Accounting
Financial Accounting Standards for Financial Institutions

Introduction

The Financial Accounting Standards Board (FASB) promulgates accounting standards for the financial industry. When implemented, those standards become general accounting principals (GAP). The following are the Financial Accounting Standards (FAS) that have the greatest impact on the banking industry.

FAS 91

At one time, generally accepted accounting principles (GAAP) allowed a financial institution to take into income, without any restriction, all nonrefundable loan fees at the time they were received. This practice was abused, and the rule was changed to allow taking into current income at the time the loan was made, loan fees not exceeding one percent of the loan amount (one point). All fees in excess of that amount were amortized over the loan term. Under both of the above rules, all costs associated with loan origination were expensed at the time they were incurred. In December 1986, the Financial Accounting Standards Board Promulgated FAS 91, which requires that all loan fees and loan origination costs be amortized over the life of the loan with which they are associated.

General Rule. The general rule of FAS 91 is that all loan origination fees and all direct loan origination costs for a given loan are to be deferred and recognized over the life of the loan as an adjustment (either increase or decrease) to its yield. Loan fees and loan costs are offset against each other and the net amount is what is deferred and amortized.

Loan Fees. Loan fees typically fall into one of two categories, origination fees or commitment fees. Origination fees are generally to reimburse the lender for origination activities or costs, or they are prepaid interest to reduce the loan’s nominal interest rate. A commitment fee is a fee for agreeing to make a defined loan on a future date and to assume the interest rate risk and credit risk in the intervening period. Though the fees are quite different and serve different purposes, with minor exceptions, they are treated in the same way by FAS 91 and both are amortized over the term of the loan. If a borrower does not take down a committed loan, the commitment fee is recognized as income at the end of the commitment period. If a commitment is not intended to be exercised, and the potential that it will be exercised is remote, then the commitment fee can be recognized over the commitment period.

Direct Loan Origination Costs. Direct loan origination costs include only incremental direct costs of loan origination incurred in actual transactions, and costs directly related to activities performed by the lender for that loan. Costs involved in underwriting the loan, negotiating loan terms, preparing and processing loan documents, closing the transaction and recording documents are included. Also included are the proportionate compensation and payroll–related fringe benefits of bank personnel involved in those listed activities. As a general rule, the costs included are those costs that would not have been incurred but for the particular loan involved.

Not included are costs related to advertising or soliciting potential borrowers, costs of loan servicing, and costs generic to the overall lending process, such as establishing credit policies, supervision and administration. Also not included are administrative costs such as rent, depreciation, equipment, occupancy costs and other similar indirect costs.

Amortization of Net Fees and Costs. After the fees and costs relating to a loan are determined, they are netted against each other and the resulting amount is amortized over the
life of the loan. The deferred fees or costs are recognized by the interest method. The purpose of the interest method is to provide a constant effective yield on the net investment in the receivable. If the loan is a variable-rate loan, that is, the interest rate varies based on future changes in an independent index, the calculation of the constant effective yield and the amortization of the deferral to accomplish it may be based either on the initial interest rate and carried for the life of the loan or it may be recalculated each time the interest rate changes. If the loan’s stated interest rate increases or decreases during the term of the loan (including teaser rates for variable-rate loans) there are special rules, beyond the scope of this article, limiting the amount of the deferral to be recognized.

For a loan that is payable on demand, any net fees or costs are recognized on a straight-line basis over a period consistent with any understanding between the borrower and lender about when payment will be made, or if there is no understanding, the lender’s estimate of the period of time the loan will be outstanding. For revolving lines of credit, the net fees or costs are recognized on a straight-line basis over the period the line of credit is outstanding. If the line does not revolve, that is, the borrower cannot reborrow amounts paid, any unamortized amount relating to a payment must be recognized at the time of the payment.

Other Situations. FAS 91 applies to the purchase and sale of loans in the same manner that it does to loan originations. It also applies to refinancings and restructurings.

Loan Purchases. The initial investment in a purchased loan is the amount paid to the seller plus any fees paid or less any fees received. If the initial investment differs from the loan’s principal amount at the date of purchase, this difference is recognized as an adjustment of yield over the life of the loan. One difference from the normal FAS 91 rules is that all costs incurred in purchasing a loan are charged to expense as incurred, rather than being deferred.

Loan Sales. When a loan is sold all unamortized fees or costs are recognized as income or expense. If a participation in a loan is sold, then a portion of the unamortized fees or costs equal to the percentage of the loan sold is recognized as income. If the yield on the portion of the loan that is retained is less than that on the participation sold, however, special rules apply.

Refinancings. If a loan is refinanced or restructured (other than a troubled-debt restructuring) and the terms are at least as favorable to the lender as the terms for comparable loans to other customers that are not the result of a refinancing, then for FAS 91 purposes the refinancing is a new loan. Any unamortized fees or costs from the prior loan are recognized as income and the net of fees and costs from the refinancing are deferred.

Practical Aspects

Defining Costs. It is neither feasible or necessary to determine the cost of every loan made. Most loans fall into one of several categories where the cost of originating each loan in the category is approximately the same. In those cases, determine the cost of originating the average loan in each category and use that average cost in all cases. Reexamine your costs at least annually to see if your averages should be adjusted. Consult your CPAs to see where they will accept the use of average cost and where they will want detailed cost breakdowns. Typically, the costs for large loans or unusual loans should be documented separately.

“Not Significant” Accruals. Generally accepted accounting principles grant some leeway in the normal rules where the result does not have a significant effect on the overall financial statement or results. On any given loan, if the net of fees and costs is small, and if that net amount, when multiplied by the number of similar loans the bank will make in a
year, would not have a significant or material effect on the bank’s financial statements, then the net of fees and costs should be recognized in income immediately as loans are made and not amortized. Obviously, what is significant for one bank may not be for another. Again, a bank should consult its CPA for advice and counsel on what the CPA will accept.

**FAS 107**

For several years accountants and financial statement analysts have debated whether the historical cost method of accounting presents an adequate or accurate picture of a bank’s financial condition.

FASB Statement No. 107 requires disclosure in the **footnotes** to a financial statement of the “fair value” of all financial instruments, both asset and liability, including those reflected on the balance sheet as well as those that are not. Banks with assets of $150 million or greater must make the FAS 107 disclosures in their financial statements for all fiscal years. Banks with assets of less than $150 million are not required to make the disclosures until fiscal years ending after December 15, 1995. This section describes the concepts of mark–to–market accounting as it applies to financial instruments and the requirements of FAS 107.

**Market Value Measurement.** The market value (or the fair value as the term is used in FAS 107) “of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.” In other words, the fair value of a loan is the price for which you could sell it. The fair value of a deposit is the amount you would have to pay to be relieved of the obligation. The fair value of a loan commitment, letter of credit, or guarantee is the amount you would have to pay someone, or someone would pay you, to assume your obligation.

If there is a quoted market price for a financial instrument, that quoted price is the best evidence of fair or market value. For example, the market value for a U.S. Treasury bond or a publicly traded stock is the current quote. Where an instrument is traded in more than one market, select the quote from the most active market.

If there is no quoted market price for an instrument, but there is an active market or quoted market price for a similar instrument, then that is the best evidence of the instrument’s value. For example, the best evidence of the value of a residential first mortgage loan is the price that a loan with similar characteristics (e.g., rate, term, loan-to-value ratio) is selling for in the secondary market.

Finally, if there is no market for the instrument or for a similar instrument, then fair value must be determined based on valuation techniques, such as discounting future projected cash flows to present value. In this valuation method, the difficulties are the selection of the correct discount rate and the prediction of the amount and timing of future cash flows.

**What is a Financial Instrument?** With a few exceptions, FAS 107 requires footnote disclosure of the fair value of all “financial instruments.” The statement defines a financial instrument as:

- Cash
- Evidence of an ownership interest in an entity (e.g., corporate stock, a partnership interest)
- A contract that both:
  - Imposes on one entity a contractual obligation to deliver cash or another financial instrument to a second entity or to exchange financial instruments on potentially unfavorable terms with the second entity
  - Conveys to that second entity a contractual right to receive cash or
another financial instrument from the first entity. In essence, every contract that a bank is a party to that requires a bank to pay cash or entitles a bank to receive cash is a financial instrument. This includes all deposits with the bank, all loans made or held by the bank, and all securities owned by the bank. It also includes all guaranties, letters of credit, and unfunded commitments made by the bank. The definition even includes such items as trade accounts payable.

**FAS 107.** In general, FAS 107 requires that the fair value of all financial instruments, as well as the methods and significant assumptions used to estimate the fair value, be disclosed in footnotes to the financial statement.

However, some financial instruments are specifically excluded from the disclosure requirements and for others, FAS 107 specifies a value.

**Exclusions.** A fair–value disclosure is not required (but is not prohibited) for the following types of financial instruments:

- Employer’s pension, health care, stock option, deferred compensation, and similar arrangements
- Substantively extinguished debt
- Insurance contracts
- Lease contracts
- Warranty obligations and rights
- Unconditional purchase obligations (other than a financial instrument)
- Investments in common stock accounted for under the equity method
- Minority interests in consolidated subsidiaries
- Equity investments in consolidated subsidiaries
- Equity instruments.

**Specified values.** FAS 107 requires that the disclosed fair value of deposit liabilities with no defined maturity (e.g., checking accounts, savings accounts) be the account balance at the reporting date (including accrued interest).

For short–term financial instruments and loans that reprice frequently at market rates, the carrying amount is sufficiently close to fair value to satisfy the disclosure requirements, provided that there has been no significant change in the credit risk.

No value is to be given to core deposit intangibles, that is, the long–term relationships with depositors in this disclosure. It is the view of FASB that the core deposit value is in the relationship with the customer, not in the deposits the relationship produces, thus the disclosure of a value is not appropriate in a disclosure relating to financial instruments. The statement does not prohibit the disclosure of the core relationship/deposit value separately from the FAS 107 disclosures.

**Practicable.** FAS 107 limits a bank’s disclosure requirement, both as to completeness and to accuracy, to that which is “practicable.” The term practicable is used within the context of what is reasonable, considering cost and the materiality of the instrument, for the institution in question. In some instances it may not be practicable to estimate the fair value of an instrument or class of instruments. In that event, a bank must disclose information pertinent to estimating the fair value and the reasons it was not practicable for it to do so. It may not be practicable to estimate fair value on an instrument–by–instrument basis, but it is practicable to do it on a portfolio basis. That is allowed. FASB very clearly appears to temper hard and fast requirements with regard to reasonableness under the circumstances of the situation.

**Disclosure of methods and assumptions.** In addition to fair value, a bank must disclose the methods used in estimating fair value and the assumptions used in applying those
methods. The illustrations of example disclosures in Appendix B to FAS 107 are straightforward and not complex.

**Getting Ready for FAS 107.** Compliance with FAS 107 is complex, time-consuming, and costly. Determine before year-end what disclosures you will have to make and what information is required to make those disclosures. The first step in the preparation is to meet with your outside auditors and determine what they will require. The most important interpretation to you of what FAS 107 requires is the one held by your auditors. They must give their opinion on your financial statement; if your disclosures do not match their requirements, that opinion will be hard to come by.

Meet with your auditors and obtain from them, in writing, the methods of value estimation that they will accept for the various classes of instruments in your portfolio and the assumptions that they will allow. Make them define clearly:

- In what circumstances must instruments be evaluated on an individual basis?
- In what circumstances may portfolios of instruments be evaluated?
- When evaluation is done at the portfolio level, how homogeneous must the portfolio be? That is, how much variance can there be in time to maturity, loan–to–collateral value, credit quality, etc?
- When value is determined by discounting future cash flows, how will the discount rate be determined? Will it be the rate then being paid/charged on similar instruments?
- In determining future cash flow streams, must prepayments and early withdrawals be taken into consideration?

Most importantly, determine guidelines for evaluating troubled loans and how troubled a loan has to be to fall into that category. Most banks probably will not be terribly surprised at the fair value of their deposit liabilities or of their performing loans. The troubled loan portfolio, however, has the potential to be surprising. Recognize that banks do not now use generally accepted accounting principles (GAAP) in their loan accounting. GAAP requires that financial assets (e.g., loans) be valued at the lower of cost or market. Banks account for loans at the lower of cost or the amount deemed ultimately collectible.

For example, assume a $1,000,000 loan has been restructured as a troubled debt whereby the borrower will pay $200,000 per year for the next five years, without interest, in full settlement of the loan. Alternatively, assume a $1,000,000 loan is secured by real estate having a current appraised value of $1,000,000 and is in foreclosure. Moreover, the borrower has advised that when a foreclosure judgment is obtained he will file for bankruptcy and delay the foreclosure by two or more years. In both cases the bank is now carrying that loan at or close to its $1,000,000 historical cost because that is the amount deemed collectible. But also in both cases its fair value, that is the amount for which the bank could sell the loan, is substantially less than $1,000,000. At least in the first case, the cash flow stream can be measured, and based on the credit, a discount rate selected. In the second case, where do you begin? What is the present value of the foreclosure right to a $1,000,000 property two or three years from now, particularly considering that the property could deteriorate in the interim, that taxes will not be paid and that the attorney’s fees that will be required are unknown? These are the issues better hashed out with your accountants now, rather than under the pressure of a deadline.
The second step in compliance is to determine what data is required to meet your accountant’s requirements. Is the information necessary to accomplish the evaluation methods it will accept available to you in a usable format? For items that are missing, what must be done to obtain them?

The third step is to run a fair–value evaluation of your September 30 quarter–end balance sheet to see what it looks like. If there are any surprises, this will give you some time to deal with them.

Finally, develop a plan for FAS 107 compliance that puts as much of the burden as possible on bank personnel and as little as possible on your outside auditors. There will be a significant cost to FAS 107 compliance. The more you rely on your accounting firm to do the work for you, the higher that cost will be.

**FAS 114**

In May 1993 the Financial Accounting Standards Board published Statement of Financial Accounting Standards No. 114 (FAS 114), Accounting by Creditors for Impairment of a Loan. The statement amends FAS 5, Accounting for Contingencies and FAS 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings. FAS 114 is effective for fiscal years beginning after December 15, 1994, but earlier application is encouraged.

**FAS 5.** FAS 5 is the historic fundamental standard for recognizing estimated losses that have not yet occurred. There are two requirements for FAS 5 to apply to any given asset: (a) there is information available that indicates that it is probable that an asset has been impaired (i.e. that a loss has or will occur), and (b) the amount of the loss can be reasonably estimated. If the conditions in both (a) and (b) are met, then a charge to income must be made of the reasonable estimate of the loss. For a loan, the loss to be recognized is the principal amount of the loan less the amount anticipated to be collected. For example, if a bank has a $100,000 loan outstanding and because of circumstances it is probable that the bank will collect only $80,000, then a $20,000 charge must be taken. FAS 5 does not take into account the timing of the collection of the $80,000 or any interest that may be lost. In other words, FAS 5 disregards the time value of money.

**FAS 15.** The logic of FAS 15 is similar to that of FAS 5. If a troubled debt is restructured, and the total of the payments of principal and interest to be paid under the restructured debt equal at least the remaining principal of the original debt, no loss is recognized. Again, no consideration is given to the timing of the payments, interest that would otherwise be earned, or the time value of money.

**FAS 114.** FAS 114 amends FAS 5 and FAS 15 to the extent that they do not measure the timing of future payments and thereby the potential interest that is lost. FAS 114 does not address how a bank should identify loans to be evaluated for collectibility or when a write–down should be made. As to those issues, FAS 5 still governs. What FAS 114 does do is change the calculation for the write–down when it is determined that one is necessary.

**Impaired Loans.** FAS 5 speaks in terms of loss contingency. FAS 114 uses the term “impaired.” A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The statement further provides that a loan is not impaired if the delay in payment is insignificant or if the creditor expects to collect the interest accrued during the delay. The key word in the definition is “probable.” The statement adopts FAS 5’s definition of probable, which is that a future event or events are probable if they are likely to occur. This is contrasted to “reasonably possible” which means more than
remote but less than likely. Once the odds are greater than 50/50, the event is probable.

All troubled debt restructurings are treated as impaired loans, the logic being that if the loan were not impaired it would not qualify as a troubled debt restructuring.

**Measurement of Impairment.** When a loan is determined to be impaired, the extent of its impairment (i.e., the anticipated loss) must be charged to a valuation allowance with a corresponding charge to bad debt expense. The extent of the impairment is no longer measured by the principal amount of the loan that is anticipated to be unrecoverable. FAS 114 requires that a bank estimate the amount and timing of all future payments on the impaired loan and discount those payments to their present value at the loan’s effective interest rate. (The effective interest rate of a loan is the contractual interest rate of the loan adjusted for any net deferred loan fees or costs, premium, or discount.) If the interest rate on the loan is a floating rate, a bank may use either the interest rate at the time that the loan became impaired or the rate as it changes over the life of the loan. Whichever rate a bank chooses, it must apply that choice consistently for all floating-rate loans. In the case of a troubled debt restructuring, a bank must use the loan’s original interest rate before the restructuring, not the rate in the restructuring agreement. The estimates of future cash flows “shall be the creditor’s best estimate based on reasonable and supportable assumptions and projections.” In virtually every instance, the degree of impairment (charge–off) under FAS 114 will be greater than that calculated under the old rules.

There are two exceptions to use of the discounting method to measure impairment. One is when foreclosure of a collateralized loan is probable. The other is the instance of a collateral–dependent loan. A loan is collateral dependent if repayment is expected to be provided solely by the underlying collateral. In those two circumstances, the measure of impairment is the difference between the principal balance of the loan, and the value of the collateral reduced by any costs to carry and sell and the amount of any senior mortgage.

Assume a $100,000 loan at 10% interest. The bank reasonably believes that it will collect $80,000 in one year. The present value of $80,000, payable in one year, discounted at 10% is $72,727. The impairment is $27,273 or $7,273 more than would have been charged to bad debt expense under the prior rules.

Assume a $100,000 loan at 10% interest has been restructured as a troubled debt and under the restructuring requires five annual payments of principal and interest of $20,000, all of which the bank reasonably believes it will receive. The present value of the five future payments discounted at 10 % is $75,815. The impairment and charge to bad debt expense is $24,185. Under the prior troubled debt restructuring accounting rules, there would have been no charge.

**Future events.** If a bank measures impairment of a loan by a present value calculation, the amount of impairment may change because of:

- The passage of time (i.e., the discount will reduce as the timing of the anticipated payments becomes shorter)
- A revision of the estimate in the amount or timing of the cash flows
- A change in the interest rate for floating–rate loans.

If impairment is measured by the fair value of the collateral, that fair value may change.

In the event of a change in the measure of an impaired loan, the entire change may be reported as bad debt expense or as a reduction in bad debt expense. Alternatively, the increase in value that is attributable to the passage of time may be reported as interest income. Changes based on the other factors would be again reported as bad debt expense.
or as a reduction of bad debt expense. Whichever method a bank chooses, it must be consistent across its portfolio.

**Disclosures.** After a bank implements FAS 114, it must make the following disclosures in either the body or the notes to its financial statements:

- The investment in the loans for which impairment has been recognized and the allowance for credit loss related to those impaired loans
- The activity in the credit loss account during the period of the statement
- The bank’s income–recognition policy.

**Effective Date.** FAS 114 is effective for all financial statements for fiscal years beginning after December 15, 1994; however, the board encourages earlier application. If the statement is adopted during an interim period of a year other than the first interim period, (for example, the fourth quarter) then all prior interim periods of that year must be restated. If the statement is adopted in the first interim period, the entire effect of the adoption is shown in that period. In no event are prior years’ statements restated.

A troubled debt restructuring completed before the adoption of the statement does not have to be treated as impaired if it is not impaired in relation to its restructured terms. A bank may continue to account for those loans in accordance with the rules of FAS 15 prior to its amendment by FAS 114.

Adoption of FAS 114 will create a greater allowance for credit loss than previously required by FAS 5 and FAS 15. Prior to year-end, a bank should calculate the additional credit loss FAS 114 will require and determine the least disadvantageous time to recognize that loss. Recognition of the loss will create an equal reduction in both earnings and capital and may have income–tax consequences.

If FAS 114 is adopted in the last quarter of a year, the impact on the quarterly earnings for the quarter of adoption will be much less than if it is adopted in the first quarter of a year, although annual earnings will take an equal hit in either case. For some banks it may be best to adopt FAS 114 now. For others it may be better to wait, even to the first quarter of 1995. In any event, bankers should be aware of the amount of loss they will have to recognize and consider all the ramifications of the timing of the recognition.

**FAS 115**

Statement of Financial Accounting Standards No. 115 is the most recent in a line of accounting pronouncements requiring more complete and accurate disclosure of the present or fair value of assets and liabilities on a financial institution’s balance sheet. FAS 115 defines the rules for accounting for debt and equity securities owned by financial institutions.

**Definitions**

**Security.** A security is a share, a participation, or other interest in the issuer, or an obligation of the issuer, that (a) is represented by an instrument in bearer or registered form, or is registered in records maintained by or for the issuer, (b) is of a type commonly traded on securities exchanges or is dealt in as a medium for investment; and (c) is one of a class, or is divisible into one of a class, of shares, participations, interests, or obligations.

