

Banking Industry Group

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A NEWSLETTER FOR THE BANKING INDUSTRY

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WELCOME TO ZOMBIELAND! How To Spot “The Living Dead”

Zombies have long been popular among a certain segment of moviegoers, but what does this have to do with commercial lending?

The present state of the economy and the small business segment, in particular, is starting to resemble a modern-day zombieland. There are a number of businesses today that can best be described as “the living dead”: They managed to survive the recession by aggressively managing receivables and inventory and delaying replacement capital expenditures, but are destined to fail once the recovery starts kicking into gear.

Here’s why: As sales rebound, they will need to rebuild working capital in order to fund new receivables and inventory and fill new orders. However, they no longer qualify for working capital loans or lines of credit due to losses and excessive leverage. Without some sort of external cash infusion, these companies will soon bleed to death for lack of capital.

Picking Winners and Losers

With the much tighter lending standards now in place among most lenders, not to mention the disappearance of many traditional sources of financing for many small businesses (think credit cards and



home equity lines of credit), this problem may become widespread as the year goes on.

As a commercial lender, you have to decide which survivors you’re going to support and which ones you aren’t. Here are a few questions to ask about companies as you try to make this determination.

- Is there still a viable core business, strong management team, workable business plan and solid customer base in place?
- What is the company’s value proposition distinguishing it from competitors? Does it offer products or services that meet a unique need in the marketplace and that customers will be willing and able to buy as the economy recovers?

DEFERRED TAX ASSETS

The Good *and* the Bad



When examining potential borrowers' financial statements, some lenders are beginning to see something that's unfamiliar to many of them: deferred tax assets.

These are created as a result of timing differences that occur between book and taxable income for things such as depreciation and investment gains and losses. With more companies experiencing losses the past couple of years due to the recession, many are setting up deferred tax assets associated with their operating loss carryforwards in their financial statements. And there are many others that aren't recording these deferred tax assets, but should be.

Legitimate Tool When Used Properly

Deferred tax assets can be extremely valuable to the financial position of a small business. In fact, GAAP requires that they be included in reviewed and audited financial statements. But they also present opportunities for owners to manipulate financial information and misrepresent the true financial condition of their companies.

There are several implications that commercial lenders should keep in mind:

- First, deferred tax assets will only show up on the financial statements of regular C corporations, not on the statements of companies that are Subchapter S corps or partnerships.

If you're considering loaning money to a borrower that has experienced recent losses, ask them if there are any tax-loss carryforwards that aren't disclosed in the financial statements. Considering them as part of your credit analysis may improve the business's chances of obtaining financing.

- At the opposite end of the spectrum are companies that present financial statements with significant deferred tax assets. This should raise a red flag, especially on internally generated and compiled statements. Deferred tax assets must be challenged as to whether they are more likely than not realizable.

Deferred tax assets can be a good "hiding spot" for companies to manipulate earnings and make their financial position look better than it really is. So do a little extra digging into these companies – talk to the COO or the company's accountant or auditor to help you get a better feel for how realizable the deferred tax assets are. Otherwise, you could make a lending decision based on financial statements that misrepresent the company's true financial condition.

- The key factor with regard to the legitimacy of utilizing deferred tax assets is whether the tax-loss carryforward will be realizable in the future. In other words, how realistic is it that the company will have operating income going forward that can be offset by the tax-loss carryforward? Or put another way, is the company a legitimate going concern?
- Also keep in mind that lenders usually deduct deferred tax assets when determining a borrower's tangible net worth.

Data is King

Once again, the heart of this issue goes back to the reliability of the financial information presented by borrowers to their lenders. Data is king in today's environment, and the more current the data you have access to, the easier it is to make sound lending decisions. ■

We can help you analyze deferred tax assets and tax-loss carryforwards on your borrowers' financial statements and determine how likely it is that they are realizable. For assistance, please give us a call.

- What is the company’s current working capital position? Is there access to capital beyond just a bank loan; for example, the owner’s personal savings or family and friends?
- How strong are the company’s internal controls? Does it generate timely financial information? Is management willing to invest in systems that allow current monitoring of receivables and inventory?
- Is the owner willing to make personal sacrifices (if he or she hasn’t already) in order to keep the business afloat? This may include scaling back lifestyle choices and putting some of his or her own capital into the business.
- Has the company made large investments in non-productive fixed assets?
- Does its current debt exceed three times the business’ net worth?
- Is the business in, or is it dependent on, a currently troubled industry, like transportation (especially automobiles), financial services, construction or income property?

