounts because of BSA/AML concerns. As a result, higher-risk customers often have moved to smaller banks with less experience managing the associated BSA/AML risks.

VISUAL ANALYTICS

Data visualization software — also known as visual analytics — can be a powerful AML tool. Traditional

AML software products and methods do a good job of detecting *known* AML issues. But data visualization software, which is commonly used as an antifraud weapon, excels at spotting new or unknown AML activity.

> VISUALIZATION HELPS BANKS IDENTIFY SUSPICIOUS PATTERNS, RELATIONSHIPS, TRENDS OR ANOMALIES THAT ARE DIFFICULT TO SPOT USING TRADITIONAL TOOLS ALONE.

As criminal activity becomes more sophisticated and more difficult to detect, traditional AML software or methods may no longer be enough. Data visualization software creates visual representations of data. These representations may take many different forms, from pie charts and bar graphs to scatterplots, decision trees and geospatial maps. Visualization helps banks identify suspicious patterns, relationships, trends or anomalies that are difficult to spot using traditional tools alone. It's particularly useful in identifying new or emerging risks before they do lasting damage.

Criminal enterprises that wish to launder money typically use multiple entities and multiple bank accounts, both domestic and foreign. Using data visualization software, banks can map out the flow of funds across various accounts, identifying relationships between accounts and the entities associated with them. Data visualization can reveal clusters of interrelated entities that would be difficult and time-consuming to spot using traditional methods.

These clusters or other relationships don't necessarily indicate criminal activity. But they help focus a bank's AML efforts by pinpointing suspicious activities that warrant further investigation.

MONEY-LAUNDERING MAPS

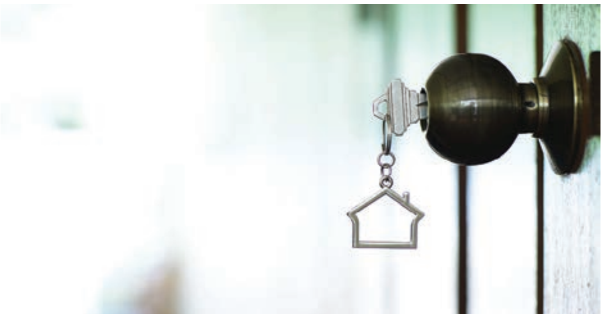
To counter today's sophisticated money-laundering schemes, community banks need to consolidate their databases and stay up to date on the latest technological tools at their disposal. By using data visualization software to map trends, clusters and relationships that would be difficult to discern otherwise, community banks can more quickly and easily detect potential money-laundering activities — and take steps to head them off. ■

BANK WIRE

HOMEOWNERS PROTECTION ACT IS ON CFPB RADAR

In the Winter 2019 issue of its *Supervisory Highlights* report, the Consumer Financial Protection Bureau (CFPB) signaled a renewed focus on compliance with the Homeowners Protection Act (HPA). The HPA requires residential mortgage servicers to cancel private mortgage insurance (PMI) if certain conditions are met. The CFPB identified several deceptive practices among servicers, such as failing to properly disclose the reasons for denying PMI cancellations, providing inaccurate or incomplete reasons for such denials, and misleading consumers about the conditions for PMI removal.

You can find the full report at consumerfinance.gov under Policy & Compliance / Compliance & Guidance. ■



HOW S CORPORATION BANKS CAN QUALIFY FOR THE PASS-THROUGH DEDUCTION

The Tax Cuts and Jobs Act created a new "pass-through" deduction (found in Internal Revenue Code Section 199A), which allows owners of S corporations and other pass-through entities to deduct up to 20% of their "qualified business income." But Sec. 199A is subject to several restrictions and limitations. These include disallowance of the deduction with respect to *specified service trades or businesses* (SSTBs) for owners whose income exceeds certain thresholds.

SSTBs include financial services, brokerage services, investing and investment management, securities dealing, and several other services. So some S corporation banks have been uncertain about whether they're eligible for the deduction. But recently finalized regulations provide welcome guidance, clarifying that "financial services" don't include taking deposits or making loans. Further, originating loans for sale on the secondary market doesn't fall under the "dealing in securities" umbrella.

Banks whose trust departments or wealth management advisors provide investment-related services or are involved in other SSTB activities may still qualify for the deduction, if either:

- These activities produce less than 5% of gross receipts (10% for banks with gross receipts under $25 million), or
- The bank is able to segregate its SSTB from its non-SSTB activities. ■

GUIDANCE OUT ON MORTGAGE SERVICING RULE

The CFPB has released several important implementation tools to help servicers comply with amendments to the mortgage servicing rules in Regulations X and Z. They include 1) a set of frequently asked questions regarding periodic billing statement requirements for borrowers in bankruptcy, 2) an updated small entity compliance guide that reflects the final amendments, and 3) an updated mortgage servicing coverage chart that incorporates the final amendments. You can find these tools by visiting the CFPB page listed at upper left; then, under "Compliance resources," click on "Mortgage servicing." ■

P&G Associates

P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

P&G's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the use of Subject Matter Experts — designated individuals performing audits in their specific field of expertise. The use of such professionals provides a unique value-added approach that is both efficient and productive.

We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

We pride ourselves in our ability to provide effective and practical solutions that are commensurate with our clients' needs by emphasizing high-quality personalized service and attention. Our services are truly customized.

For **Solutions** *to your internal audit needs, please contact our service coordinators at (877) 651-1700, or log-on to www.pandgassociates.com to learn more.*

P&G Associates

www.pandgassociates.com

Headquarters:
646 US Highway 18
East Brunswick, NJ 08816

Offices:
New York, NY
Philadelphia, PA
Chicago, IL
Miami, FL