**Debt Security.** A debt security is any security representing a creditor relationship with an enterprise. Normal consumer and commercial loans are not securities and thus not debt securities. The term “debt security” includes, among other things, U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, convertible debt, commercial paper, and securitized debt instruments such as CMOs and REMICs.

**Equity Security.** An equity security is any security representing an ownership interest in
an enterprise, or the right to acquire or dispose of such an ownership interest at a fixed or determinable price. Included are all forms of capital stock, warrants, rights, and put and call options.

**Fair Value.** Fair value is the price at which a debt or equity security could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available, that is the security’s fair value.

**Historical Perspective.** Traditionally, financial institutions have held securities in either a trading account or an investment account. Securities purchased and held principally for the purpose of sale in the near term are held in the trading account; all other securities are held in the investment account. Securities in the trading account are accounted for at fair value. Increases or decreases in fair value are reflected in profit and loss and in shareholder equity or capital. Investment securities are accounted for at amortized cost. No fluctuation in value of an investment account security is reflected in a financial institution’s financial statements until the security is sold. When the investment account security is sold, gain or loss is reflected in earnings and in shareholder equity.

The logic used to justify book–value accounting for investment securities is that what is really purchased is a stream of future cash flow and that stream does not vary with the security’s value. If the security is held to maturity, the financial institution that owns the security will get exactly what it bargained for. Another argument for book–value accounting is that it promotes stability in the securities market. Also it is argued that if book value accounting is not allowed, banks will not invest in long–term securities because of their increased volatility in value over securities of shorter terms.

The drawback of book–value accounting is that it can lead to mischief known as “gains trading.” A bank has purchased two securities, each at $100, and each is carried on the bank’s financial statements at a $100 value. One security has increased in fair value to $125 and the other decreased to $75. It is near the end of a quarter and the bank’s earnings are not what they should be. The temptation is great to sell the $125 value security and book the profit. Unfortunately, too many bankers succumbed to the temptation. “Those requirements provide the opportunity for the managers of an enterprise to manage its earnings by selectively selling securities and thereby selectively including realized gains in earnings and selectively excluding unrealized losses from earnings. An impressive amount of empirical evidence indicates that many financial institutions have engaged in that behavior.” As with most new regulations and regulatory changes, it is the greed or misdoing of a relative few that brings wrath on everyone. Several large banks have been caught selectively booking their profits and riding out their losses.

**The Rules**

FAS 115 establishes three categories of securities. Each prescribes a different accounting treatment for the securities assigned to it. The three categories and their accounting rules are as follows:

**Trading Securities.** The definition of securities in this category and their accounting treatment has not changed. Securities that are bought and held principally for the purpose of selling them in the near term shall be classified as trading securities. Trading securities shall be carried on a bank’s financial statements at fair value and gains and losses in the fair value of these securities shall be included in earnings.

**Held–to–Maturity Securities.** This is a new category. A held–to–maturity security is one that the financial institution has the “positive intent and ability” to hold to maturity. Positive intent and ability” means that there is no circumstance that could be reasonably anticipated that would cause the financial
institution to sell the instrument. Changes in interest rates, changes in the security’s fair value, changes in the institution’s investment policy, changes in the institution’s liquidity or asset/liability risk are all foreseeable and not justification for selling a held–to–maturity security. Types of permissible reasons for selling a held–to–maturity security are

- A significant decrease in the issuer’s creditworthiness
- A change in tax law that changes the tax–exempt status of interest on the security
- A change in regulatory requirements that makes the security inappropriate or not permissible for investment
- A regulatory increase in industry capital requirements that forces the institution to downsize
- An increase in the security’s risk weight for risk–based capital purposes.

The accounting treatment for held–to–maturity securities is the same as the present treatment for investment securities. That is, the securities are carried on the bank’s books at amortized cost and changes in fair value are not included in earnings or shareholder equity. Gain or loss on the security is recognized only upon sale.

Available–for–Sale Securities. Securities not classified as trading securities or held–to–maturity securities shall be classified as available–for–sale securities. Available–for–sale securities are accounted for on a bank’s balance sheet at fair value. Unrealized gains and losses are excluded from earnings but reported in a separate component of shareholders’ equity until realized. For example, assume a security is purchased for $100 and assigned to the available–for–sale category. At the next reporting period its fair value is $125. The security’s fair value of $125 will be shown as an asset on the balance sheet. A new category, “Unrealized gains and losses from available–for–sale securities” will be added to the capital and surplus section of the balance sheet with a value of $25. No change is reflected on the income statement. If at the end of the next period the fair value of the security had dropped to $75, that value would be shown as the security’s value on the financial statement and the unrealized gains and losses would show a deficit of $25. If the security were then sold for $75, the unrealized gains and losses would be zero and retained earnings would be decreased by $25.

Disclosures

In addition to the information presented in the balance sheet and the income statement, FAS 115 requires that substantial disclosures be made in the footnotes to the financial statement about a bank’s available–for–sale and held–to–maturity securities portfolios as of the statement date. The disclosure also must contain the major categories of securities that are held, and as to each, the fair value, the unrealized gain and the unrealized loss, and the amortized cost basis. The disclosure also must set out the maturity of each portfolio by placing each security in one of four maturity groupings.

Additionally, for the available–for–sale category for each period, the disclosure must show the proceeds from sales, the gross realized gains and the gross realized losses from those sales, and the change in unrealized gain or loss included in the separate component of shareholder’s equity during the period.

For the held–to–maturity category, the disclosure must set out the cost of any securities sold or transferred to another category, the unrealized gain or loss and the circumstances leading to the decision to sell or transfer the security.

Effective Date

FAS 115 is effective for fiscal years beginning after December 15, 1993.
**Effect of FAS 115**

Financial statement analysts will have more information about a bank’s securities portfolios than ever before. They know the composition of the portfolio by security type and maturity, as well as its performance. Bankers will be judged every quarter on the performance of their securities portfolios. While unrealized gains and losses in the available-for-sale portion of the portfolio will not be reflected in profit and loss, the result will be easily determined by subtracting the prior period’s separate shareholder equity from that of the current period.

Unrealized losses can no longer be hidden, and unrealized gains will not be available to bolster a period with earnings below par. Unrealized gains will actually reduce a bank’s return on assets and return on equity, while unrealized losses will increase both measures, a perverse result.

**FAS 122**

Statement of Financial Accounting Standards No. 122 (FAS 122) amends Financial Accounting Standard No. 65 relative to the accounting for mortgage loan servicing rights (MSRs) acquired through loan origination activities. The new standard eliminates the accounting distinction between mortgage servicing rights that arise from origination activities and those that arise from purchase transactions. FAS 122 also provides standards for valuing and amortizing MSRs as well as standards for estimating the fair value of MSRs.

**Application of FAS 122**

FAS 122 applies only to real estate mortgage loan originations and the subsequent sale of such a loan with the retention of the loan servicing by the seller of the loan. FAS 22 also applies to a purchase of a loan and the related MSR by an entity that subsequently sells the loan and retains the servicing. However, FAS 122 does not apply to the servicing of any loan other than real estate mortgage loans. It also does not apply to a transaction where the servicing is sold and the loan is retained.

**Effects of the New Standard**

Under the present rules, when a bank originates a mortgage loan, its accounting basis in the loan asset is the amount disbursed. Because of the realities of the mortgage industry, the value of the loan is the combination of the value of two distinct items. One is the value of the cash flow stream from the loan obligation as that cash flow stream is reduced by the cost of servicing the loan. The other is the value of the servicing fee cash flow stream. Under the present rules, if the lender sells the loan but retains the MSR, the lender may not reflect the value of the retained MSR in its financial statement. On the other hand, if the lender purchased the MSR from a third party, the lender would then show the MSR value on its financial statement at its acquisition cost.

Under the old rules, if a lender originated a mortgage loan and sold that loan but retained the MSR, the accounting rules did not reflect the total value that was earned from the combined transaction. On the other hand, the originally unrealized MSR value was ultimately realized over the term of the servicing. Under the new rule, the total value of the loan origination and sale will be recognized regardless of the fact that servicing is retained, but the future income from the servicing will be reduced by the amortization of the value placed on the servicing.

**Fair Value of Mortgage Servicing Rights**

Under the rules of FAS 122, mortgage loans (without the servicing rights) and the related servicing rights have separate, determinable fair values. It is the fair value of the servicing rights that the bank or mortgage company should use to amortize the cost of the
servicing rights. The fair value of mortgage servicing rights will generally be based on observable market prices, if they are available. Quoted market prices in active markets are the most objective and relevant measure of fair value, and these should be used if they can be readily obtained. If a quoted market price cannot be obtained, then the estimate of fair value should be based on the best information available in the circumstances. Such information could be prices for similar assets or the results of various valuation techniques, such as present value of estimated expected future cash flows using a risk–adjusted discount rate, option pricing models, and fundamental analysis.

A bank or mortgage company may find that it is not practical to determine the fair value of its mortgage servicing rights, such as when the institution holds a very small or illiquid servicing portfolio. In this instance the mortgage servicing rights should be recorded at zero, and the bank or mortgage company should describe the MSRs in its financial statements and explain why their fair value cannot be determined.

If the bank or mortgage company has a **definite plan to sell** a loan and retain its servicing rights (defined as the institution having commitments from investors in place before the purchase or origination date with estimates of the selling price having been made), then the institution should allocate the cost of the loan between the value of the loan without servicing and the value of the MSR, based on their respective fair values at the date of the purchase or origination. If the bank has no definite plans to sell a loan at the time of purchase or origination, but later makes a plan to do so, the cost should be allocated based on the respective fair market values at the date of the sale.

**Profit and Loss**

The new FASB rules do not change the rules regarding how a bank recognizes a loss on mortgage servicing rights in certain circumstances. A loss is still accrued if the estimated servicing costs are expected to exceed normal servicing revenue. A liability is recognized if less than a normal servicing fee will be received. This liability is then amortized to provide a normal servicing fee in subsequent periods. Impairment of the mortgage servicing rights will also be recognized under the new rules by fair value. The amount to be recognized as impairment is the amount by which the value of the capitalized mortgage servicing rights exceed their fair value, taken in the form of a valuation allowance. The valuation allowance should be adjusted periodically to reflect changes in the measurement of impairment.

**Timing**

The new standard is to be applied prospectively in fiscal years beginning after December 15, 1995. For most institutions this will mean beginning January 1, 1996. The standard applies only to loans sold with servicing retained after the effective date. The new rule is not to be used to revalue MSRs that an institution acquired prior to the effective date.
Accounting for Investments in Debt and Equity Securities

A sample policy can be found in our Policy Manual.

Procedures – Chief Financial Officer
Upon Acquisition of a Security

Step  Action
1  Classify the security as trading, available–for–sale, or held–to–maturity in accordance with the definitions in the bank’s policy.
2  Enter the security’s acquisition cost in the appropriate account in the bank’s general ledger.
3  This procedure is complete.

Daily Procedure

Step  Action
1  Determine the fair value of all securities held for trading at the close of business (or trading).
2  Adjust the value on the bank’s general ledger of the securities held for trading in accordance with the fair value determined in Step 1.
3  Include in the bank’s earnings for the day the net change in fair value from the prior day fair value was recorded.
4  This procedure is complete.

Monthly Procedure

Step  Action
1  Review all securities owned by the bank to determine if each is correctly categorized as trading, available–for–sale, or held–to–maturity.
2  For each security that is found to be incorrectly categorized, categorize it properly and make the necessary changes in the bank’s general ledger accounts as follows:
   • For a security transferred from the trading category, the unrealized holding gain or loss recognized in earnings shall not be reversed and the security shall thereafter be accounted for as if acquired at its then fair value.
   • For a security transferred into the trading category, any unrealized holding gain or loss shall be recognized in earnings.
   • For a security transferred into the available–for–sale category from the held–to–maturity category, the unrealized holding gain or loss at the date of transfer shall be recognized in a separate component of shareholder equity.
For a security transferred into the held–to–maturity category from the available–for–sale category, the unrealized holding gain or loss at the date of transfer that has been reported in a separate component of shareholders’ equity shall remain in the separate component but shall be amortized over the remaining life of the security as an adjustment of yield.

3 This procedure is complete.

**Procedure Upon Sale of a Security**

**Step** **Action**

1 Was the security classified as trading prior to sale?
   - **Yes** — Include in earnings the difference between the net sales price of the security and its most recent fair value reflected on the bank’s general ledger. Go to Step 3.
   - **No** — Go to Step 2.

2 Was the security classified available–for–sale prior to sale?
   - **Yes** — Include in earnings (and shareholders’ equity) the difference between the net sales price of the security and its acquisition cost. Eliminate from the special component of shareholders’ equity any amount reported therein relative to the security.
   - **No** — Include in earnings the difference between the net sales price of the security and its acquisition cost. Review other securities of the same type in the held–to–maturity classification and determine if they are still properly classified. If they are not, follow the monthly procedure to reclassify them.

3 This procedure is complete.
Risk-Based Capital

Introduction

The risk-based capital rules that we have known for years took effect December 31, 1990. They were the result of an international agreement among bank supervisory authorities that came to be called “The Basel Accord” after the Swiss resort town where the bureaucrats met to finalize the agreement. With the advent of a second capital accord, this first one is now called Basel I. It requires a bank to maintain a minimum leverage ratio and two minimum risk-based ratios. The leverage ratio is a measure of regulatory capital as a percentage of total on-balance-sheet assets reported in accordance with Generally Accepted Accounting Principles (GAAP). The risk-based ratios measure regulatory capital as a percentage of both on- and off-balance-sheet credit exposures, with some differentiation based on perceived risk.

After a decade of experience with this system, and further developments in financial products and services offered by the very largest internationally-active financial institutions, those same regulators felt the need for another vacation in Basel … er, rather, another scheme of capital calculation for those few very large banks. So they came out with what is now referred to as Basel II. (“Son of Basel” lacked gravitas.) We will summarize the existing rules under Basel I first, then, to the extent possible, explain the rules under Basel II.

Basel I

Each federal bank regulatory agency in the United States has adopted regulations to implement the Basel I standards. The rules assign conversion factors to off-balance-sheet activities to convert them to on-balance-sheet equivalents, and then risk weights are applied to the converted off-balance-sheet items and to on-balance-sheet assets. Cash and United States Government securities are assigned a zero risk, government agency securities a 20% risk, conventional mortgages 50%, and purchased mortgage servicing rights and commercial loans 100%, just to list a few. The products of these multiplications are added to arrive at the “risk–weighted” figure against which the bank must maintain a specified capital percentage.

The principal objectives of Basel I are to: 1) make regulatory capital requirements more sensitive to differences in risk profiles among banks; 2) factor off–balance–sheet exposures into the assessment of capital adequacy; 3) minimize disincentives to holding liquid, low risk assets; and 4) achieve greater consistency in the evaluation of the capital adequacy of banks.

There are two types, or tiers, of capital under the Basel I rules. Tier 1 is composed of common equity, any retained earnings, and any noncumulative perpetual preferred stock. Tier 2 is composed of loan loss reserves, any cumulative preferred stock, and any subordinated debt. Loan loss reserves in excess of 1.25% of risk–weighted assets do not count as capital, however.

The Basel I rules were drafted largely in contemplation of the balance sheets and off–balance–sheet activities of international money–center banks. Therefore, many of their provisions have little effect on the balance sheets of most U.S. banks.

Federal regulators take the position that, other than for Basel II banks, the risk–based capital requirement is the minimum, minimum capital necessary; depending on other risk areas in a bank, a higher level of capital may be required. Some of the significant areas are discussed below.
CAMELS Ratings and Leverage Ratios

The Capital, Asset quality, Management, Equity, Liquidity, and Sensitivity to market risk (CAMELS) rating is used to set the minimum leverage ratio, that is the ratio of Tier 1 capital to total assets. Banks the regulators award a CAMEL rating of 1, the best rating, theoretically will be permitted to maintain a leverage ratio of only 3 percent. We say “theoretically” because the C in CAMELS does stand for “Capital” and the regulators have said they believe it unlikely that a bank with only a 3 percent leverage ratio would have sufficient capital to qualify for a rating of 1. This regulatory Catch-22 may render largely illusory any possibility of a bank that is governed by Basel I being able to maximize its capital leverage. Furthermore, a reduction in capital generally requires the separate, express approval of the appropriate federal regulator, and, for most state–chartered institutions, the state regulator as well. Such approvals cannot realistically be expected without very unusual circumstances under Basel I.

Institutions given lower CAMELS ratings (2–5) by the regulators will be required to maintain higher leverage ratios. The FDIC, for example, says four percent is its minimum.

The following is a summary of the assigned risk–based capital weights and conversion ratios of common items under Basel I. Foreign country assets are not included. A bank should consult the regulations of its particular regulator for further details.

I. Qualifying Capital

A. Tier 1 - Core Capital (Must represent at least 50% of qualifying total capital.)
   1. Common stockholder equity
      a. Common stock
      b. Capital surplus related to common stock
      c. Retained earnings
      d. Less net unrealized holding losses on available–for–sale equity securities with known fair market values

2. Noncumulative perpetual preferred stock
   a. Must have no maturity date and no provision requiring future redemption.
   b. May not be redeemable at option of holder
   c. Issuer must have legal right and ability to defer or eliminate preferred dividends
   d. Must not have a dividend rate that is reset periodically based on bank’s credit (but may be reset periodically based on an index)

   Note: For bank holding companies, preferred stock cannot exceed 25% of Tier 1 capital. Any excess preferred stock may be included in Tier 2 capital.

3. Minority interest in equity accounts of consolidated subsidiaries

4. Minus goodwill (except goodwill acquired in supervisory mergers with troubled or failed institutions and that were given explicit authority to include such good will in capital under the then existing capital policy) and certain defined intangible assets

B. Tier 2 - Supplementary capital (amounts in excess of Tier 1 do not count)
   1. Allowance for loan and lease losses other than reserves created against identified losses (specific reserves) and allocated
transfer risk reserves. (May not exceed 1.25% of weighted risk assets.)

2. Perpetual preferred stock
   a. Must have no maturity and may not be redeemed at option of holder (Original maturity or redemption right in excess of 20 years may be included.)
   b. Must have no provision that will require future redemption
   c. Not included in Tier 1 capital

3. Hybrid capital instruments and mandatory convertible debt securities
   a. The instrument must be fully paid, unsecured, and subordinated to claims of general creditors and depositors
   b. The instrument must not be redeemable at the option of the holder (callable) prior to maturity, except with prior approval of Federal Reserve (implies that payment may be accelerated only in event of bankruptcy, insolvency, or reorganization).
   c. The instrument must be available to participate in losses while the issuer is operating as a going concern, that is, instrument must convert to stock in the event accumulated losses exceed capital surplus plus retained earnings.
   d. Issuer must have right to defer interest if the issuer:
      i. Did not have a profit in the prior annual period, and
      ii. Eliminates cash dividends on common and preferred stock.

4. Subordinated debt and intermediate term preferred stock.
   (May not exceed 50% of Tier 1 capital.)
   a. Must be subordinate to claims of depositors and general creditors,
   b. Must have original weighted average maturity (i.e., sooner of maturity or earliest date holder can redeem) of at least five years.
   c. Must be unsecured and state that it is not a deposit and not insured by FDIC. Redemption before maturity requires prior approval of regulator.
   d. Must have other features listed in agency policy statements.

5. Minus discount of supplementary capital instruments. Supplementary capital instruments must be discounted 20% per year during each of their last five years prior to maturity. That is, when an instrument reaches five years to maturity, it must be discounted 20% and an equal discount must be taken on each succeeding anniversary.

C. Deductions from capital and other adjustments.

Note: Goodwill was deducted from Tier 1 core capital, as previously noted in I.A.4.

1. Intangible assets (other than goodwill).
   a. All intangible assets must be deducted with the exception of readily marketable mortgage
servicing assets, nonmortgage servicing assets, and purchased credit card relationships. However, the total amount of these assets cannot exceed 50% of Tier 1 capital and purchased credit card relationships are subject to a separate sublimit of 25% of Tier 1 capital calculated by special parameters.

b. The book value of all intangible assets must be reviewed quarterly and, if necessary, adjusted.

c. Book value and fair market value will be closely scrutinized and independent valuation may be required.

d. The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships included in capital shall be the lesser of 90% of the fair market value or 100% of their book value calculated in accordance with specific definitions.

e. In assessing capital adequacy for applications purposes, the agencies may consider the overall capital and the quality and value of tangible and intangible assets. In substantial growth situations, the regulator will expect strong capital positions substantially above minimum supervisory levels with little reliance on intangible assets.

2. Investments in certain subsidiaries.

a. Capital investment in a finance subsidiary whose financial statements are not consolidated with the bank will be deducted. Loans or other extensions of credit to such a subsidiary may also be deemed capital and deducted dependent on the risk associated with it.

b. The regulator may, on a case–by–case basis, also deduct from capital investments in other subsidiaries.

3. Reciprocal holdings of banking organizations’ capital instruments. Cross–holdings of capital instruments between two banks (or among more than two via a daisy chain) whether by formal or informal agreement will be deducted.