Focus on Cash

As you survey the small business landscape and decide which borrowers you want to lend to and which are “zombies,” it’s worth brushing up on a few of the basics of small business lending. Let’s start with a concept that was often overlooked in the run-up to the financial crisis: Only cash repays loans. As many banks are learning the hard way now, a heavy reliance on collateral only goes so far in today’s environment.

The most important thing to determine about a potential small business borrower is how much cash will be available in the future to repay the debt. To calculate this, you must project the company’s historical performance into the future. Of course, the past couple of years have been anything but normal for many companies, so keep this in mind as you analyze projections.

There are several different methods that can help determine the amount of cash flow available to a small business borrower in order to service debt. It’s important to note, however, that while these methods will measure the company’s ability to earn its debt service, they will tell you nothing about its ability to actually pay the debt service, which is the factor that’s most crucial to your bank.

Therefore, it’s important that you and potential borrowers prioritize the use of cash and, just as important, determine when it may be appropriate to change these priorities.

One common example: Should cash be used to grow the business, support the owner’s lifestyle or repay the loan? Not surprisingly, many owners will prioritize business growth and their lifestyle, while you prioritize loan repayment.

Statement of Cash Flows

The most important thing to determine as you gauge a potential borrower’s ability to repay debt is simple: What is happening to the cash the business generates? Put

another way, where did cash come from – and where did it go?

To find out, you’ll need to scrutinize the statement of cash flows. While there are several different approaches that can be used in the presentation of cash flow, many banks today are moving toward an integration of business and personal cash flow into what is called global cash flow. This is due to the close relationship between the business and personal affairs of many small business owners.

Unfortunately, many owners have done such a good job of managing their earnings to minimize tax liability that they can’t show enough income to qualify for a loan. You can help potential borrowers by encouraging them to invest in quality accounting and financial systems that will help them present the kind of information you need to determine whether or not they will qualify for a loan.

Also encourage borrowers to turn to their accountants for help. For example, they may be able to prepare compiled financial statements (instead of just tax returns) or present Schedules K-1 to give you an accurate picture of multiple business entities and their interrelationships with each other. ■

If you have borrowers who need assistance with their financial and accounting systems, please contact our office to discuss how we can help them.

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BANKING BRIEFS

TEFRA Disallowance for S Corporation Banks in the Wake of *Vainisi v. Comm'r* *by Thomas B. Murtagh*

The Seventh Circuit Court of Appeals recently dealt a blow to the IRS when it ruled in the taxpayer's favor in *Vainisi v. Comm'r*. This appeal sprung from a Tax Court case that affirmed the IRS' position that the bank in question should be subject to the Section 291 20% disallowance of interest expense attributable to carrying qualified tax-exempt obligations. The appellate court disagreed based upon a plain reading of the statute.

This decision hinges on the reading of Section 1363(b)(4), which states that "the taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that Section 291 shall apply if the S corporation (or any predecessor) was a C corporation

for any of the 3 immediately preceding taxable years." The IRS argued first that Section 1363(b)(4) does not apply to banks that are qualified subchapter S subsidiaries (QSUBs) of a bank holding company because the provision does not mention QSUBs. They further argued that because the applicable provision of Section 291 became law before banks could be S corporations, Congress did not intend to exempt S corporation banks and as such Treasury could rescind the application by issuing regulations. They also argued that the regulation would be an attempt to clarify some ambiguity between the two code sections.

Ultimately, the court rejected all of the government's arguments

indicating that there really is no ambiguity in the statute and held that unless Congress acts to amend the statute or Treasury issues valid regulations to the contrary, if a bank has either always been an S corporation or has been an S corporation for at least three years after initially operating as a C corporation, all interest expense incurred in acquiring qualified tax-exempt obligations is deductible.

Based on this ruling, an Illinois bank that has been operating as an S corporation may have an opportunity to file amended returns for applicable open years to claim the previously disallowed interest expense. ■

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