Note: Any assets deducted from capital are similarly deducted from weighted risk assets.

4. Deferred tax assets. The amount of deferred tax assets that are dependent on future taxable income, net of the valuation allowance for deferred tax assets that may be included in (not deducted from) bank capital may not exceed the lesser of:

a. The amount of these deferred tax assets expected to be realized within one year of the calendar quarter ending date, based on future taxable income projections for that year, or

b. Ten percent of Tier 1 capital.

D. Add the sum of Tier 1 capital and Tier 2 capital and subtract deductions from capital to determine qualifying capital.
II. Risk Weights of Most Commonly Held Assets

0%
- Cash
- U.S. Treasuries
- Balances due from Federal Reserve
- Stock in Federal Reserve Bank
- GNMA Securities

20%
- Cash items in process of collection
- Deposits in U.S. banks
- FNMA, FHLMC securities
- Municipal bonds

50%
- 1–4 family first mortgages
- 1–4 family second mortgages where bank also holds first mortgage
- Municipal revenue bonds

100%
- Everything else (except items such as goodwill deducted from capital)

III. Conversion Factors for Most Common Off–Balance–Sheet Items

100%
- Financial standby letters of credit
- Banker’s acceptances
- Loans sold with recourse

50%
- Performance standby letters of credit
- Loan commitments with a term exceeding one year
- Overdraft facilities
- Home equity lines

20%
- Commercial letters of credit

0%
- Loan commitments with a term of one year or less, credit cards

IV. Examples of Typical Transactions

- $10,000 unused home equity line secured by second mortgage where bank also holds first mortgage.
  
  Conversion factor – 50%  
  Risk Weight – 50%  
  $10,000 X 50% X 50%  
  Converted, weighted amount = $2,500

- $10,000 financial standby letter of credit, $5,000 of which is secured by cash on deposit.
  
  Conversion factor – 100%  
  Risk Weight – $5,000 - 100%  
  $5,000 - 20%  
  $10,000 X 100% = $10,000;  
  $5,000 X 100% + $5,000 X 20%  
  Converted, weight amount = $6,000

- $10,000 financial standby letter of credit securing municipal revenue bonds
  
  Conversion factor – 100%  
  Risk weight – 50%  
  $10,000 X 100% X 50%  
  Converted, weighted amount = $5,000

- $50,000 single family home loan, top 20% of loan guaranteed by V.A.
  
  Risk weight –  
  $10,000 (guarantee by VA) – 0%  
  $40,000 – 50%  
  $10,000 X 0 percent + $40,000 X 50%  
  Weighted amount = $20,000
Basel II

Basel II, as mentioned earlier, will be mandatory for only the very largest banking organizations in the United States, called “core banks” under the new rules. “Core bank” is defined for now as one having total banking assets of a quarter of a trillion dollars or more or total on-balance-sheet foreign exposure of $10 billion or more. The regulators estimate that there will be approximately ten of them. (A small number of other large US banks will be allowed to opt in to the Basel II system if they wish.) Why so few? Because banking assets have become very concentrated, even though there are thousands of smaller banks. To take an example from another area of compliance regulation, when the regulators first proposed to double the asset size measure for “large” banks under the Community Reinvestment Act from $250 Million to $500 Million, they said it would cut the number of those “large” banks by half, while reducing total bank assets covered by the “large” bank rules by only about one percent! Clearly, the vast bulk of US banking assets are in a very few, very large banks, many of which engage in sophisticated transactions. Basel II tries to deal with their capital in more tailored ways than the Basel I system that is applied to the large number of little folks in the back of the plane.

The vast majority of banks in the U.S. will not be directly affected by Basel II, because of their lack of size and sophisticated international activities. They may be indirectly affected if Basel II permits their super-large competitors to get by with much less capital than the smaller banks are required to maintain. That is one of the largest unresolved issues in the implementation of Basel II. It results from the different banking systems in use in most foreign countries versus that in the US. Here, we have 51 different bank-chartering governments, the 50 states plus the federal government. “Barriers to entry,” that is things that prevent a person from starting a bank, are amazingly low, so new, initially very small, banks crop up all the time. In contrast, in many foreign countries there are only a very few, very large banks, few (if any) small ones, and the barriers to entry either are insurmountable or require “connections” or significant bribes to corrupt officials.

Basel II contains three elements:

Minimum regulatory capital;
Supervisory review; and
Market discipline.

One of the principal purposes of Basel II and its three elements is to address the “too big to fail” feeling among customers of the largest banks. And one of the problems with actual implementation of Basel II is that in many foreign countries two of these three elements either do not exist or are present only in a much attenuated form.

Regulatory capital generally is hard to get around. Real assets of a certain amount must back up the bank’s activities that are subject to capital requirements. The other two elements, however, are lacking in many countries. Supervisory review often is cursory or performed by poorly-trained examiners. Sophisticated international banking specialists know more about what they are doing than the person from the supervisory agency. In some countries, corruption and connections gut the supervisory process, as well.

For these reasons, market discipline, the reaction by bank customers upon learning what a bank’s capital position and risks are, that, “if that’s what that bank is doing, I don’t want to do business with them!” simply does not occur. Customers still know that the bank is “too big to fail” (or that well-connected person X is the owner) so they don’t pull their business even though the bank is doing risky things. They know the government will bail
the bank, and them, out of whatever trouble it gets into. So the bank, in turn is not at all disciplined by its market.

**Minimum Regulatory Capital**

The few extremely large U.S. banks covered by Basel II will calculate capital requirements for both credit risk and operational risk. If they engage in significant trading activity, they will calculate capital requirements for market risk, as well. Basel II does not change the definition of what qualifies as regulatory capital, the minimum risk-based capital ratio, or the methodology of determining capital charges for market risk. It does provide several new methodologies for determining the capital requirements for both credit risk and operational risk.

Basel II gives two general approaches for credit risk: the “standardized approach,” which is essentially a series of modifications to Basel I; and the “internal risk-based approach,” (IRB) which uses the bank’s own internal estimates of key risk drivers to develop the capital requirements. Within IRB, there is a “foundation” methodology, in which the regulators provide key risk component inputs for banks to use, and an “advanced” methodology (A-IRB), in which the banks develop many of their own inputs.

Basel II also provides three methodologies for determining the capital required for operational risk: the “basic” indicator approach; the “standardized” approach; and the advanced measurement approach (“AMA”). Under the first two, capital requirements for operational risk are fixed percentages of specified objective risk measures. The AMA allows a bank to develop its own approach, subject to supervisory oversight. Naturally, most big banks would like to use their own measures for both credit and operational risk, and therein lies the rub.

Because so much of the important quantitative material under Basel II is to be developed by those few big banks themselves, the regulatory implementation process has unfolded in the reverse order from the way it normally unfolds. Instead of the agencies proposing a rule, taking comments, analyzing the comments, and revising the proposal to make a final rule, the agencies have had to use a different process. They have a general international agreement, but have to find out what banks would do if given a free hand before they can decide just how free a hand to give them.

So far the agencies have asked the big banks for, and have received and studied, not one but four quantitative impact studies on this topic. The answers in the most recent one as we write, “QIS4” as it is called, surprised the agencies. The dispersion among banks in their estimates of key parameters used to calculate Basel II capital requirements was, in the words of one regulator, “quite wide – much wider than expected.” The reductions in the minimum required regulatory capital figures resulting from the banks’ estimates were “often substantial – far more than previous quantitative impact studies, both here and abroad, had suggested.”

For the ten or so “core” banks in the US that are required to move to the Basel II system, and for any of the few other qualified banks that choose to opt in, a period of parallel running of Basel I and Basel II calculations and capital maintenance will be mandated. The year 2007 will be the first year of parallelism, and the agencies will review the results of the application of the two systems to live transactions in real banks to see what the results would have been under Basel II.

After four quarters of what the agencies call “credible” Basel II estimates, a bank will enter a minimum two-year transition run, during the first year of which it will operate under Basel II rules but will not be permitted to reduce its capital to a level less than 90% of what Basel I would require. During the second year, it
could reduce its capital to 80% of the Basel I level. Both the parallel run and the transition run may be lengthened if the agency has doubts about either the bank’s Basel II system or the prudence of the resulting minimum regulatory capital level. If the two runs go satisfactorily in the eyes of the agency, the bank then will be released to play by pure Basel II rules.

One final note about the as yet undefined Basel II rules: the agencies have promised to publish a revision to the Basel I rules simultaneously with the proposed Basel II rules. The purpose: to make the Basel I rules “more risk-sensitive and to blunt any unintended harm that Basel II might impose on non-adopters.” The agencies say their “intention is to keep these proposed changes simple [one remembers the Truth in Lending Simplification Act and one shudders] to minimize costs imposed on the many non-adopters.” So apparently the agencies do intend to impose some costs on the thousands of small and medium–sized banks at the time their super-sized competitors are granted lower capital requirements. Nothing more in the way of detail on what those costs will be has been released as we write. Stay tuned!
Accounting for Troubled Real Estate Loans

Introduction

"... income property loans [should] not be assessed solely on the basis of liquidation values but also on the income–producing capacity of the properties over time. Supervisory evaluations should take into account the lack of liquidity and cyclical nature of real estate markets and the temporary imbalances in the supply and demand for real estate that may occur." The quotation is from the OCC, FDIC, FRB, and OTS General Statement on supervisory policy issued March 1. With 20/20 hindsight the regulators finally realize the chaos they have created in the real estate finance industry and are belatedly trying to blunt the effect of their actions.

But like trying to put toothpaste back in the tube, often once an act is done its results cannot be reversed. The apparent intent of the regulators’ General Statement is to indicate to banks a lessening of the strict standards that have been applied to real estate loans. The regulators hope that banks will forget the meat grinder they have been through and loosen their purse strings to the real estate industry.

The regulators’ statement is an epitome of understatement. "It is possible ... that some depository institutions may have become overly cautious in their lending practices. In some instances this caution has been attributed to concerns on the part of lenders that the regulators of depository institutions are applying excessively rigorous examination standards.” In a classic of Orwellian double speak the regulators say "It is important that valuation techniques reflect not only existing market conditions, but also reasonable expectations of the property’s performance in the market over time. The Federal regulatory agencies are reiterating their policy on the assessment of real estate values and the establishment of loan loss reserves. The basic thrust of this guidance is to ensure that income property loans not be assessed solely on the basis of liquidation values, but also on the income–producing capacity of the properties over time.” If ever a statement was published that would not produce confidence in its audience this is it. If the statement is supposed to represent an easing of pressure on real estate loans the change appears to be more of form than substance.

A little jawboning by the regulators will not salve the wounds suffered by bankers, accountants or appraisers. And how about the examiner in the field? Will he be willing to risk his credentials by following his boss’s lead today knowing the potential of being second guessed tomorrow?

The crux of the issue of regulating and accounting for real estate loans and related assets is the question of valuation. On December 11, 1990 the Accounting Standards Division of the American Institute of Certified Public Accountants issued an Exposure Draft of a Proposed Statement of Position, Accounting for Foreclosed Assets. The proposed statement also carries forward the criteria for determining whether collateral for a loan has been in–substance foreclosed as set out in FASB Statement No. 15 and therefore the proposed position applies equally to foreclosed and in–substance foreclosed assets.

AICPA Practice Bulletin 7 states in paragraph 5 "A creditor should consider collateral for a loan in–substance foreclosed if all of the following criteria are met:

1. The debtor has little or no equity in the collateral, considering the current fair value of the collateral; and
2. Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral; and
3 The debtor has either —

A. formally or effectively abandoned control of the collateral to the creditor, or

B. retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor and/or the collateral in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

Very few troubled (unsound as defined by the Comptroller) commercial real estate loans do not meet the criteria of in–substance foreclosure if viewed honestly and realistically. In today’s market few troubled real estate loans have a collateral value greater than the unpaid balance of the loan and few real estate borrowers, if they have personal liability for debt, have independent resources sufficient to cover their obligations. It is the accounting requirements for assets deemed to be in–substance foreclosed that are most troubling to bankers and are an impediment to loan workouts that could be beneficial to both the bank and the borrower.

Both the Comptroller’s Handbook for National Bank Examiners and the AICPA Proposed Statement of Position speak of “fair value” as the appropriate measure for evaluating other real estate owned and in–substance foreclosures. Fair value is not defined in either publication as appraised value; however, the Comptroller’s Handbook states that fair value must be supported by a current appraisal. Undoubtedly in practice, appraised value will be used for fair value, market value, and all of their synonyms. The role of the appraiser in commercial real estate valuation will remain critical. Few regulators and even fewer accountants will challenge the value of a current appraisal, particularly if it is conservative. The FIRREA–mandated appraisal standards, particularly sections 323.4(a) (6)–(9), are forthright in their delineation of the facts that must be analyzed in predicting a favorable future market condition. Moreover the regulators (or their first cousin the RTC) are the single largest contractor for appraisal services and appraisers are of the opinion that conservative appraisals will win them a place on the approved appraiser list.

One of the principal purposes of the AICPA proposed statement is to reconcile the different accounting practices used by thrifts, banks, and finance companies. Because a reconciliation of accounting practices is supported by all of the regulators and the SEC, it is probable the proposed statement, will be adopted fundamentally as written. Under the proposed statement the following is the proper accounting treatment for in–substance foreclosed assets and other real estate owned:

- The recorded investment in the loan (or asset) should be reduced to the fair value (probably appraised value) of the collateral
- The fair value should be further reduced by the estimated cost to sell the asset (similar to net realized value calculations used by savings and loans and real estate investment trusts)
- Any excess in the cost of an asset over its fair value (as reduced by the cost to sell) should be recognized as a valuation allowance and charged to income.
- If the fair value of the asset changes, the valuation allowance should be charged or credited as appropriate and a similar charge or credit made to income.
- For other real estate owned there is a presumption the asset is held for sale:
negative cash flow from the asset is charged to income

- net cash receipts reduce the carrying value of the asset

- no depreciation or amortization expense should be recognized

- For in–substance foreclosures there should be a differentiation between assets the bank is attempting to gain control of (i.e., through legal proceedings) and assets the bank is allowing the borrower to continue to manage.

- Those the bank is trying to gain control of should be accounted for as OREO.

- Those that the borrower is left in possession of should not have a presumption of being held for sale and any income or expense should be recognized conventionally. This treatment is in conformity with paragraph 3 of the regulator’s general statement.

Subsequent to the regulator’s general statement, the FFIEC issued for comment an accounting treatment for returning assets that would otherwise be classified as in–substance foreclosures to accruing status. The procedure requires writing down the asset (i.e., the loan balance) to a point where the remaining balance has a loan to collateral ratio consistent with prudent underwriting standards, for example 75 to 80%. This procedure would require a bank to take a charge to income of 20 to 25% of the fair value of the collateral in addition to the write down to fair value. It is doubtful that many banks will choose to take this additional charge–off just to obtain the small advantage gained by returning the asset to accruing status.

The most advantageous accounting treatment for troubled loans remains the procedure for troubled loan restructuring contained in FASB 15. It provides that if certain concessions are granted to the borrower, including a reduction of the principal balance, the procedure may be used. Under the procedure, if the total of the payments to be made pursuant to the restructured loan exceeds the original principal balance no write off need be made. Any excess of payments over the original principal balance may be taken into income as interest ratable over the life of the loan.

Regardless of the accounting treatment chosen, accountants will require annual reappraisals of the collateral for all significant troubled real estate loans. In addition to the cost of the appraisals, bank earnings will suffer the results of continuing conservatism by appraisers. And the regulators will be overseeing and second–guessing all efforts by bank personnel to work out their troubled loans.
Quarterly Review of Allowance for Loan and Lease Losses

A sample policy can be found in our *Policy Manual*.

**Procedure**

<table>
<thead>
<tr>
<th>Step</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>An <em>ad hoc</em> committee composed of the bank’s chief executive officer, chief financial officer, senior loan officer, and loan review officer shall review the adequacy of the bank’s allowance for loan and lease losses, by credit type, as follows:</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Credit Types</th>
<th>Estimating Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Significant credits that are individually analyzed (including all significant credits classified “doubtful”).</td>
<td>- Individual assessment of the inherent loss in each credit, without regard to when that loss might be required to be charged off. In making the assessment, consider the present financial condition of the borrower and bank management’s best estimate of the direction and magnitude of any future changes in that condition. Determine from the borrower’s financial statements supplied to the bank what cash flow will be available to make the payments required on the borrower’s loan from the bank. Perform the same analysis on any guarantors or similar supporting parties. Estimate the present (and probable future) value of any collateral, net of the likely expenses in foreclosing/seizing it, and discount that net value by an appropriate factor for the likely length of time between the bank’s decision to proceed against the collateral and the ultimate sale of the collateral.</td>
</tr>
<tr>
<td>- Determine whether the borrower is more likely to surrender the collateral peaceably or dispute the bank’s rights to it. If the latter appears more probable, determine whether the borrower is likely to include a bankruptcy filing (or similar insolvency filing under any more favorable state law) as part of its defensive maneuvering. If so, include in the time discount estimate appropriate experience–based estimates</td>
<td></td>
</tr>
</tbody>
</table>
of the time before the collateral is likely to be adjudicated free of any applicable automatic (or other) “stay” orders prohibiting enforcement of liens. In estimating the value of collateral, the quality and enforceability of the bank’s documentation (mortgages, security agreements, UCC filings, and the like) must be evaluated in light of likelihood of a legal contest. Guarantee and other loan documents should be similarly analyzed, and values appropriately discounted for any questionable enforceabilities discovered.

- Other problem credits grouped as:
  - Doubtful C&I credits too small to be significant
  - Substandard C&I credits
  - OAEM C&I credits
  - Doubtful RE credits too small to be significant
  - Substandard RE credits

- Pool each group and determine the historical loss rate for each pool over an appropriate period (one year or other as appropriate). Adjust for changes in conditions over time, including current conditions that probably have affected the losses in the pool. Shorten the time period when economic conditions in the relevant area are changing rapidly, and lengthen it when they are relatively stable. (Alternatively, apply appropriate migration analysis techniques (beyond the scope of this policy) if the bank’s portfolio, size and sophistication justify them). Loans that were individually analyzed above should be grouped in their respective pools here for purposes of calculating historical loss rates, but, to avoid double counting, they should be removed from each pool before the loss rate is applied to the pool. In adjusting the bank’s historical loss experience consider any credit concentrations that might affect losses in various components of the portfolio (such as military base closings) and trends in:
  - Delinquencies
  - Volumes of loans
  - Loan terms, including credit policy changes
  - The national and local economies.
• Homogeneous uncriticized credits grouped as:
  − Consumer, direct
  − Consumer, indirect
  − Credit card
  − Home equity lines
  − Residential mortgages
  − (Others as appropriate)

• All other credits, grouped as:
  − Uncriticized C&I
  − Other binding commitments
  − Standby L/Cs
  − (Others as appropriate)

• Transfer risk on international credits.

• Same as other credit problems.

• Analyze risk country–by–country considering:
  − Portfolio mix
  − Bank’s strategy and debt–management plans
  − Country’s balance of payments position
  − Country’s level of international reserves
  − Country’s social and political environment
  − Country’s standing with multilateral and official creditors
  − Country’s standing with bank creditors
  − Country’s most recent ICERC evaluation.

• Develop a factor for the risk of error in the loss estimates for each of the above categories, recognizing the imprecision in the process of calculating those inherent losses, exposures existing in the bank’s portfolio, and other relevant factors.

• All credits, including those described above.
2 If, after the above review, the committee finds the bank’s allowance for loan and lease losses is adequate, it shall so report to the full Board of Directors. If the committee finds the bank’s allowance is inadequate in some respect, it shall so report to the full board, and shall include in its report the specific inadequacies noted and suggested remedial actions and amounts.

3 Document the analysis of the adequacy of the allowance. Include all work papers and supporting documentation from outside parties, such as appraisers and attorneys. Retain the documentation through the next examination of the bank in which the examiners review the bank’s work in this area.

4 This procedure is complete.

*For FDIC–insured, state–chartered banks that are not members of the Federal Reserve System.
Asset Liability Management – Measuring Interest–Rate Risk

Introduction

Asset Liability Management (ALM) is the science of measuring and managing interest–rate risk within a portfolio of interest-bearing assets and liabilities. This article describes the two most widely used methods of measuring interest rate risk and the framework of the ALM policy that a bank should have. Its purpose is to give the reader a basic knowledge about the methods of measuring interest–rate risk and of a bank’s responsibility to manage its portfolio in that regard.

The two most commonly used methods of measuring interest–rate risk are gap analysis and duration analysis. Gap analysis, often referred to as the accounting perspective” of interest–rate risk focuses on the risk to earnings, primarily in the near term. Duration analysis, often referred to as the “economic perspective” of interest–rate risk focuses on the risk to net worth. Gap analysis generally provides a better measurement of short–term risk and its timing than does duration analysis. Duration analysis provides a more comprehensive measurement of interest–rate risk. Its weakness is that it does not identify the timing of the accounting recognition of that risk. A bank’s interest–rate risk measurement policy should be tailored to its portfolio and should consider both the gap and duration methods of risk measurement.

Gap Analysis

The basic function of gap analysis is to measure the difference between dollar amounts of assets and liabilities in various maturity or repricing categories. A bank’s cumulative gap is derived by adding the individual gaps from each maturity period. The interest–rate risk for each period can be determined by multiplying the cumulative gap to that point by the potential change in interest rates.

By way of explanation assume the following example:

<table>
<thead>
<tr>
<th>Maturity or time to repricing</th>
<th>1 year</th>
<th>2 years</th>
<th>3 years</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$50</td>
<td>$50</td>
<td>$200</td>
<td>$300</td>
</tr>
<tr>
<td>Liabilities</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Gap</td>
<td>–50</td>
<td>–50</td>
<td>+100</td>
<td>0</td>
</tr>
<tr>
<td>Cumulative Gap</td>
<td>–50</td>
<td>–100</td>
<td>–0</td>
<td>0</td>
</tr>
</tbody>
</table>

Assumptions:

- Interest rates increase by 100 basis points (1 percent) for both assets and liabilities at all maturity levels at the beginning of year one.
- All assets and liabilities are repriced at the beginning of the year in which they mature.
- Changes in spreads, rate volatility, prepayments and all other factors affecting income are ignored.

Effect in year one:

Cumulative Gap x Rate Change = Income Effect

–50 x .01 = –$500,000

Effect in year two:

Cumulative Gap x Rate Change = Income Effect

–100 x .01 = –$1,000,000

Effect in year three:

Cumulative Gap x Rate Change = Income Effect

0 x .01 = 0

Total Income Effect = –$1,500,000

The institution in the example had a negative gap. If interest rates go up, institutions with a negative gap will be hurt. Conversely, if rates go down, those institutions will experience a like gain in income. The opposite is true with a positive gap. The fact that a gap is positive...
or negative is neither good nor bad. The size of the gap is what is important. The sign, positive or negative, shows which way a bank is betting rates are going. The size indicates how much is being bet.

There are several criticisms of gap analysis. The first is that the individual gap numbers are arbitrary since they depend on the time frame (length in time) of the maturity buckets selected by the person doing the analysis. In the example above, where one–year maturity buckets were used, any repricing under one year in term is ignored as a risk. In reality, there can be significant risk within a year. A one–year loan that reprices daily funded by a one–year, fixed–interest deposit can have a significant risk. Depending on the size and sophistication of an institution and its portfolio, gap analysis maturity buckets should range from one day to a calendar quarter. A second criticism of gap analysis is that it does not provide a simple, reliable index of interest–rate exposure. On the other hand, interest–rate risk is a complex concept and a single–measure index would camouflage many of its nuances.

**Duration Analysis**

Duration analysis ignores the accounting considerations of income and its timing and looks solely at the potential change to the market value of an instrument or portfolio caused by interest rate changes. Increase or decrease in market value is a leading indicator of the direction of the net interest stream.

**Duration Analysis of a $1000 Security with a 9 percent coupon and 5–year maturity.**

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow</th>
<th>Present Value @ 9%</th>
<th>Present Value (Col. 3 x Col. 1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>90</td>
<td>82.6</td>
<td>82.6</td>
</tr>
<tr>
<td>2</td>
<td>90</td>
<td>75.8</td>
<td>151.5</td>
</tr>
<tr>
<td>3</td>
<td>90</td>
<td>69.5</td>
<td>208.5</td>
</tr>
<tr>
<td>4</td>
<td>90</td>
<td>63.8</td>
<td>255.0</td>
</tr>
<tr>
<td>5</td>
<td>1090</td>
<td>708.3</td>
<td>3,541.5</td>
</tr>
</tbody>
</table>

$1000 $4,239.1

Duration = $4,239.1 = 4.24

1,000

An even more accurate measure of market value sensitivity is modified duration, which is duration divided by one + yield, in this case 4.24 ÷ 1.09 or 3.9.

An instrument’s duration (or modified duration) is a measurement of how much the instrument’s market value will change if market interest rates increase or decrease by one percentage point. For example, the instrument described above has a market value of $1000 when prevailing rates are nine percent. If rates drop to eight percent the instrument’s market value would be $1041 (a 4.1 percent gain) and if rates increase to 10 percent, it would be $961 (a 3.9 percent decrease).

Duration Estimate: 4.24
Modified Duration Estimate: 3.9
Actual Change: 3.9 percent to 4.1 percent
One note of caution, the accuracy of a duration analysis decreases as the change in interest rate increases.

Most users of duration analysis calculate assets and liabilities separately. If the overall duration of assets exceeds that of liabilities, the holder will suffer as rates rise and profit as rates fall. The converse is true if liability duration exceeds asset duration.

One advantage of duration analysis is that because it gives a single index it is possible to balance the interest-rate risk. A second advantage is that the number is not arbitrary, that is, based on the time length of a maturity bucket. The disadvantage of duration analysis is that it does not predict the timing of the effect of an interest-rate change on income.

**Use of Gap and Duration Analysis**

Both gap and duration analysis have their proponents and critics. Both provide accurate measures of the risks in short-term instruments; duration is a more accurate and understandable measure of risk in long-term instruments. A comprehensive ALM program uses both approaches as complementing one another, each providing information that the other does not.

Historically, most banks have relied more heavily on gap analysis than duration analysis in their ALM programs because more emphasis was placed on earnings and most instruments were fairly short term. To the extent that either the Financial Accounting Standards Board or the Securities and Exchange Commission mandate either disclosure or recognition of market values (mark-to-market accounting) the use of duration analysis will increase in importance.

**Compliance Aspects of ALM**

In January 1990, the Comptroller of the Currency issued an Examining Bulletin and Advisory Letter informing the banks that it regulates that it was concerned about interest-rate risk, and that thereafter its examiners would look more closely to see that banks had systems in place to identify and measure interest-rate risk. The letter also warned that where excessive risk was found, additional capital might be required to sustain it. The bulletin did not mandate any particular measurement technique over another. The OCC left it to each bank to decide whether its identification and measurement techniques are adequate for its particular situation.

Examiners look for four components in a bank’s interest-rate risk management program:

- A policy statement
- Risk limits
- Risk–measurement systems
- Management and board reports.

Interest–rate risk, like credit risk, is an appropriate risk for a bank to take. Measured and controlled properly, it can enhance earnings. Like credit risk, there must be a policy regarding how much risk the bank is prepared to take, a system in place to measure the risk taken and a provision to report the results to the policy makers.

The policy statement and risk limits must be set by the board of directors. The board must establish the bank’s philosophy and policy regarding interest–rate risk. The board should also set specific outer limits for the extent of interest–rate risk and its timing beyond which the bank may not go.
The establishment of appropriate risk measurement systems is primarily the task of management; however, the board has the responsibility to determine that it is adequate. As stated above, the regulators have not specified the risk–measurement techniques or the level of sophistication a bank must achieve in its risk–measurement systems. They have described the types of risks and variables that should be taken into consideration and then left the selection process to each individual bank based on its particular situation.

The reporting back to the board of the results of the risk–measurement process and the comparison of the actual risk to the bank’s risk policy is the most important step in the procedure from the regulators viewpoint. Every month’s board package should contain an ALM report.

A sample policy can be found in our Policy Manual.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.
IRS Information Reporting

IRS Form 1099 – Filing Requirements

The Internal Revenue Code requires that payors of various types of payments and participants in real estate transactions file with the IRS information returns providing information about those payments and transactions. The information must be filed on one of the eleven different form 1099s. Each form has very specific requirements for what must be reported and how it must be reported. This section describes the requirements of the Form 1099s as they relate to transactions or payments in which a bank might be involved.

Form 1099–A
Acquisition or Abandonment of Secured Property

A Form 1099–A must be filed anytime a bank takes title by foreclosure, takes title in lieu of foreclosure, or is aware that the borrower has abandoned real property or intangible property or personal property held for investment or used in a trade or business. (Intangible property includes such things as stocks, bonds, promissory notes, and similar obligations.) The requirement to file a Form 1099–A applies regardless of the nature of the borrower. For example, a Form 1099 is not generally required for payments made to corporations. The Form 1099–A filing requirement extends to all borrowers, including corporations.

An acquisition occurs whenever a bank takes title or other ownership interest in property, which it held as security for a loan, in full or partial satisfaction of the loan. Anytime a bank takes title through foreclosure or takes a deed or title in lieu of foreclosure, an acquisition has occurred. An abandonment occurs when a borrower intends to and actually does discard or permanently cease use of a property or the property is taken through a foreclosure proceeding by another party. The latter type abandonment generally occurs in two situations. In the first, a bank files for foreclosure and a third party is the successful bidder at the foreclosure sale. In the second, a bank holds a junior mortgage or lien position and the holder of a senior mortgage forecloses and takes title. In the event of an actual abandonment, or in either of the two other situations described, a 1099–A is required to be filed by a secured lender. It is now possible to combine forms 1099–A and 1099–C when a particular loan requires filing of both. See the material on 1099–C, below.

Information Required

Box 1. Date of acquisition or abandonment. If an acquisition, enter the date the property was acquired, unless the borrower had a right of redemption. In that case, enter the date the right of redemption expired. If the property was abandoned, enter the date you knew or had reason to know of the abandonment unless you did or plan to file foreclosure within three months of the abandonment date. In that event, the date is when the foreclosure is complete.

Box 2. Balance of principal outstanding. Enter the balance of the principal portion of the loan outstanding on the date shown in Box 1. Include only the principal portion of the original debt. Do not include accrued interest or any costs of foreclosure. If the debt had been previously recast and accrued interest was capitalized, do not include the capitalized interest; report the unpaid principal balance of the original debt.

Box 3. This box has been deleted for tax years 1995 and later. There is no replacement. It is simply cross–hatched on the form.
Box 4. Fair market value of property. For a foreclosure, execution, or similar sale, enter the fair market value (“FMV”) of the property. Generally, the gross foreclosure bid price is considered to be the FMV. If an abandonment or voluntary conveyance to the lender in lieu of foreclosure occurred and you checked “Yes” in Box 5, enter the appraised value of the property, otherwise, make no entry in this box.

Box 5. Was borrower personally liable for repayment of the debt? Check “no” if the loan documents provide that the bank will look solely to the collateral for repayment of the debt and/or the bank will not seek a deficiency judgment against the borrower and/or the loan is without recourse to the borrower and/or the borrower is not personally liable on the loan. If none of the above, check “yes.”

Box 6. Description of property. If the property is real estate, enter the address. If there is no address or the address does not sufficiently identify it, enter another way to identify it such as lot, block, and section number. If it is personal property, give a general description such as “1992 Buick Regal” or “office equipment.”

In the unnumbered boxes enter the bank’s name, address, and federal identification number, and the borrower’s name, address, and taxpayer identification number.

If there are multiple borrowers on a loan, a 1099–A must be filed for each borrower. If several lenders own an interest in a single loan, only the lead lender or the lender servicing the loan is required to file.

Most lenders recognize the requirement for filing a 1099–A when real estate is foreclosed on, but many do not realize that a 1099–A is also required when the collateral is intangible property or personal property held for investment or used in a trade or business. If personal property is used by a borrower for personal use and is also held for investment or used in a trade or business, a 1099–A is required.

Form 1099–B
Proceeds from Broker and Barter Exchange Transactions

Not applicable to the business of banking.

Form 1099–C
Cancellation of Debt

Form 1099–C is used for reporting discharges of debts in certain situations. A creditor must file a Form 1099–C for any discharged indebtedness of more than $600 in a single year, provided that an “identifiable event” has occurred. Multiple debts of smaller than $600 are not aggregated in order to exceed the threshold. An identifiable event is one of the following:

- The bankruptcy discharge of debt for business or investment purposes. Reporting is not required for the bankruptcy discharge of consumer debt or a debt where the creditor is unaware or uncertain of the debt’s purpose. Note also the identifiable event is the discharge in bankruptcy, not the filing of a bankruptcy petition.
- If the creditor sues for recovery of a debt, the debtor raises the statute of limitations as a defense, the court renders judgment in favor of the debtor based on that defense, and the appeal time has expired. Otherwise, it is not necessary to report a loan when the statute of limitations to collect the debt expires.
- If a debt is forgiven or made uncollectible because of a law other than bankruptcy or the statute of limitations. For example, in some states a foreclosure judgment may preclude a creditor from seeking a deficiency under an “election of remedies” doctrine. In addition, a claim may be discharged in a probate proceeding. The rule does not
purport to provide an exhaustive list of such laws. The key is whether any such law renders the debt unenforceable. If the law is a statute of limitations or the United States Bankruptcy Code, the reporting requirement is limited as discussed in the previous paragraphs. Otherwise, the rule does not provide any exceptions for discharges under the operation of any other laws.

- An agreement between creditor and debtor to discharge all or part of the debt. Such agreements include deeds in lieu of foreclosure, settlement stipulations filed in court proceedings, and formal workout agreements.

- Cessation of collection activity if the creditor decides to discontinue any further collection activity and to discharge the indebtedness. If the bank has not received a payment on the debt or engaged in any bona fide collection activity during a 36-month period, a “rebuttable presumption” arises that a discharge has occurred, and a 1099–C must be filed. This period is known as the “nonpayment testing period.” In order to rebut the presumption and avoid filing a 1099–C, the bank must demonstrate that it has engaged in “significant, bona fide collection activity” at any time during the final 12 months of the nonpayment testing period. Nominal activities, such as automated mailings, are not enough. Sending the loan to a collection agency or actions initiated through counsel would qualify. Secondly, if on January 31 of the year following the expiration of the 36-month period, “facts and circumstances” exist that indicate that the debt has not been discharged, a 1099–C need not be filed. Such “facts and circumstances,” according to the IRS, may be the fact that the bank has a lien against the debtor (though only for the value of the lien), or that the bank has sold the loan or packaged it for sale.

However, merely charging off the loan on the bank’s books for financial or regulatory reporting purposes is not an identifiable event if the creditor intends to continue collection activity, or even reserve the option to do so later. Discharge and charge–off are not the same. A discharge legally extinguishes the obligation. A charge–off is simply an accounting transfer of the loan from good loan status to bad debt status. A charged–off loan remains enforceable as long as it is not discharged. Moreover, if one of the other identifiable events has not occurred, it is difficult to think of any circumstances where a bank would discharge a charged–off debt. Although the debt may be difficult to collect at present, the debtor’s circumstances might change, making the debt collectable later.

If there is a discharge of debt in a situation which also must be reported on Form 1099–A, (Acquisition or Abandonment of Secured Property), the bank must file both Form 1099–A and Form 1099–C. However, if a 1099–A is required in addition to the 1099–C, there is a way to fulfill the requirement of filing a 1099–A on the 1099–C. See the discussion in boxes 5 and 7 below.

**Information Required**

**Box 1. Date canceled.** Enter the date of the identifiable event, such as discharge in bankruptcy or the running of the statute of limitations to sue on the debt. If the event is an agreement with the bank to discharge the debt, the appropriate date is that on which the last event (e.g., executing a deed to a piece of realty) occurred that was necessary to make the discharge effective.

**Box 2. Amount of debt canceled.** For lending transactions, only discharged
Accounting
IRS Information Reporting

principal is required to be reported. Other amounts owed by the debtor to the bank, whether principal, interest, penalties, administrative costs, or fines, can be reported at the option of the bank. In case of a partial discharge, report only the amount discharged, not the total amount of the debt.

Box 3. Interest included in box 2. Report only the amount of interest discharged.

Box 4. Penalties, fines, admin. costs included in box 2. Make no entries in this shaded box. It is no longer used.

Box 5. Debt description. Enter a brief description of the type of debt that was discharged, such as “mortgage,” “credit card,” or “student loan.” If you are filing a combined Form 1099–C and 1099–A, also enter a description of the property.

Box 6. Check for bankruptcy. Self-explanatory.

Box 7. Fair market value of property. This box was added to the form for tax years 1995 and later to enable a lender to file only one form when both a 1099–A and a 1099–C otherwise would be required. If boxes 5 and 7 of 1099–C are correctly completed, no 1099–A need be filed, even though secured property was abandoned by the borrower or foreclosed on or otherwise acquired by the bank. Enter in box 7 the fair market value of property acquired through foreclosure or similar sale, and the appraised value of property abandoned or voluntarily conveyed to the bank.

In the unnumbered boxes, enter the bank’s name and street address, the bank’s tax ID number, the debtor’s tax ID number, and the debtor’s name and street address. If the bank wishes, it may enter the debtor’s account number in the box so labeled, but that is optional.

Additional Issues

Multiple debtors. In some cases, each of several co–debtors must be the subject of a 1099–C if he, she, or it had over $600 discharged. This means if the debtors were jointly and severally liable for the debt, report the full amount discharged on each 1099–C. For example, assume that John Smith and Mary Jones were jointly and severally liable to FURST Bank on a $10,000 debt. Both are discharged from that debt. Each should be sent a Form 1099–C showing that a $10,000 debt was discharged.

The final rule limits the multiple debtor reporting requirement to discharged debts of $10,000 or more incurred on or after January 1, 1995. Smaller debts, or those incurred before January 1, 1995, need only be reported under the primary (i.e., the first–named) debtor. Further, only one 1099–C need be filed for husband and wife co–debtors, provided the creditor knows the husband and wife were living together when they incurred the indebtedness and these circumstances have not since changed.

Obtaining the debtor’s TIN. If the bank has not already obtained the taxpayer identification number of the debtor before the discharge occurs, the bank must notify the debtor that the IRS requires it, and that failure to furnish it will subject the debtor to a $50 penalty. No particular form of request or notice is required, but the IRS says Form W–9 will suffice.

Recordkeeping. A bank must retain a copy of each 1099–C or be able to reconstruct the data on it for at least four years after it is filed.

Filing. Form 1099–C must be filed with the IRS by February 28 of the year following the year the discharge occurred. The same magnetic media filing requirements apply to 1099–C as to other 1099–series forms. The bank must furnish the debtor a copy of the 1099–C (or a substitute that meets IRS standards) by January 31 of the year following the year the discharge occurred.

Interest. Although discharged principal must be reported subject to the limits discussed above, the reporting of discharged interest is completely optional.
Penalties, Fees, Administrative Costs, Fines. If discharged, these items need only be reported in connection with a nonlending transaction. For example, fees associated with deposit accounts, such as overdraft or returned check fees, would be reportable.

Guarantors. A guarantor is not treated as a debtor under the rule, so no reporting is required for any guarantor.

The prior rule’s penalty relief provisions will continue through December 31, 1996. This means that through that date, the IRS says it will not penalize a bank for failing to report:

- A debt discharged in bankruptcy
- A debt discharged by the running of the statute of limitations
- In a lending transaction, any amount other than principal
- A debt discharged for anyone other than the primary (or first–named) debtor, if the debt was incurred before January 1, 1995.

Accordingly, for reporting discharges of indebtedness for calendar year 1996, either the old rules or the new rules may be followed. For 1997 and beyond, the new rules must be followed.

Form 1099–DIV

Dividends and Distributions

Form 1099–DIV is for the reporting of dividends or other distributions that a corporation pays to its stockholders. The responsibility for reporting is on the entity actually making the payment, not necessarily the corporation declaring the dividend or distribution. A bank will generally fall within the 1099–DIV reporting requirement in one of three ways:

- Paying dividends to its own shareholders
- Acting as a dividend disbursing agent for a corporation
- Acting as the nominee for the receipt of dividends for the actual owner.

For purposes of 1099–DIV reporting, a dividend is a distribution in money or property made by a corporation to its stockholders out of either accumulated prior–year earnings or current–year earnings. It also includes distributions of $600 or more in liquidation (or partial liquidation). Payments made by a savings and loan association or a credit union to an account holder on the basis of the account are frequently called dividends, but they are not dividends for 1099–DIV purposes. These payments should be reported on a 1099–INT. A bank responsible for 1099-DIV reporting must report all payments to an entity if the aggregate of all payments made to that entity during the year was $10 or more. It is not required to report payments to a corporation, a tax-exempt organization or charitable trust, a real estate investment trust, or a registered securities dealer.

Information Required

Box 1a. Ordinary dividends. Enter ordinary dividends, including those from money market funds and net short-term capital gains from mutual funds and other distributions on stock. Include reinvested dividends and section 404(k) dividends. Include the recipient’s share of investment expenses that you report in box 5.

Box 1b. Qualified dividends. Enter the portion of the dividends in box 1a that qualify for the 5% and 15% capital gains rates.

Box 2a. Total capital gain distr. Enter total capital gains distributions (long-term). Include all amounts shown in boxes 2b, 2c, 2d, 2e, and 2f.

Box 2b. Post-May 5 capital gain distr. Enter the portion of the capital gain distribution that is taxed at the 5% and 15% capital gains rate.

Box 2c. Qualified 5-year gain. Enter any amount included in box 2a that is a qualified 5-year gain.
Box 2d. Unrecap. Sec. 1250 gain. Enter any amount included in box 2a that is unrecaptured section 1250 gain from certain depreciable real property.

Box 2e. Section 1202 gain. Enter any amount in box 2a that is a section 1202 gain from certain qualified small business stock.

Box 2f. 28% rate gain. Enter the amount included in box 2a that is a 28% rate gain from sales or exchanges of collectibles.

Box 3. Nontaxable distributions. Enter nontaxable distributions, if determinable.

Box 4. Federal income tax withheld. Enter backup withholding. For example, persons who have not furnished their TIN to you in the manner required are subject to withholding at a 28% rate on certain dividend payments reported on this form.

Box 5. Investment expenses. Enter the stockholder’s pro rata share of certain amounts deductible by a non-publicly offered regulated investment company in computing its taxable income. This amount is included in the stockholder’s gross income and must also be included in box 1a.

Box 6. Foreign tax paid. Enter any foreign tax withheld and paid on dividends and other distributions on stock. A regulated investment company must report only the amount it elects to pass through to the shareholder. Report this amount in U.S. dollars.

Box 7. Foreign country or U.S. possession. Enter the name of the foreign country or U.S. possession to which the withheld tax applies.

Liquidation Distributions. Boxes 8 & 9. These boxes apply only to corporations in partial or complete liquidation.

Box 8. Cash liquidation distr. Enter cash distributed as part of a liquidation. Do not include this amount in box 1a or 1b.

Box 9. Noncash liquidation distr. Enter noncash distributions made as part of a liquidation. Show the fair market value as of the date of distribution. Do not include this amount in box 1a or 1b. In the unnumbered boxes, enter the bank’s name, address, and federal identification number, and the recipient’s name, address, and taxpayer identification number. Account number is optional.

Form 1099-G
Certain Government Payments

This form is used only for payments made by units of federal, state, or local governments.

Form 1099-INT
Interest Income

Most financial institutions will file more 1099-INT information returns than any other type. In general, a bank must file a return for every person to whom it has paid $10 or more in interest during the preceding year.

For a bank, the most common type of reportable interest is that which it pays on interest-bearing deposits such as savings accounts or time deposits. Other types of reportable interest are interest paid on corporate obligations that are registered or of a type offered to the public, and amounts paid on banker’s acceptances. Also included are interest transactions where the bank is not the obligator on the debt but pays the interest for a third party, such as window transactions (e.g. payments on U.S. savings bonds, treasury obligations) and safekeeping transactions where a bank holds bearer securities and accepts payments in its name as agent for the owner.

A bank is required to file a 1099-INT for every person to whom it paid $10 or more of reportable interest during the year or from whom it withheld any federal income tax or withheld and paid a foreign tax. In either of those latter two cases, the $10 deminimis rule does not apply, and any interest payment must be reported. Interest is deemed paid when it is actually paid to the recipient or credited to the recipient’s account. Interest that is accrued but unpaid or not credited is not reported on Form 1099-INT. However, the accrued interest for the
year is reported on Form 1099-OID. (See discussion of Form 1099-OID below.) Therefore, whether interest is actually paid or merely accrues during a tax year, it is still reportable and the customer will owe tax on the annual interest amount.

The $10 level is determined by customer, not account. Thus, if a customer had two accounts and on one was paid $6 in interest and on the other $8, a 1099-INT is required showing $14 of interest paid.

It is permissible to file separate 1099-INTs for each account of a customer who has been paid $10 or more, but the better and more cost-efficient way is to combine all interest payments on one return.

Some recipients are exempt from 1099-INT reporting. Principal among these are corporations and individual retirement arrangements (IRAs). Do not report interest paid to corporations, but be cautious about business entities that are not formally incorporated, but have the word company or a similar term in their name. For those entities, reporting is required. Reporting is also required for partnerships, associations, and sole proprietors. 1099-INT reporting is not required for payments to a tax-exempt organization, a U.S. agency or possession, a state or the District of Columbia, or a registered securities or commodities broker.

Aliens. Payments to a resident alien are reported in the identical manner as payments to U.S. citizens. Payments to a nonresident alien do not have to be reported on 1099-INT provided the bank has a valid, current Form W-8 on file for the person. The multipurpose version of Form W-8 is being replaced with a series of forms (W-8BEN, W-8ECI, W-8EXP, W-8IMY, or an acceptable substitute). All old W-8 forms expire on or before 12/31/2000. Properly completed replacement forms (W-8BEN for bank account interest) must be on file for all nonresident aliens by then or the bank will be required to back-up withhold and report on interest payments made to those individuals.

Early withdrawal penalties, forfeited interest and service charges. When a time deposit is prematurely withdrawn, interest may be forfeited, a penalty may be imposed, or both. In reporting on 1099-INT, do not reduce the interest earned by the amount of interest forfeited or by the penalty charged. Report all of the interest earned (i.e., all interest accrued to the date of withdrawal). Report the forfeiture and/or penalty separately. Likewise, do not reduce the amount of interest reported by any service fees or charges to the account.

Bonuses or Incentives. If you offer a customer a bonus, incentive, or premium to open, add to, or maintain an interest-bearing deposit account, that bonus, incentive, or premium generally is treated as interest. Beginning in calendar year 2000, however, the IRS has provided for a “diminimis” amount that “for administrative convenience, the Service will not require a financial institution . . . to treat as interest for purposes of information reporting.” For 1099-INT reporting purposes, a “diminimis premium” is a non-cash inducement, provided by a financial institution to a depositor to open or add to an account that does not have a value in excess of $10 for a deposit of less than $5,000 or $20 for a deposit of $5,000 or more. The cost to the financial institution of the premium is used in determining whether the dollar limitations are met. Note that this exclusion applies only to non-cash premiums, bonuses, or incentives given. Any cash premiums, bonuses, or incentives given, regardless of amount, must be aggregated together with other interest paid to the customer, and reported if it exceeds the $10 reporting threshold. Non-cash premiums, bonuses, or incentives with values in excess of the diminimis amount (based upon cost to the financial institution) must also be added together with interest paid to the customer and reported. If you give a bonus, premium, or incentive to one person who causes another person to open or add to an account, you should report that bonus, premium, or incentive on a form 1099-MISC, which has a $600 threshold.
Paying Agent or Middleman. When a bank acts as a paying agent for a third party’s interest payments (that is, the bank issues the interest checks or payments) or when a bank acts as middleman (that is, it collects interest from a third party and pays it to a customer, such as in the redemption of a U.S. savings bond) the bank is responsible to report the interest paid. The test in either case is whether the bank issued or made the payment. This is in contrast to where one party draws a check on a bank in payment of interest to another party. Even though the bank may have knowledge that the check is for interest, it has no responsibility to monitor or report the transaction.

Timing of Filings
1099-INT forms must be mailed to recipients by January 31 each year for the preceding calendar year ending December 31. For reportable window transactions such as payments on U.S. savings bonds and treasury obligations, financial institutions are allowed to deliver a 1099-INT to the recipient either at the time of the transaction, or at the end of the calendar year for transactions processed during the year. This is entirely the bank’s option. If 1099-INT forms are provided at the time of the transaction, the information should not be duplicated in year end filings.

Information Required
Box 1. Interest income not included in box 3. Enter all interest paid to the person or credited to the person’s account other than interest on U.S. Savings Bonds and Treasury obligations.

Box 2. Early withdrawal penalty. Enter the amount of early withdrawal penalties paid by the person or charged to the person’s account. Do not enter any fees or charges not associated with early withdrawal.

Box 3. Interest on U.S. Savings Bonds and Treas. obligations. Enter the amount of interest paid to the person on U.S. Savings Bonds and Treasury obligations.

Box 4. Federal income tax withheld. Enter the amount of federal income tax withheld (back-up withholding).

Box 5. Investment Expenses. This box is used to report for single-class REMICs only.

Box 6. Foreign tax paid. Enter the amount withheld and paid to any foreign country or U.S. possession.

Box 7. Foreign country or U.S. possession. Enter the name of the country or U.S. possession to which the amount in Box 5 was paid.

In the unnumbered boxes enter the bank’s name, address, and federal identification number, and the recipient’s name, address, and the recipient’s taxpayer identification number.

2nd. TIN NOT. This box is optional. You may enter an “x” if you have received two B-Notices within the last three years. If you mark the box, the IRS will not send any further B-Notices regarding that person or account.

Payer’s RTN (optional). Enter your routing and transit number if you wish to participate in the program for direct deposit of refunds for electronic filers.

Form 1042-S
Reporting Interest Income on Canadian Residents

The rules on reporting interest to individual aliens are divided into three categories: resident aliens, nonresident aliens who are Canadian residents, and all other nonresident aliens. If an alien is a resident of the United States, he or she is treated the same as U.S. citizen, and interest is reported to the IRS on a 1099-INT. If the alien is a nonresident of the United States (Canadian citizen and otherwise), an IRS form W-8 or its replacement form W-8BEN must be filed with the bank by the nonresident alien certifying that he or she is neither a U.S. citizen nor resident and giving his or her permanent residence. All old W-8 forms expire on or
before 12/31/2000. W-8BEN forms are valid through 12/31 of the third calendar year after the year in which the form is signed unless it contains a valid ITIN number, in which case the form is valid, indefinitely, or until the status of the reporting individual changes. To avoid filing a 1099-INT (and to avoid backup withholding requirements) nonresident aliens must either provide a valid ITIN number on their W-8BEN or must re-file a new W-8BEN every three years.

The United States has a tax treaty with Canada, and Canada wants information on its residents who have bank accounts in this country.

Accordingly, since January 1, 1997, banks have been required to examine each W-8 or W-8BEN form received to check if its nonresident alien customer lists his or her permanent address as being in Canada. If it is, the bank is required to report interest paid on the customer’s deposits to the IRS on form 1042-S.

The rule does not require these people to be citizens of Canada, only residents. They can be citizens of Canada, France, Nigeria, or Outer Mongolia. If they are not citizens or residents of the United States and are residents of Canada, a 1042-S must be filed. Backup withholding does not apply provided a proper, current W-8 or its replacement, W-8-BEN is on file, but the interest paid must be reported.

**Information Required**

**Box 1.** Enter an “01” as the income code for a normal bank deposit, such as a certificate of deposit (CD), a savings account, or a money market account.

**Box 2.** Enter the gross amount of interest paid.

**Box 3, 4, 5, and 6.** These are left blank.

**Box 7.** Enter any U.S. tax withheld. Usually there will not be any.

**Box 8.** Amount repaid to recipient. Complete only if a recipient was repaid an amount over withheld and you are going to reimburse yourself by reducing any deposit for the payment period by the amount of tax actually repaid.

**Box 11.** This line is optional. The customer’s account number may be entered here.

**Box 12.** Enter “01” for the recipient code for individuals. Only individuals are caught by the requirement, so the other 20 codes are not applicable to the 1042-S form in this context.

**Box 14.** Enter the customer’s U.S. taxpayer ID number, if any. If the customer does not have a U.S. Tax Identification Number (TIN), none need be obtained or entered.

**Box 16.** This column is critical. Enter the two-letter country code for the alien’s country of residence, in this case “CA” for Canada. There are three lines in columns a through h to repeat this process if the customer had multiple kinds of reportable income, but most banks need simply show all deposit interest on line 1.

**Boxes 17 through 20.** Nonqualified intermediary’s (NQI) flow-through entity’s name, country code, address and TIN. Complete amounts paid to recipient whose withholding certificates or other documentation has been submitted with a form W-81MY provided by an NQI or flow-through entity.

The remaining lines are for the name, address, and similar information on the recipient and the bank.

**Form 1099-MISC**

**Miscellaneous Income**

Form 1099-MISC is a catchall for payments that are not reported on any of the other 1099 series of forms. Generally, a payor must report all payments to a person that during a year aggregate $600 or more for rent, fees,
payments for services (to nonemployees), premiums, annuities or other fixed or determinable gains, profits, and income. Generally, reporting is not required for payments to corporations. However, payments to lawyers and law firms are required to be reported regardless of whether the lawyer or firm is classified as a sole proprietorship, partnership, corporation, or anything else. Reporting is not required for payments made to purchase merchandise, goods, telephone service, or freight service. Rent for real property is not reportable if it is payable to a rental agent (but it is reportable if paid directly to the owner).

The payments that must be reported on 1099-MISC that a bank most frequently makes are to accountants, advertising agencies, appraisers, attorneys, directors, equipment rental companies, landlord maintenance service companies, and property management companies. Premiums, prizes, or promotional gifts given to a customer that are not reportable on 1099-INT are reportable on 1099-MISC. These items include premiums given to borrowers taking out loans or lines of credit, and premiums given to one person for inducing another person to open a deposit account.

Confusion has arisen regarding the reporting obligation of a bank disbursing the proceeds of its own construction loans. If a bank disburses the proceeds to its borrower, or by joint checks payable to the borrower and the subcontractors, there is no reporting requirement. If, however, a bank issues single-payee checks to subcontractors, there is a reporting requirement. To avoid the reporting requirements and for safety and soundness reasons, we recommend disbursing construction loan proceeds with joint checks payable to the borrower and the subcontractor.

The 1099-MISC reporting requirement is on the person who writes the check to the service provider, regardless of who the service was provided to. Accordingly, if a bank writes a check to a third party who performed services for a customer of the bank’s trust department, the reporting requirement for that payment is on the bank. Likewise, if a bank pays an appraiser, even though the bank is reimbursed by its customer, the reporting requirement is on the bank. Regardless of the circumstances, the person who writes the check to the person providing the service has the requirement to report.

**Information Required**

**Box 1. Rents.** Enter all amounts paid as rent both for real property, such as office rental, and for personal property, such as machine or equipment rental.

**Box 2. Royalties.** Enter all royalty payments. (For royalty payments only, the *de minimis* level is $10 rather than $600 as it is for other 1099-MISC payments).

**Box 3. Other income.** Enter the fair value of all prizes and awards paid to non-employees. (Employee prizes and awards are reported on form W-2). Also report in this box any payment that is required to be reported on 1099-MISC for which there is not another appropriate box.

**Box 4. Federal income tax withheld.** Enter the amount of back-up withholding that you have withheld from any payment shown on the form.

**Box 5. Fishing boats.** Enter the fair value of the share of a catch paid in kind to a crew member.

**Box 6. Medical and health care payments.** Enter the amount paid for medical and health care to suppliers and providers. Include the amount paid by any insurer under a health or accident insurance program.

**Note:** The exemption from reporting payments to a corporation does not apply to medical and health care payments

**Box 7. Non-employee Compensation.** This is the box where most reportable payments by banks will be reported. Enter the amount paid to a nonemployee as compensation for services rendered. This includes payments to
accountants, attorneys, directors, etc. If a payment meets the following four tests, it is generally reportable:

- Payment was made to a nonemployee
- The payment was compensation for services rendered
- The recipient was not a corporation
- The total payments to the person during the year totaled $600 or more.

Box 8. Substitute payments in lieu of dividends or interest. Applies only to securities brokers.

Boxes 9 and 10. Not applicable to banks.

Boxes 11 and 12. Leave blank.


Box 14. Gross proceeds paid to an Attorney.

Attorney’s fees of $600 or more are reportable in box 7 of the form. However, if you make payment in the course of your trade or business to an attorney and the attorney’s fee cannot be determined, the total amount paid to the attorney (gross proceeds) must be reported in box 14 with Code “A.” For example, a bank pays an attorney $100,000 to settle a claim. The attorney’s fee cannot be determined by the bank. Therefore, the bank must report $100,000 in box 14 of Form 1099-MISC with Code “A.” If the bank knows that the attorney’s fee is, for example, $34,000, the bank must report $34,000 in box 7 and nothing in box 14. Also not that the exemption from reporting payments made to corporations no longer applies to payments for legal services. Therefore, you must report attorney’s fees (in box 7) or gross proceeds (in box 14) paid to corporations that provide legal services.

Box 15. Leave blank.

Boxes 16-18. State information. These boxes do not need to be filled in for IRS purposes. If state income taxes were withheld, the information can be filled in and the form used for state reporting purposes.

Form 1099-OID
Original Issue Discount

In general, Original Issue Discount (OID) means the difference between the issue price of a debt instrument and its stated redemption price at maturity. For banks, OID reporting is usually necessary only if the institution offers certificates of deposit or other time deposits with maturities greater than one year and the payment of interest is deferred for more than one year. It is also required if certificates of deposit are issued at a discount from their face or redemption value.

For time deposits issued at par, but with the deferred payment of interest, OID is calculated on a daily economic accrual basis.

Reporting is not required for payments made to corporations, tax-exempt organizations, IRAs, government bodies, or registered securities dealers. Reporting also is only required if the payee’s OID is at least $10. Separate 1099-OIDs should be filed for each instrument a person holds unless the instruments are identical as to time of issue and maturity, in which event the information can be combined on one form.

Information Required

Box 1. Original issue discount for 2XXX. Report the OID on the instrument(s) that accrued during the year for the period it was owned by the recipient (holder).

Box 2. Other periodic interest. Enter any interest other than OID paid on the instrument during the year. If none was paid, leave the box blank. Do not report interest reported here on 1099-INT.

Box 3. Early withdrawal penalty. Enter the amount of interest and/or principal forfeited because of an early withdrawal. Do not reduce the amount shown in boxes 1 or 2 by the penalty. Show the gross amount in all three boxes.
Box 4. Federal income tax withheld. Enter any amount of backup withholding.

Box 5. Description. Applicable only for listed securities.

Box 6. Original issue discount on U.S. Treasury obligations. Enter the OID on a U.S. Treasury obligation for the part of the year it was owned by the record holder. Do not include this amount in box 1. You may enter any stated interest on the Treasury obligation in box 2.

Box 7. Investment expenses. To be used for single-class REMICs only.

**Form 1099-PATR**

Patronage Dividends. Not applicable to banks.

**Form 1099-R**

Distributions from IRAs, etc. Refer to “Individual Retirement Accounts.”

**Form 1099-S**

Proceeds from the Sale or Exchange of Reportable Real Estate. “The reporting person” is required to report any “sale” of “reportable real estate” if the gross proceeds equal $600 or more and no “exception” to reporting applies.

The reporting person. Generally the person responsible for closing the transaction is responsible for reporting it. If a Uniform Settlement Statement is used, the person listed as settlement agent is responsible. If another form settlement statement is used or if no one is listed as settlement agent, then the person who prepared the closing statement is responsible. If no closing statement is used, then the responsible person, if they exist, in order is the transferee’s attorney, the transferor’s attorney, and finally, the mortgage lender.

Sale. A sale is a transfer of real estate in exchange for money, indebtedness, services, or other property. A gift is not a sale and is not reportable. A foreclosure or deed in lieu of foreclosure is technically a sale, but it is reported on 1099-A rather than 1099-S.

Reportable real estate. Virtually any type of real estate constitutes reportable real estate. The property involved can be vacant land, improved property, structures, or even air rights. Both condominiums and stock in a cooperative housing project qualify.

Ownership interest. The interest sold in the real estate need not be full ownership. Life estates, reversions, remainders, and perpetual easements also must be reported. Leases and timeshares must also be reported if they have remaining terms of at least 30 years. Any renewal option must be included in determining whether the remaining term is at least 30 years.

Exceptions. A transaction in which a corporation or a unit of government is a transferor is exempt from reporting. Also transfers by “exempt volume transferors” are exempt. An exempt volume transferor is someone, such as a home builder, who has sold at least 25 separate properties to at least 25 different transferees in each of the last two years or has or expects to have that many sales in the current year.

Acceptable Written Assurance. A 1997 amendment to the tax law allows a bank to avoid filing a 1099-S if it receives “acceptable written assurance” from the seller of a principal residence of $250,000 or less ($500,000 or less if the written assurance includes an assurance that the seller is married). To avoid filing, the written assurance must include the following:

- The seller owned the residence, and, for at least two of the previous five years, used the residence as his or her principal residence.
- The seller has not sold or exchanged another principal residence in the prior two years.
- No portion of the residence has been used for business or rental purposes by the seller (or the seller’s spouse) after May 6, 1997, and
• The sale of exchange is of the entire residence and is for $250,000 or less (or $500,000 if the seller is married).

The IRS has issued a sample acceptable written assurance (reproduced at the end of this chapter), to be used for this purpose. Use of the IRS form is not required; a bank may use its own form as long as all necessary elements are included. The use of this written assurance is strictly optional. A bank may decide it the better practice to file a 1099-S whenever it serves as settlement agent in a transaction for reportable real estate.

Sales of crops, timber, and minerals or mineral rights are not reportable. Likewise a sale of a burial plot or a mobile home, provided it is not affixed to a foundation, is not reportable.

Information Required

Box 1. Date of closing. Enter the date of closing of the transaction in MMDDYY format. If a settlement statement was used, enter the date on the settlement statement. If there was no settlement statement, enter the date the consideration was paid to the transferor.

Box 2. Gross proceeds. Gross proceeds includes the total economic benefit received by the transferor, including cash, promissory notes, indebtedness assumed, services, or other property. Do not include the value of anything received for personal property and do not reduce the gross proceeds by any expenses paid by the transferor. If all or part of the payment is contingent on future events, assume the maximum amount of gross proceeds possible that can be determined with any certainty.

Box 3. Address or legal description. Enter the address of the property. If the address does not sufficiently identify the property, enter the legal description as well.

Box 4. Enter a check mark in the box if the transferor received or will receive property or services as part of the consideration for the sale.

Box 5. Buyer’s part of real estate tax. Show the real estate tax on a residence charged to the buyer at settlement.

IRS Form 1098 - Mortgage Interest Reporting

Introduction

A Form 1098 information return must be filed with the Internal Revenue Service by any person engaged in a trade or business who, in the course of such trade or business, receives from any individual $600 or more of interest on a qualified mortgage during a calendar year. In addition, in some circumstances, the return must also report loan points paid by the borrower. This section defines the reporting requirements of IRS Form 1098.

Receives. Generally, the entity that initially receives the interest from a borrower is responsible for reporting it, regardless of whether the interest is income to the receiver. Thus, a bank that is servicing mortgages for others is responsible for filing Form 1098 for those mortgages that it services. The only exception is where the person initially receiving the interest does not have the information necessary to file a Form 1098.

Any Individual. A bank must file a Form 1098 relative to interest received on a mortgage only if the payor of record is an individual, including an individual acting as sole proprietor of a business. Reporting is not required where the payor of record is a corporation, partnership, trust, or other nonindividual type entity.

Where there are joint borrowers on a mortgage loan, a bank may select which of them will be designated as the “payor of record.” Reporting, if required, is based on the borrower selected. For example, if a corporation and an individual are joint borrowers and the individual is designated as the payor of record, reporting is required. Alternatively, if the corporation is selected, reporting is not required. The best policy is to select a borrower other than an individual as the payor of record whenever
possible, and thereby avoid the reporting requirement.

$600 or More of Interest. Six hundred dollars ($600) is the minimum level at or above which the amount of interest received must be reported. Interest received of less than $600 may be reported, but it is not necessary to do so. A Form 1098 must be filed for each mortgage on which $600 or more of interest was received from an individual. The reporting requirement is at the mortgage or account level, not the customer level. For example, if an individual has two mortgage loans with a bank, and during the year pays $500 of interest on each, no reporting is required. Though the individual paid over $600, $600 was not received on any one mortgage. Both late fees and prepayment penalties are interest for 1098 reporting purposes.

In computing the amount of interest paid on a mortgage to determine if the $600 level was reached, add any reportable loan points to the interest paid.

On a Mortgage. A loan is a mortgage for 1098 reporting purposes if it is secured in whole or in part by real property. It does not matter whether the loan proceeds were used in relation to the collateral; the fact that the loan is secured by real estate is the only determining factor. For 1098 purposes, a loan secured by a mobile home is real-estate-secured, even though a mobile home may be considered personal property under the law of the state in which it is located. The loan need not also be secured by the lot or land on which the mobile home is placed; only the security of the mobile home is required. To qualify, a mortgage need not be a first mortgage; it can be junior to any number of prior mortgages. Also, the type of real estate involved does not matter; it may be vacant land, a home, or a shopping center.

During a Calendar Year. In determining the amount of interest to report, report the lesser of the amount of interest paid during the calendar year or the amount of interest accrued during the calendar year. The amount of interest paid during a calendar year is the amount actually received, plus any prepaid interest from prior years that has not been previously reported. The amount of interest accrued during a year is the amount actually accrued plus accrued but unpaid interest from prior years. Additionally, interest accrued by January 15 of the following year may be considered as accrued in the current year, but it is not mandatory that it be so considered. For example, on December 20, an individual makes a payment on a mortgage that includes interest accrued from December 5 to January 5 and also a second payment that includes interest that will accrue from January 5 to February 5 of the following year. Assuming that paid and accrued interest for the year through December 5 are equal, there are three permissible ways to deal with the two payments:

- Report only the interest in the first payment that accrued during the year and none of the second payment.
- Report all of the interest in the first payment and none of the second payment.
- Report all of the interest in the first payment and all of the interest in the second payment that accrued by January 15.

Reportable points must meet all of the following conditions:

**IRS Form 1098**

Box 1. Mortgage interest received. In this box put the sum of the two items listed below.

- The lesser of:
  - Mortgage interest paid (including prepaid interest from prior years not previously reported)
  - Mortgage interest accrued during the year (including accrued but unpaid interest from prior years)
- Any late fees or prepayment penalties paid.
Box 2. Points paid directly by payor(s)/borrower(s) (as well as seller-paid points) on purchase of principal residence. This box has caused more confusion than any other requirement of mortgage interest reporting because the IRS amended the regulations regarding it several times. Reportable points must meet all of the following conditions:

1. They are clearly designated on the Uniform Settlement Statement (HUD-1) as points: for example, “loan origination fee” (including amounts for VA and FHA loans), “loan discount,” “discount points,” or “points.”

2. They are computed as a percentage of the stated principal loan amount.

3. They are charged under an established business practice of charging points in the area where the loan was issued and do not exceed the amount generally charged in that area.

4. They are paid for the acquisition of the payor of record’s principal residence, and the loan is secured by that residence.

5. They are paid directly by the payer of record. Points are paid directly if:

   a. The payer of record provides funds that were not borrowed from the lender of record for this purpose as part of the overall transaction. The funds may include down payments, escrow deposits, earnest money applied at closing, and other funds actually paid over by the payer of record at or before closing, OR

   b. The seller pays points on behalf of the payer of record. Points paid by the seller to the interest recipient on behalf of the payer of record are treated as paid to the payer of record and then paid directly by the payer of record to the interest recipient. Report points paid under 5a or 5b on the payer of record’s 1098 in box 2.

Exceptions. Do not report on Form 1098 points paid:

1. For loans to improve a principal residence;
2. For loans to purchase or improve a residence that is not the payor of record’s principal residence;
3. For a home equity or line of credit loan, even if secured by the principal residence;
4. For a refinancing (there are special rules for construction refinancing);
5. In lieu of items ordinarily stated separately on the Form HUD-1, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes; and
6. To acquire a principal residence to the extent the points are allocable to an amount of principal in excess of $1 million.

Construction loans. Points paid on a loan to construct a residence or to refinance a loan incurred to construct a residence are reportable on Form 1098 if they:

1. Are clearly designated on the loan document as points;
2. Are computed as a percentage of the stated principal loan amount;
3. Conform to established practices in the area;
4. Are paid in connection with a loan incurred by the payor of record to construct (or refinance the construction of) the payor’s principal residence;
5. Are paid directly by the payer of record; and
6. Are not allocable to an amount of principal in excess of $1 million.

Amounts paid to refinance a loan to construct a residence are not points to the extent they are allocable to debt that exceeds the debt incurred to construct the residence. In addition, the entity filing the return must report all points paid by the borrower in the transaction. Thus, if a mortgage broker was involved and was paid one point by the borrower, the bank reporting the transaction must report the point paid to the
mortgage broker together with any points the bank received.

**Box 3. Refund of overpaid interest.** In this box, show the amount of any overpaid interest the bank refunded to the borrower(s). You need not report amounts aggregating less than $600 unless you are otherwise obligated to file a form 1098 on that borrower. Report reimbursed interest for the tax year in which the refund occurred, not the year(s) to which the refund may have related. If the refund occurred in the same year it related to, do not put any amount in box 3. Instead, show the net figure (after subtracting the reimbursement from the total interest paid during that year by the borrower) in box 1.

**Box 4. Checkbox.** Box 4 is a courtesy box and need not be completed. A bank may use it to provide other information to its borrower, such as taxes or insurance paid from escrow.

**Payor's Social Security Number.** An entity required to report mortgage interest received on Form 1098 has the same obligation to obtain a customer's taxpayer identification number (TIN) as an entity required to report interest paid on Form 1099-INT. Likewise, the failure to report a correct TIN carries the same $50 fine.

The best policy for a bank is to have a potential mortgage borrower certify his/her TIN at the time a loan application is taken using Form W-9. If the bank is subsequently notified by the IRS that the customer's name/TIN combination does not match that on government records, the bank must contact the customer and tell him or her that the IRS has notified the bank that the name/TIN combination provided by the customer is inaccurate. The bank should request the borrower's correct TIN and advise that the IRS will impose a $50 fine on the borrower if he or she fails to provide it. While not required, it is a good policy to supply a Form W-9 with the notice.

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**Miscellaneous**

**Time for Filing.** Form 1098 must be filed with the IRS by February 28 each year. A copy must be provided to the borrower by January 31.

**Non-resident Alien.** You must report interest received from a nonresident alien if all or part of the property secured by the mortgage is in the U.S.

**Part-time Mortgage.** If a bank takes real estate as collateral for an existing loan that previously was not secured by real estate, the loan becomes a mortgage loan when the real estate collateral is pledged. Likewise, if a lender releases all real estate collateral for a loan, the loan ceases to be a mortgage loan when the real estate is released.

**Magnetic Media Reporting.** If you file over 250 returns, you are required to file on magnetic media.

**Form 1098-E Student Loan Interest Statement**

You should use Form 1098-E to report when you receive student loan interest payments of $600 or more from an individual during the calendar year. For loans made before January 1, 2004, you are not required to, but you may include loan origination fees and/or capitalized interest. Report interest only on “covered” student loans that have a “covered period” ending during or after the applicable tax year. The $600 threshold applies to each borrower regardless of the number of student loans obtained by that borrower; however, you may file a separate Form 1098-E for each student loan of the borrower, or you may file one Form 1098-E for the interest from all student loans of the borrower.
Covered Student Loan. To be reportable, a student loan must have a covered period ending during or after the current tax reporting calendar year and must be either:

- Subsidized, guaranteed, financed, or otherwise treated as a student loan under a program of the Federal, state, or local government or of a post-secondary educational institution, or
- Certified by the borrower as a student loan. You may use Form W-9S to obtain the certificate.

Covered period. A covered period is generally the first 60 months after the loan enters repayment status. For loans other than consolidated, collapsed, or defaulted loans, the covered period begins on:

1. The date the loan went into repayment status, or
2. January 1, 1998, if you do not know or have reason to know the date in 1 above.

A "consolidated loan" is a single loan refinancing more than one student loan. A "collapsed loan" is a set of loans of a single payer treated as a single loan for loan servicing purposes. For consolidated and collapsed loans, the covered period begins on:

1. The most recent date any of the loans subject to consolidation or collapse went into repayment status, or
2. January 1, 1998, if you do not know or have reason to know the date in 1 above.

A "defaulted loan" is one for which required interest and principal payments were not made when due, you have declared the loan in default, and if applicable, you have sought recourse against the ultimate loan guarantor. For defaulted loans, the covered period begins on:

1. The date the loan went into repayment status,
2. The date the loan went into default if you do not know or have reason to know the date in 1 above, or
3. January 1, 1998 if you do not know or have reason to know the dates in 1 or 2 above.

The covered period ends the last day of the month that is 60 months after the period begins. However, the covered period is extended by the number of months the loan was subject to any grace period, deferment, or forbearance. After the 60 months ends, stop reporting interest on that student loan if you know about such periods.

Revolving accounts. For revolving accounts, such as credit cards, report interest paid only if the borrower certifies that all the loan proceeds are solely to pay for qualified higher education expenses. You do not have to verify the borrower’s actual use of the funds. Do NOT report interest on mixed use loans.

Mortgage Loans. If you treated a loan as a mortgage before 1998 for purposes of reporting the interest on Form 1098, Mortgage Interest Statement, continue to report on Form 1098 even if the loan is used to pay for educational expenses. For a loan made after 1997 that is secured by real property and certified by the borrower to be used solely for paying qualified higher education expenses, report the interest on Form 1098-E.

Box 1. Student loan interest received by lender. Enter the interest you received on a student loan(s) during the calendar year.

Box 2. Checkbox. Check this box if loan origination fees and/or capitalized interest are reported in Box 1.

In the unnumbered boxes of the form, enter the name and address and telephone of the lender, the recipient’s Federal identification number, the borrower’s social security number, name, and address. Account number information is optional on the form.

Copy B of the form should be furnished to the borrower by January 31 of each year. Copy A should be filed with the IRS by February 28 if filed by paper filing, or by April 2 if filed electronically.
**Individual Retirement Accounts (IRAs)**

**Introduction**

The income tax laws and regulations governing retirement accounts are extremely complex. We receive more questions from our customers about the correct way to report Individual Retirement Account (IRA) transactions to IRS than for any other form of IRS information reporting. The confusion stems from a combination of a lack of understanding about the nature of IRAs, the number of different transactions that can occur in an IRA, and the number of different reporting requirements. This section describes the IRS reporting requirements for a bank acting as an IRA trustee where all funds are invested in the bank’s time deposits. For banks that act as retirement plan trustees in more complex arrangements, the reporting requirements are more stringent than described here.

**IRAs in General**

IRAs are established by section 408(a) of the Internal Revenue Code. An IRA is “a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries ...” Generally, the trustee must be a bank. Contributions must be made in cash and, with exceptions, cannot exceed $2,000 per year. Contributions to an IRA may be tax deductible by the contributor, depending on the contributor’s income and other retirement arrangements. IRAs are exempt from taxation; that is, earnings of IRAs are not taxed. Distributions, however, with limited exceptions are taxed as they are made. Distributions from an IRA made before the holder is 59 1/2 years old are also charged a 10 percent nondeductible excise tax. Distributions from an IRA must begin by April 1 of the year following the year in which the account holder is 70 1/2 years old. In general, the minimum required annual distribution is determined by dividing the account balance by the account holder’s life expectancy (or the joint life and survivor expectancy of the account holder and the beneficiary).

From the IRS standpoint, a person may have only one IRA with a bank. There may be multiple instruments or investments in the account, but only one account. Accordingly, the account holder’s relationship with the IRA trustee (bank) must be reported as one relationship, even though the account has multiple relationships.

Upon the death of an IRA holder, the account automatically passes to the beneficiary—if one is named. If the beneficiary is not a spouse, the use of the inherited IRA by the beneficiary is restricted and the proceeds must be distributed within five years. A spouse has the option of treating the IRA as his/her own. In this case, the IRA is treated as if the surviving spouse was the original contributor, and it is included as part of any other IRA the spouse has with the bank.

**IRS Form 1099-Q**  
**Payments from Qualified Education Programs**

Any distribution or rollover from a Coverdell ESA will no longer be reported on the 1099-R. Report these distributions on Form 1099-Q along with distributions from Qualified Tuition Programs.

**Information Required**

- **Box 1. Gross distribution.** Distributions from any qualified tuition program whether in cash or in-kind, include tuition credits or certificates, payment vouchers, tuition waivers, or other similar items.
- **Box 2. Earnings.** If there is a loss and this is not the final year for distributions from the account and there are no earnings, enter zero.
- **Box 3. Basis.** Enter the basis in the gross distribution reported in Box 1.
- **Box 4. Trustee-to-Trustee transfer checkbox.** Check if applicable.
Box 5. Checkbox. Check either “private” or “state”.

Box 6. Designated Beneficiary Checkbox. Check if the recipient is not a designated beneficiary.

**IRS Form 1099-R**

Distributions from an IRA must be reported to the IRS on Form 1099-R. Like all 1099 forms, a copy must be provided to the taxpayer by January 31 and to the IRS by February 28 of the year following the tax year of the distribution. A 1099-R should be completed as follows:

**Payer’s name, etc.** -- Relevant information about the bank trustee.

**Payer’s Federal ID No** -- Bank’s ID number.

**Recipient’s identification No.** -- Recipient’s taxpayer identification number. (When the recipient is a beneficiary of a deceased IRA holder, use the recipient’s TIN, not that of the decedent).

**Recipient’s name, address, etc.** -- Relevant information about the recipient. (When the recipient is a beneficiary of a deceased account holder, he/she must be designated as such. For example, Sam Smith beneficiary of John Jones).

**Account No.** -- The account number of the IRA. This box is optional.

**Box 1. Gross distribution** -- Enter the total number of dollars distributed to the account owner before income tax withholding. If penalties are charged for early withdrawal, such as from a certificate of deposit, enter the amount distributed after deduction of the penalties. Distributions of less than ten dollars do not need to be reported. From an IRS standpoint, generally, unless money was actually distributed from the bank to the account owner, there was no distribution to be reported. For example, if the account owner dies, leaves the account to a beneficiary and the beneficiary makes no withdrawal, there was no reportable distribution. Likewise, a transfer from an IRA at a bank to an IRA of the customer at another bank is not reportable; no distribution was made to the customer. If a bank charges its IRAs an administrative fee and deducts this fee from the account, then no 1099-R should be produced, as the distribution was not made to the account holder.

**Box 2a. Taxable Amount** -- Generally, the trustee is not required to calculate the taxable amount of an IRA contribution. In most cases, assume the entire distribution is taxable and put the same amount in Box 2a as is in Box 1. An exception is the distribution of an excess contribution. Generally, when you distribute an excess contribution, you must also distribute the earnings on it. In that event, put the entire distribution in Box 1 and only the amount of the earnings in Box 2a. Another exception is a revoked IRA, that is, one that is canceled within seven days of when it is established. Do not put the amount of the returned contribution in Box 2a.

**Box 2b. Taxable amount not determined** -- If Box 2a was left blank, a check should be put in this box. Technically, Box 2a can usually be left blank and a check put in Box 2b. That, however, is contrary to the way the IRS would like it done. The better way is to fill in Box 2a and leave Box 2b empty.

**Box 2b. Total distribution** -- Put a check in this box if the distribution was a complete distribution of the IRA. Remember, a customer may have only one IRA relationship with a bank. If a customer’s IRA relationship has five CDs, a full distribution of the proceeds of one of the CDs is not a complete distribution of the IRA.

**Box 3. Amount in Box 2a eligible for capital gain election** -- Not applicable to IRAs.

**Box 4. Federal Income Tax withheld** -- Enter amount withheld. Withholding is at the rate of 10 percent for nonperiodic distributions and at the same rate as for wages for periodic distributions. An IRA trustee is obligated to advise the recipient of the withholding rules prior to a distribution, and the recipient may elect to have no withholding. Absent a
recipient’s no-withholding election, a bank must withhold at the appropriate rate.

Box 5. Employee contributions or insurance premiums -- Not applicable to IRAs.

Box 6. Net unrealized appreciation in employer’s securities -- Not applicable to IRAs.

Box 7. Distribution Codes -- This box determines whether the 10 percent additional excise tax applies.

- **Code 1. Early** (premature) distribution, **no known exception**. The major exceptions are the account owner reaching age 59 1/2, and death or disability of the account owner. The other exceptions will seldom occur in an IRA.

- **Code 2. Early** (premature) distribution, **exception applies**. This seldom applies to an IRA. Do not use this code for death or disability exception.

- **Code 3. Disability**. The account owner must be unable to engage in any substantial gainful activity due to a medically determinable physical or mental impairment expected to continue for an indefinite duration or until death.

- **Code 4. Death**. This is used for all distributions to a nonspousal beneficiary and to a spouse, if the spouse did not make an election to have the IRA treated as his/her own IRA. If the spouse did make the election, do not use “due to death” as distribution code.

- **Code 5. Prohibited transactions**. Certain activities by the account holder, such as borrowing money from an IRA, are prohibited and can disqualify the IRA.

- **Code 6. Section 1035 exchange**. Not applicable to IRAs.

- **Code 7. Normal distribution**. This is used for all distributions (other than due to death) to an account holder older than 59 1/2.

- **Code 8. Excess contributions plus earnings/ excess deferrals (and/or earnings) current tax year**. Use Code 8 for an IRA distribution under section 408(d)(4), including excess Roth contributions, unless Code P applies. Also use this code for corrective distributions of excess deferrals, excess contributions, and excess aggregate contributions, unless Code D or P applies.

- **Code 9. PS 58 costs**. Not applicable to bank-administered IRAs.

- **Code A. May be eligible for 10-year option**. Use only for participants born before 1936 or their beneficiaries to indicate the distribution is eligible for the 10 year tax option method of computing the tax on lump sum distributions.


- **Code E. Excess annual additions under section 415**. Not applicable to IRAs.

- **Code F. Charitable gift annuity**. Not applicable to IRAs.

- **Code G. Direct rollover and rollover contribution**. Not applicable to IRA distributions.

- **Code J. Distribution from a Roth IRA**. Use Code J for a distribution from a Roth IRA or from a conversion Roth IRA when Code Q and Code T do not apply. You may use code 1, 2, 3, 8, or P with Code J.

- **Code L. Loans treated as deemed distributions under section 72(p)**. Not applicable to IRAs.
• **Code N. Recharacterized IRA contribution for 2003.** Use to recharacterize an IRA contribution or recharacterize an IRA type in a trustee-to-trustee transfer or with the same trustee.

• **Code P. Excess contributions plus earnings/excess deferrals taxable in 2002.** See the explanation for Code 8. The IRS suggests that anyone using Code P for the refund of an IRA distribution under section 408(d)(4), including excess Roth contributions, advise payees, at the time the distribution is made, that the earnings are taxable in the year in which the contributions were made.

• **Code Q. Qualified distribution for Roth IRA.** Use if the 5-year holding period has been met and the participant has reached 59 ½, died or become disabled.

• **Code R. Characterized IRA contribution for 2002.** Use this code for a recharacterization of an IRA contribution to another type of IRA by a trustee-to-trustee transfer or with the same trustee.

• **Code S. Early distribution from a SIMPLE IRA in first two years, no known exception.** Use this code only if the distribution is from a SIMPLE IRA in the first two years, the employee/taxpayer has not reached age 59½, and none of the exceptions under section 72(t) are known to apply. The two-year period begins on the day contributions are first deposited in the individual’s SIMPLE IRA. Do not use code S if code 3 or 4 applies.

• **Code T. Roth IRA distribution, exception applies.** Use if it is not known if the 5-year holding period has been met but the participant has reached 59 1/2.

**Box 8. Other -- Not applicable to IRAs.**

**Box 9a. Your percentage of total distribution --** If a total distribution was made and it was made to more than one person enter the percentage of the total paid to the person named on the return. This box does not have to be completed for an IRA.

**Box 9b. Total Employee Contributions.** This box is optional.

**Boxes 10-15 --** You are not required to complete these boxes for IRS purposes.

### IRS Form 5498

A bank must file a Form 5498 for every person for whom it maintained an IRA during the year. The only exception is if the account holder made no contribution and took a complete distribution. As with the 1099-R, a 5498 must report the entire relationship between the account owner and the bank; a bank should file one, and only one 5498 for each IRA plan.

The unnumbered boxes on Form 5498 are identical to those on form 1099-R with one exception. On Form 5498, Payer is referred to as Trustee or Issuer, and Payee is referred to as Participant. In either case the terms refer to a bank and its customer, respectively.

**Box 1. Regular IRA contributions --** Enter the amount of all contributions other than rollover contributions. Include contributions made after year-end and before April 15 that the account owner designates as made for the prior year. Include excess contributions even if subsequently distributed, and contributions that were revoked.

**Box 2. Rollover IRA contributions --** Enter all contributions that the account owner designates as rollover contributions. A bank may rely on the designation given a contribution by the account owner. Do not report a transfer from another IRA trustee. Trustee to trustee transfers are not distributions or rollover contributions.

**Box 3. Roth conversion amount --** Enter the amount converted or reconverted from a
traditional IRA, SEP, or SIMPLE to a Roth IRA during the tax year. Do not include a rollover from one Roth IRA to another Roth IRA. Include a rollover in box 2.

**Box 4. Recharacterized contributions.** Enter any amounts recharacterized plus earnings from one type IRA to another.

**Box 5. Fair Market Value of Account** — Enter in this box the fair market value of the account on December 31. For the account of a decedent, a trustee may report the fair market value on either the date of the decedent’s death or on December 31. If December 31 reporting is used, the value will almost always be zero. Also, if December 31 reporting is used, the trustee must advise the administrator or executor of the decedent’s estate that he/she has the right to a date-of-death valuation.

**Box 6. Life insurance cost included in box 1** — Not applicable to bank IRAs.

**Box 7. Checkboxes.** If you did not enter an amount in box 1, 3, 8, 9, or 10, even if you entered an amount in box 2 or 4 you must mark the appropriate box. If you entered an amount in one of those boxes, you may, but do not have to mark the appropriate box.

IRA. Check “IRA” if you are filing Form 5498 to report information about a traditional IRA account.

SEP. Check “SEP” if you are filing Form 5498 to report information about a SEP account.

SIMPLE. Check “SIMPLE” if you are filing to report information about a SIMPLE account.

Roth IRA. Check “Roth IRA” if you are filing on a Roth IRA account.

**Box 8. SEP contributions** — Enter the employer contributions made to a SEP (including salary deferrals under a SARSEP) during the tax year. Do not enter employee contributions to an IRA under a SEP plan. Report any employee contributions to an IRA under a SEP plan in box 1. Also include in Box 8 SEP contributions made by a self-employed person to his or her own account.

**Box 9. SIMPLE contributions** — Enter any contributions made to a SIMPLE during the tax year. Do not include contributions to a SIMPLE under a 401(k) plan.

**Box 10. Roth IRA contributions** — Enter any contributions made to a Roth IRA in the tax year and through April 15 of the following year designated for the tax year. However, report Roth conversion amounts in box 3.

**Box 11. Check if RMD taken.** Self-explanatory.

Form 5498 must be filed with the IRS by June 1 to report the prior end-of-year value. Additionally, if there were contributions during or attributable to the year, that information must be provided to the account holder by May 31. The account holder must also have been provided a statement of end-of-year value by January 31.

**Common Questions**

1. The account holder died, what do I report?

   A. File a 5498 for the deceased account holder, showing any contributions and an end-of-year value of zero. (Alternatively, show the date-of-death value.)

   B. File a 5498 for the beneficiary, showing the end-of-year value, unless the beneficiary took a total distribution; in that case, no 5498 is required. If the beneficiary is not a spouse (or if the spouse does not want to treat the IRA as his/her own) you must designate the beneficiary as the beneficiary of the deceased (e.g., Sam Smith beneficiary of Joe Jones). Additionally, you must continue to designate the account in this manner on all 5498s and 1099-Rs in future years. If the spouse elects to make the IRA his/her own, no beneficiary designation is required.

   C. File a 1099-R for each person to whom a distribution was made. If the
decendent received a distribution prior to death, a 1099-R is required for the decedent. A nonspousal beneficiary must be designated as the decedent’s beneficiary as on Form 5498. If no distribution was made, that is no money was paid to a beneficiary, do not file a 1099-R. The transfer of the account from the decedent to the beneficiary is not a distribution.

2 It is after May 31, the account holder died last year, and we were not advised. What do we do? Nothing. No corrected return or additional return is required. Next year, file as if the beneficiary died in the current year.

3 We charge all IRA accounts an annual fee. How do I report that? You don’t. The fee is not paid to the account holder; thus, it is not a distribution and not reportable.

4 We transferred the balance of a customer’s IRA to an IRA of the customer at another bank. What do we report? File a Form 5498 with a year-end value of zero. Do not file a 1099-R. A transfer from trustee to trustee is not a distribution.

5 A customer, age 50, took a total distribution of his account on July 1. On August 1, he opened a new IRA with a contribution equal to the amount of the distribution, plus $2,000. What do we report? File a 1099-R for the distribution with a “1” in Box 7. File a 5498 showing the contribution of the distribution as a rollover contribution and the $2,000 as a regular contribution.

IRS Form 5498-ESA
Coverdell Education Savings Account (ESA)

Use to report any contributions, including rollover contributions to a Coverdell ESA. Do not report on form 5498.

Information Required

Box 1. Contributions. Enter amount excluding rollover contributions.

Box. 2. Rollover contributions. Enter amount of any rollover contribution.

B-Notices, Taxpayer Identification Numbers, Due Diligence, Backup Withholding, Reasonable Care, and Penalties

Introduction

This section deals with the regulations for backup withholding where there is not a match between a payee’s name and Taxpayer Identification Number (TIN) on an information return and that which is on government records. This section describes the requirements for obtaining a customer’s Taxpayer Identification Number, for backup withholding, and the penalty for failure to meet either requirement.

General

A bank is required to impose backup withholding on payments made to a customer in four different situations. They are:

- When the customer fails to furnish his/her TIN to the bank in the manner required by law
- When the IRS notifies a bank that a customer’s TIN does not match that on file with the IRS or Social Security Administration
• When the IRS notifies a bank that a customer has failed to report or has underreported his/her interest or dividend income and directs the bank to begin backup withholding on all future payments made to that customer.

• When a customer fails to certify that he/she is not subject to backup withholding.

Backup withholding is always at the rate of 28 percent. It applies only to payments that are reportable on a Form 1099. For example, a bank will never be required to backup withhold against a corporate customer because payments to corporations are not reportable.

**Taxpayer Identification Number**

A Taxpayer Identification Number (TIN) can be either a Social Security Number (SSN) issued by the Social Security Administration, an Employer Identification Number (EIN), an Individual Taxpayer Identification Number (ITIN) or Adoption Taxpayer Identification Number (ATIN) issued by the Internal Revenue Service. A person who is a sole proprietor of a business may have both an SSN and EIN. In any case, the number contains exactly nine digits with no alphabetic characters. Anything else would be patently invalid.

**Requirement to Furnish a TIN**

The Internal Revenue Code requires any person filing a tax return, statement, or other IRS document to furnish a Taxpayer Identification Number (TIN). For U.S. citizens and certain aliens admitted to the United States for permanent residence or employment, a Social Security Number (SSN) must be obtained and recorded on all returns, statements, and other IRS documents. Entities that are not human beings are issued Employer Identification Numbers (EINs), used for the same purposes. Nonresident aliens who are not employed in the United States are not eligible for an SSN; however, in certain situations these individuals are still required to file a U.S. tax return. For these individuals, the IRS has created a third category of TIN, called an Individual Taxpayer Identification Number (ITIN). Individuals who are not eligible for an SSN but who are required to file a tax return or refund claim must apply for an ITIN on Form W-7.

Situations where an alien who is not eligible for an SSN must apply for an ITIN and list it on a return are as follows:

• Filing a U.S. tax return to support income derived from a U.S. source (including income, estate, gift tax, and amended returns).

• Filing a U.S. tax return to claim a refund of tax withheld,

• Being the spouse of a U.S. citizen or resident who files a joint return,

• Being claimed as a spouse for an exemption on a U.S. tax return, or

• Being claimed as a dependent on another person’s U.S. tax return.

An ITIN is not required on information returns (such as the 1098 and 1099 series), so a foreign individual ineligible for a SSN does not need to obtain an ITIN solely for that purpose. However, for those individuals who do have an SSN, it must appear on all information returns filed by the bank.

**Bank Secrecy Act.** The Bank Secrecy Act also requires that a bank obtain a TIN for each deposit account and certificate of deposit that it opens. If an individual needs to apply for a TIN to open an account or certificate, form SS-5 is used to apply for a SSN, and form SS-4 is used to apply for an EIN. If the account or certificate has more than one owner, the TIN of only one person having a financial interest in the account need be provided. However, the better policy is to obtain the TIN of every owner on an account or certificate, so that the bank will have each TIN on file in case it is needed later for other IRS or BSA purposes.

There are exceptions to the rule. In the following situations a TIN is not required when opening a certificate or account. The exceptions are:
An account opened under the name of a federal or state governmental entity,

An account opened for a person under the age of 18 under a school thrift savings program, when the account will yield less than $10 of interest annually,

A Christmas or vacation club account, or other similar installment savings program account, where the annual interest will be less than $10,

Accounts opened for aliens who are ambassadors, diplomats, ministers, or who otherwise are granted international immunity,

Accounts opened for aliens residing in the United States for less than 180 days,

Accounts opened for aliens who do not work or derive any income from business in the United States, who are attending a college or university, or

Accounts opened for nonresident aliens who do not work or derive any income from business in the United States.

The TIN must be obtained by the bank within 30 days of opening the account, or the bank may be cited for a violation. However, if the bank has made a reasonable attempt to obtain the information and it maintains a list with the account holder's name, address, and account number, the bank will not be in violation.

Customer Fails to Furnish TIN

A bank must backup withhold against all payments of interest, dividends, etc. to a customer for whom the bank does not have a valid TIN. Thus, if a bank opens an interest-bearing account for a customer and does not obtain the customer's TIN, the bank must backup withhold on all payments made to the customer. The best way to obtain a customer's TIN is to have the customer complete and sign IRS Form W-9. Only one Form W-9 is required per customer, regardless of the number of accounts the customer has.

If the customer has a TIN, the bank is allowed only 30 days to record it in the bank’s files. If the bank has not obtained a TIN for a particular customer within the 30-day period, it can avoid penalties if it can show it has made a “reasonable effort” to obtain the TIN and it maintains a list of customers from whom it has been unable to obtain TINs (with their addresses and account numbers) and makes that list available to the IRS upon request. IRS has specific standards a bank must meet to satisfy the “reasonable effort” test.

The only exception to the rule requiring obtaining a TIN is where the customer does not have a TIN and has applied for one. In that case the customer may write “awaiting TIN” in the space on the W-9 designated for the TIN. The “awaiting TIN” certification allows a bank to delay backup withholding 60 days. However, if the customer makes a withdrawal of more than $500 during the 60-day period (in a single transaction), backup withholding must be instituted to the extent of any reportable interest or dividend made to the account during the period up to the time of withdrawal. If at the end of the 60-day period the bank has not received the customer's TIN, the bank must either close the customer's account or institute backup withholding. If the bank does not close the account, and does not obtain the customer's TIN before it is required to file an information return for the customer, the bank will be liable for a $50 fine for filing an information return without a proper TIN. This is true even though the bank instituted backup withholding.

The best policy to avoid fines and backup withholding is to refuse to open an interest-bearing account for a customer who certifies he, she, or it is “awaiting TIN”. In today’s world, it is very seldom that a person does not have a TIN. A person may have lost it or forgotten it, but he or she usually has been issued one. Anyone who claims that they do not have a TIN must be viewed as somewhat suspicious.

If a bank files an information return with an incorrect or missing TIN, the bank is subject to a $50 fine unless the bank used “due
diligence” in attempting to obtain the TIN. Due diligence can be accomplished by having a customer certify his/her TIN on a proper form (W-9). However, a bank has not exercised due diligence if the TIN certified is obviously wrong (for example, only eight digits). If a customer provides a bank an “awaiting TIN” certificate and within the 60-day grace period the customer does not provide a TIN, a bank may exercise due diligence by closing the account.

**TINs and Non-Resident Aliens**

Whenever a bank opens a deposit account for a non-resident alien, a form W-8BEN (certificate of Foreign Status of Beneficial Owner for United States Tax Withholding) should be obtained and kept on file. A properly completed W-8BEN will remain in effect for at least three full years (expiring on 12/31 of the third calendar year after the form is dated). If the non-resident alien provides a valid ITIN on the W-8BEN, then the form will remain valid indefinitely for as long as the customer’s status qualifies him or her as an NRA.

**TIN/Name Mismatches; B-Notices**

Whenever a bank is notified by the IRS that a customer’s name and taxpayer identification number combination is incorrect, the bank must notify the customer and must backup withhold on all reportable payments made to the customer after the close of the 30th business day after the date of the notice unless, prior to that time, the customer recertifies his or her TIN. An incorrect TIN/name combination is a combination of any TIN and name reported on an information return that the IRS determines is inaccurate.

**Exceptions.** The backup withholding rules do not apply to fiduciary or nominee accounts, that is, any account where one person is identified as acting as custodian, guardian, trustee or in another fiduciary capacity recognized under governing law. A second exception is where the payment reported was not a reportable payment, such as to an exempt payee. Information reporting is not required for certain exempt classes of a bank’s customers, such as corporations. If an information return was filed for an exempt customer and a B-Notice as to that customer was received, a bank may ignore it. While not an exemption as such, a third area where a bank may disregard a B-Notice is where the bank did not accurately report the information provided by the customer, such as where numbers in the TIN are transposed.

**Receipt of B-Notice.** The IRS normally sends B-Notices to payors in mid-September under date of October 1. The B-Notice is considered received on the later of the date under which it is sent or the date of actual receipt. If the B-Notice contains an account number, backup withholding applies only to that account. If the B-Notice does not contain an account number, then backup withholding applies to all reportable payments made to any account of the payee with the incorrect TIN/name combination that the payor can locate with “reasonable care.” Reasonable care is exercised if the payor enters the information from the B-Notices into its computer system that contains the product line relative to the B-Notices.

**Notification of customer.** Within 15 business days from receipt of a B-Notice, a bank must mail or deliver to its affected customer a notice stating that it has been notified by the IRS that the TIN/name combination furnished by the customer is incorrect and must be recertified. The requirements for the notice and the rules for recertification are different depending on whether it is the first B-Notice received relative to an account or customer or the “second within three calendar years.”

**First B-Notice.** Within 15 business days after receipt of a first B-Notice relative to an account or a customer, a bank must notify the customer that it has been notified by the IRS that the customer’s TIN/name combination is inaccurate and provide the customer a Form W-9 to recertify his or her TIN. The content of the information that a bank must provide its customer is both extensive and very specific.
The best way to comply is to use the forms and mailers available from the various commercial form companies such as Standard Register.

**Second B-Notice in three calendar years.**

If a bank receives a second B-Notice relative to an account or customer within three calendar years, the content of the notice the bank must provide the customer is different than for a first B-Notice.

If you receive a second B-Notice for a customer (account), you must send him or her a notice containing the following information:

- The date your bank was notified of the second incorrect TIN (i.e., the effective date of the IRS notice)
- The payee’s (customer’s) name and address
- That your bank has been notified by the IRS that the TIN furnished by the payee is incorrect, the name and TIN that the IRS has determined to be incorrect, and the account number(s) that contain(s) the incorrect TIN
- That your bank has been notified twice within three years by the IRS that your customer has furnished an incorrect TIN
- That your bank must disregard any future TINs received from the payee unless your bank receives notice from either the Social Security Administration (SSA) or the IRS that such TIN is correct.
- The bank’s name and address
- If the incorrect TIN is a Social Security Number, the notice must instruct the payee to take the following steps:
  - Contact the SSA by telephone to request a form SS-5, *Application for Social Security Card*
  - Furnish to the SSA a completed form SS-5 and any other documents required by the SSA along with the name and address of your bank.
- Request that the SSA send Form 7028, *Notice to Third Party of Social Security Number Assignment* directly to your bank.
- If the incorrect TIN is an employer identification number, the notice must instruct your customer to contact, in writing, the Internal Revenue Service Center (Attention: Entity Section) where he/she files his/her income tax return and request that the IRS provide a letter 147C to them.

Refer to the end of this section for a model form approved by the IRS for notifying a customer of a second B-Notice. This form is not commercially available. The words “Important Tax Document Enclosed” must be on the outside of the transmittal envelope in a “bold and conspicuous manner” and the notice must be mailed within 15 days of receipt of the B-Notice. If you choose to use this letter, be cautious about changing the language, as the requirements are very specific. If you use B-Notice forms provided by a third party vendor, **those forms are not appropriate for second B-Notices** unless your vendor has provided you a separate second B-Notice form. Do not use your normal B-Notice for second B-Notices. We have checked with the larger form vendors and have not found one who produces a second B-Notice form. If you have such a form and it was produced prior to September 19, 1991, it is in error as that is the first date the IRS made the new language required in the customer notification available. If it was produced after September 19, you should check it to make sure the new requirements are included.

**Backup withholding.** After the close of 30 business days after receipt of a B-Notice from the IRS, a bank must begin backup withholding on all reportable payments to an account or customer for which a B-Notice was received, unless the customer has recertified his or her TIN on or before that date. For a first B-Notice, a customer may recertify his or her TIN by providing the bank a new Form W-9 certifying a TIN that is not patently erroneous. It is
permissible for a customer to recertify the TIN that the IRS said was erroneous.

For a second B-Notice, a bank may not accept a W-9. It may only accept a Form SSA-7028 from the Social Security Administration if the incorrect TIN was a Social Security Number or IRS Letter 147C from the IRS if the incorrect TIN was an employer identification number. It is the responsibility of the customer to apply for and obtain the correct form. A bank may begin backup withholding at any time after receipt of a B-Notice from the IRS relative to an account or a customer; however, backup withholding must be begun after the close of business on the 30th business day following receipt of the notice. If backup withholding is begun, it must be terminated within 30 calendar days after a bank receives proper certification of a customer’s TIN.

There are both civil and criminal penalties for failure to withhold where it is required. Additionally, a bank is liable for the amount that should have been withheld.

**Notified Payee Underreporting**

If the IRS determines that a person has underreported or failed to report the amount of his or her interest or dividend income, the IRS may notify the payor (bank) to backup withhold against future payments to that person. Upon receipt of a notice of payee under-reporting from the IRS, a bank must notify its customer and must begin backup withholding on all payments to the customer after the 30th calendar day after receipt of the notice. As with other backup withholding, it may begin at any time after the notice; but, it must begin after the 30th day. The backup withholding required under this provision of the tax code must continue until the bank receives a certification from the IRS to cease backup withholding.

**Refusal to Certify Not Subject to Backup Withholding**

When a person opens an account with a bank, if he or she has not previously done so, he or she must certify both the TIN and that he or she is not subject to backup withholding for payee underreporting. (See Form W-9). If the customer refuses to certify that he or she is not subject to backup withholding, a bank must institute backup withholding against all payments made to the customer and must continue the backup withholding until a proper certification is obtained. However, a bank in this circumstance may not refuse to open an interest-bearing account for a customer who refuses to certify that he or she is not subject to backup withholding.

**Conclusion**

The requirements for TIN compliance and backup withholding must be far less complicated than they appear on the surface. Per the IRS and the Office of Management and Budget, “The estimated average annual burden per respondent is approximately 30 minutes.”
Model Text for Notifying Customer of Second B-Notice Within Three Years

(Bank Name/Address)

__________, 20____

<Customer Name>

<Mailing Address>

Account Number(s) <     >

Taxpayer Identification Number <     >

Dear < >:

You have provided us the Taxpayer Identification Number (TIN) shown above for the accounts that are listed. Effective __________, 20______, we were notified by the IRS that your name and TIN do not match their records and is incorrect. This is the second notification of this mismatch that we have received from the IRS in the last three years. We are legally required to disregard any future taxpayer identification numbers, whether or not certified under penalties of perjury, received from you with respect to account(s) shown above unless we have received the documents identified below.

If your TIN is a social security number, you must:

1 Telephone the Social Security Administration and request a Form SS-5, Application for Social Security Card;

2 Furnish to the Social Security Administration a completed Form SS-5 and any other documents required by the Social Security Administration along with our name and address; and

3 Request that the Social Security Administration send directly to us Form 7028, Notice to Third Party of Social Security Number Assignment.

If your TIN is an Employer Identification Number, you must contact in writing the Internal Revenue Service Center (Attention: Entity Section) where you file your income tax return and request that the IRS provide you a Letter 147C.

If by __________, 20______, we have not received a Form 7028 directly from the Social Security Commission (if your TIN is a social security number) or a copy of IRS Letter 147C together with IRS Form W-9 from you (if your TIN is an Employer Identification Number), we will be required to back up withhold 31% of all reportable (interest) payments made to your account(s) after that date until we do receive the required documentation.
[Sample Acceptable Written Assurance to Avoid 1099–S Filing]

Certification for No Information Reporting on the Sale or Exchange of a Principal Residence

This form may be completed by the seller of a principal residence. This information is necessary to determine whether the sale exchange should be reported to the seller, and to the Internal Revenue Service on Form 1099–S, Proceeds From Real Estate Transactions. If the seller properly completes Parts I and III, and makes a “Yes” response to assurances (1) through (4) in Part II, no information reporting to the seller or to the Service will be required for that seller. The term “seller” includes each owner of the residence that is sold or exchanged. Thus, if a residence has more than one owner, a real estate reporting person must either obtain a certification from each owner (whether married or not) or file an information return and furnish a payee statement for any owner that does not make the certification.

Part I. Seller Information

1. Name______________________________________________________

2. Address or legal description (including city, state, and ZIP code) of residence being sold or exchanged___________________________________________________________

3. Taxpayer Identification Number (TIN)___________________________________________________________

Part II. Seller Assurances

Check “Yes” or “No” for assurances (1) through (4).

Yes No

☐ ☐ (1) I owned and used the residence as my principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence.

☐ ☐ (2) I have not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the residence (not taking into account any sale or exchange before May 7, 1997).

☐ ☐ (3) No portion of the residence has been used for business or rental purposes by me (or my spouse if I am married) after May 6, 1997.

☐ ☐ (4) At least one of the following three statements applies: The sale or exchange is of the entire residence for $250,000 or less.

OR
I am married, the sale or exchange is of the entire residence for $500,000 or less, and the gain on the sale or exchange of the entire residence is $250,000 or less.

OR

I am married, the sale or exchange is of the entire residence for $500,000 or less, and (a) I intend to file a joint return for the year of the sale or exchange, (b) my spouse also used the residence as his or her principal residence for periods aggregating 2 years or more during the 5–year period ending on the date of the sale or exchange of the residence, and (c) my spouse also has not sold or exchanged another principal residence during the 2–year period ending on the date of the sale or exchange of the residence (not taking into account any sale or exchange before May 7, 1997).

Part III. Seller Certification

Under penalties of perjury, I certify that all the above information is true as of the end of the day of the sale or exchange.

______________________________  __________________________
Signature of Seller                    Date
IRS Form 1099 – Questions & Answers

Q–1. We understand that if we have codebtors whose debt is discharged, we must file a 1099–C as to each and show the full amount of debt discharged on each 1099–C. Must we do the same for guarantors?

A–1. No. The IRS does not consider guarantors to be debtors.

Q–2. A bank has sued a debtor, obtained a judgment against that debtor, recorded the judgment, and collected as much money as the debtor can be forced to part with presently, totaling 60 percent of the debt owed. The bank now ceases collection efforts and merely monitors the debtor’s financial status. Under state law, the recorded judgment is good for seven years. The bank is prepared to act if the debtor obtains significant funds or other assets. Must the bank file a 1099–C for the year it ceased collection action?

A–2. No. The lien effect of the judgment means the bank has not discharged the remaining 40 percent of the debt. (We confirmed this answer with IRS.)

Q–3. When should the bank report that debt as discharged?

A–3. When the statute of limitations expires on the judgment, but only if a court enters a new judgment sustaining the debtor’s statute of limitations defense against collection of the judgment. In most cases it is unlikely a report will ever need to be filed. Otherwise, it will be a long time, seven years in our example, and as much as 21 years in a few states. (We confirmed this answer with IRS, too.)

Q–4. If the bank ceases collection activity, discharges the debt, and files a report, and then the debtor later makes a payment, does the bank have any new reporting requirements?


Q–5. If we redeem a U.S. Savings Bond and give the customer $6 interest in March, then redeem another bond and pay another $6 interest to the same customer in November, are we required to aggregate the two interest payments totaling $12 and file a 1099 on that customer?

A–5. Good question. The instructions from IRS do not directly address it, so we called the call site. A representative told us no, you do not aggregate. Treat each bond separately for reporting purpose in this section.

Q–6. On the 1099–S, what do we do when there are multiple sellers?

A–6. Unless the sellers were husband and wife, ask them at or before closing how they want the gross proceeds allocated between or among them. If you do not receive a response, or if you receive conflicting responses, file a 1099–S for each seller showing the total gross proceeds on each form. If the sellers are a married couple who held the property as tenants by the entirety, tenants in common, joint tenants, or (in the handful of states that have some form of it, as community property) treat them as a single transferor and file one form unless they tell you to allocate gross proceeds in a particular way. (For more information, see the IRS Instructions for Forms 1099, 1098, 5498, and W–2G).
# IRS Filings and Reports Relevant to Banking

<table>
<thead>
<tr>
<th>Form #</th>
<th>Purpose</th>
<th>When Required</th>
<th>Information Required</th>
<th>Filing Party</th>
</tr>
</thead>
<tbody>
<tr>
<td>SS–4</td>
<td>Application for employer id #</td>
<td>When paying wages or filing information returns</td>
<td>Name and address of party making application and identification of nature of business</td>
<td>Applicant</td>
</tr>
<tr>
<td>W–2</td>
<td>Wage and tax statement to report wages and taxes withheld to IRS and employee</td>
<td>1–31 to employee 2–28 to IRS</td>
<td>Name and address of employer and employees respective TIN, wages, withholding tax, and FICA</td>
<td>Employer</td>
</tr>
<tr>
<td>W–2P</td>
<td>Annual statement to report payments to and withholdings from recipients of annuities, pensions, retirement pay, and IRA payment</td>
<td>1–31 to recipient 2–28 to IRS</td>
<td>Name, address, and federal tax id # (TIN or SSN) of payee and payor and payments made to payee and withholdings by payor</td>
<td>Trustee/Payor</td>
</tr>
<tr>
<td>W–2C</td>
<td>To correct errors in previously filed W–2, W–2P</td>
<td>When required to correct information on W–2, W–2P</td>
<td>Name, address, and federal tax id # (TIN or SSN) of payer or employer and recipient, and corrected information</td>
<td>Employer/Trustee</td>
</tr>
<tr>
<td>W–3</td>
<td>To transmit IRS copies of W–2 and to reconcile quarterly 941s with W–2 copy A</td>
<td>2–28 to accompany W–2 copy A</td>
<td>Name and federal tax id # (TIN or SSN) of Employer/Trustee compilation of transmitted forms</td>
<td>Employer/Trustee</td>
</tr>
<tr>
<td>W–3C</td>
<td>To transmit copies A of W–2C filed by employers and other payors</td>
<td>When transmitting W–2C copy A to IRS</td>
<td>Name and federal tax id # (TIN or SSN) of Employer/Trustee compilation of transmitted forms</td>
<td>Employer/Trustee</td>
</tr>
<tr>
<td>W–4</td>
<td>To inform and certify to employer necessary information for tax withholding</td>
<td>Upon employment (Annual)</td>
<td>Name and SSN (tax ID) and # of exemptions and determination thereof</td>
<td>Employee</td>
</tr>
<tr>
<td>W–4P</td>
<td>For recipient of pension, annuity, retirement, and IRA income to inform payor of withholding status</td>
<td>Prior to initial distribution of any such payments</td>
<td>Name and SSN (tax ID) and # of exemptions and determination thereof</td>
<td>Recipient</td>
</tr>
<tr>
<td>W–4S</td>
<td>To make request to effect withholding from sick pay</td>
<td>Prior to distribution of sickpay</td>
<td>Name and federal tax id # (SSN) of recipient and # of exemptions</td>
<td>Recipient</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
</tr>
<tr>
<td>--------</td>
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<td>---------------</td>
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<td>--------------</td>
</tr>
<tr>
<td>W–8BEN</td>
<td>Certificate of Foreign Status of Beneficial Owner: Used to claim exemption from domestic information reporting and backup withholding on bank deposit interest. The second part of the form may be used to claim NRA treaty benefits.</td>
<td>For non–resident alien to forgo backup withholding. (Banks should obtain when opening accounts, and renew as needed in order to reduce or eliminate the need to backup withhold on interest payments made.)</td>
<td>Name and address, tax id # if available, and certification as to status and information provided.</td>
<td>Non–resident Alien</td>
</tr>
<tr>
<td>W–9</td>
<td>Request for taxpayer id # and Certification. Payer to obtain from recipient of dividends, interest, or other payments, identifying numbers to report such payments to the IRS</td>
<td>When paying interest royalties, rents and other payments in excess of certain amounts to any person</td>
<td>Name, address, and federal tax id # (TIN or SSN) of recipient</td>
<td>Recipient (w/ Payer)</td>
</tr>
<tr>
<td>56</td>
<td>To provide notice of information concerning fiduciary</td>
<td>On accepting fiduciary appointment</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, type and amount of lien; responsible agent and agency office</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>668 &amp; 668(C)</td>
<td>To give notice of federal tax lien</td>
<td>To perfect a lien for the collection of taxes</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, type and amount of tax satisfied</td>
<td>IRS</td>
</tr>
<tr>
<td>668A</td>
<td>Notice of levy to give taxpayer and recipient notice of impending levy to satisfy tax obligation</td>
<td>When effecting collection of unpaid taxes</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, type and amount of tax satisfied</td>
<td>IRS</td>
</tr>
<tr>
<td>668B</td>
<td>Effects levy upon taxpayers assets to collect unpaid taxes</td>
<td>To collect assets to satisfy unpaid tax obligation</td>
<td>Name, tax id # (SSN or TIN) and mailing address of taxpayer, assets levied, type and amount of tax</td>
<td>IRS</td>
</tr>
<tr>
<td>668C</td>
<td>To provide taxpayer opportunity to redeem or effect release of assets upon which the IRS has levied</td>
<td>Following Levy (668B) or contemporaneous with Levy</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, amount and type of tax liability paid, description of property released from levy</td>
<td>IRS</td>
</tr>
<tr>
<td>668D</td>
<td>To release levy on and return property to taxpayer</td>
<td>When unpaid tax paid and property released from levy or when levied property redeemed</td>
<td>Name and tax id # (SSN or TIN) of taxpayer and description of property and to whom released or by whom released</td>
<td>IRS</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
</tr>
<tr>
<td>--------</td>
<td>---------</td>
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<td>--------------</td>
</tr>
<tr>
<td>668E</td>
<td>To receipt for the release and delivery of levied property</td>
<td>When releasing from levy property upon which the IRS has levied or filed a lien</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, type and amount of lien; responsible agent and agency office</td>
<td>IRS</td>
</tr>
<tr>
<td>668F</td>
<td>To give notice of federal tax lien</td>
<td>To perfect a lien for the collection of taxes</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, type and amount of unpaid tax; assets to be levied</td>
<td>IRS</td>
</tr>
<tr>
<td>668H</td>
<td>To give notice of federal estate tax lien upon the assets of the estate</td>
<td>When imposing and to perfect a lien for unpaid taxes on the assets of an estate</td>
<td>Name and SSN of deceased, TIN of estate, name and tax id # (TIN or SSN) of administrator (if applicable), description of assets and nature of unpaid tax obligation and its amount</td>
<td>IRS</td>
</tr>
<tr>
<td>668J</td>
<td>To give notice of federal estate tax lien upon the assets of the estate</td>
<td>When imposing and to perfect a lien for unpaid taxes on the assets of an estate</td>
<td>Name and SSN of deceased, TIN of estate, name and tax id # (TIN or SSN) of administrator (if applicable), description of assets and nature of unpaid tax obligation and its amount</td>
<td>IRS</td>
</tr>
<tr>
<td>668R</td>
<td>To release a levy made on taxpayers wages, salary and other income</td>
<td>When taxes for which levy made are paid and levy is to be lifted</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, name and office of certifying officer, name and tax id # (SSN or TIN) of source of income for which release is operative (previously served with levy)</td>
<td>IRS</td>
</tr>
<tr>
<td>668W</td>
<td>To give notice of and effect a levy on the wages, salary and other income of a taxpayer to satisfy unpaid tax obligation</td>
<td>When imposing a lien on taxpayers wages, salary and other income to satisfy unpaid tax obligations</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, name and address of responsible agency office, and name, address and federal employer id # of employer or other source of income</td>
<td>IRS</td>
</tr>
<tr>
<td>669A</td>
<td>To certify and acknowledge the discharge of unpaid tax obligation by payment, levy, sale, redemption or otherwise</td>
<td>When lien for an unpaid tax obligation or obligation itself is discharged</td>
<td>Name and tax id # (SSN or TIN) of taxpayer, location of responsible agency office, description of property discharged if not total</td>
<td>IRS</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
</tr>
<tr>
<td>--------</td>
<td>-------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>669D</td>
<td>To certify and acknowledge the subordination of a lien for an unpaid federal tax obligation to the lien of another party (individual, corporate or governmental)</td>
<td>When lien for an unpaid tax obligation against taxpayers property is to be subordinated to another lien</td>
<td>Name and tax id # (TIN or SSN) of taxpayer</td>
<td>IRS</td>
</tr>
<tr>
<td>669E</td>
<td>To certify and acknowledge the subordination of a lien for an unpaid federal tax obligation to the lien of another party (individual, corporate or governmental) for estate</td>
<td>When lien for an unpaid tax obligation against taxpayers property is to be subordinated to another lien</td>
<td>Name and tax id # (TIN or SSN) of taxpayer for estate</td>
<td>IRS</td>
</tr>
<tr>
<td>706</td>
<td>Estate Tax Return filed by a fiduciary–administrator of an estate to report estates activity and taxes and also used to report generation–shipping transfers (used only citizens or residents of the U.S.)</td>
<td>When imposing and to perfect a lien for unpaid taxes on the assets of an estate</td>
<td>Name and SSN of deceased, TIN of estate, name and tax id # (TIN or SSN) of administrator (if applicable), description of assets and nature of unpaid tax obligation and its amount</td>
<td>Administrator of Estate</td>
</tr>
<tr>
<td>669F</td>
<td>To certify and acknowledge the subordination of a lien for an unpaid federal tax obligation to the lien of another party (individual, corporate or governmental) for estate</td>
<td>When lien for an unpaid tax obligation against taxpayers property is to be subordinated to another lien</td>
<td>Name and tax id # (TIN or SSN) of taxpayer for estate</td>
<td>IRS</td>
</tr>
<tr>
<td>706–A</td>
<td>Used to supplement 706 when more than one filing required</td>
<td>At closing of estate or end of calendar year</td>
<td>Name and SSN of deceased, TIN of estate, name and tax id # (TIN or SSN) of administrator (if applicable), description of assets and nature of unpaid tax obligation and its amount</td>
<td>Administrator of Estate</td>
</tr>
<tr>
<td>706–CE</td>
<td>Used to obtain credit against U.S. federal estate tax for the payment of a foreign death or estate tax or on behalf of a deceased U.S. citizen or resident</td>
<td>When credit allowable for the payment of a foreign death or estate tax</td>
<td>Name and tax id # (TIN) of estate, identification of foreign assets against which tax levied, value of estate, amount of tax paid and underlying supporting documentation</td>
<td>Administrator of Estate</td>
</tr>
<tr>
<td>706–NA</td>
<td>To file an estate tax or generation skipping return for a non–resident alien as to U.S. assets</td>
<td>When nonresident alien with U.S. assets dies or desires the benefit of generation skipping for U.S. assets</td>
<td>Name and federal tax id # (TIN or SSN) of nonresident alien or his estate, administrator, and relevant information concerning U.S. assets</td>
<td>Nonresident Alien or Administrator of his assets</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
</tr>
<tr>
<td>---------</td>
<td>-------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------------</td>
<td>---------------------------</td>
</tr>
<tr>
<td>706 (SchS)</td>
<td>To report and pay increased estate taxes on excess retirement assumptions</td>
<td>When deceased U.S. citizen or resident has at death remaining accumulated retirement benefits in excess of allowances, or exemptions, if exercised</td>
<td>Name and tax id # of deceased and his estate and repository or administrator of retirement benefits, value or amount of remainder transferable to estate or beneficiary election, if any, of exemption</td>
<td>Administrator of Estate</td>
</tr>
<tr>
<td>940</td>
<td>To compute, report, and pay federal unemployment tax assessments</td>
<td>Annually</td>
<td>Name and federal tax id # of employer and employment information regarding employees and wages and salaries paid and applicable unemployment tax assessed</td>
<td>Employer</td>
</tr>
<tr>
<td>941</td>
<td>To report, quarterly, salaries and wages paid, withholdings, deposits of withholdings and taxes, and reporting and paying any undeposited unpaid balance due</td>
<td>30th day following end of quarter if excessive balance due, 10th day of 2nd month following end of quarter otherwise</td>
<td>Amount and date of salaries and wages paid, withholdings, taxes and their deposit, computations, and name and federal tax id # of employer</td>
<td>Employer</td>
</tr>
<tr>
<td>1041</td>
<td>Fiduciary’s return to report activity, assets, income, liabilities and expenses of certain estates and trusts</td>
<td>Annually and at termination or conversion of applicable estates and trusts</td>
<td>Name and federal tax id # of estate or trust and fiduciary and information regarding the activity, assets, income, liabilities and expenses of the estate</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>1041 (Sch. D)</td>
<td>To report capital gains and losses of an estate or trust filing 1041</td>
<td>When trust or estate filing form 1041 experiences capital gains or losses reportable by fiduciary</td>
<td>Name and federal tax id # of estate or trust and fiduciary and information regarding the occasions of capital gains and losses experienced and reportable by fiduciary</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>1041 (Sch. J)</td>
<td>To report the allocation in a trust of its distribution of income accumulated in previous years</td>
<td>Annually with 1041 if income distributed in tax year but accumulated from prior years</td>
<td>Name and federal tax id # of trust and beneficiaries and information regarding the distribution</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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<tr>
<td>1041 (K–1)</td>
<td>To report beneficiary’s share of income, deductions, credits, etc. from estate or trust</td>
<td>Annually with 1041</td>
<td>Name and federal tax id # of estate or trust and respective beneficiary and allocation to beneficiary and interest in estate or trust remaining body</td>
<td>Beneficiary</td>
</tr>
<tr>
<td>1041–A</td>
<td>Information return to be made by trust claiming certain contributions, deductions (under IRC 642(c) and their accumulation)</td>
<td>When trusts claim IRC 642 contributions or deductions</td>
<td>Name and federal tax id # of trust, amounts claimed and information concerning recipient</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>1041–ES</td>
<td>To compute and report fiduciaries estimated income tax</td>
<td>Annual, then quarterly</td>
<td>Name and federal tax id # of estate or trust and fiduciary computations used to determine amount</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>1041–T</td>
<td>Attached to 1041 when electing to allocate trust’s estimated tax overpayment among beneficiaries, under IRC 643(g)</td>
<td>When filing 1041 and electing allocation</td>
<td>Name and federal tax id # (TIN or SSN) of estate or trust, fiduciary, beneficiaries of trust, computation of overpayment, allocation among beneficiaries and supporting documentation for overpayment and allocation</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>1042</td>
<td>To report withholdings (income tax paid at source) on interest, dividends, rent, royalties, salaries, distributable income of estates and trust paid to Nonresident alien individual partnership and foreign corporation not engaged in trade or business in U.S.</td>
<td>Annually</td>
<td>Name and federal tax id # (TIN or SSN) of payor, amounts and types of payments and identification of recipient</td>
<td>Payor</td>
</tr>
<tr>
<td>941 (Sch. A)</td>
<td>Periodic report and transmittal of deposit information for backup withholdings</td>
<td>Quarterly, with 941</td>
<td>Name and federal tax id # (TIN) of payor, amount of income upon which backup withholding applies, amount of backup withholdings, deposit verification and payment of any deficiency</td>
<td>Payor</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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<tr>
<td>1078</td>
<td>To be filed by an alien resident in U.S. with withholding agent to claim the benefit of residency for income tax purpose</td>
<td>When resident alien desires to claim benefit of residency</td>
<td>Name and federal tax id # (SSN) of NRA, basis of residency claim, address, country of citizenship</td>
<td>Nonresident Alien</td>
</tr>
<tr>
<td>1096</td>
<td>To summarize and transmit Forms 1099–B, –DIV, –G, –INT, –MISC, –OID, –MED, –L, –PATR, –R</td>
<td>Annual transmittal (2–28)</td>
<td>Name and federal tax id # (TIN or SSN) of transmitter and identification and compilation of forms transmitted</td>
<td>Payor</td>
</tr>
<tr>
<td>1098</td>
<td>To report mortgage interest received from individual in excess of $600</td>
<td>When business receives mortgage interest in excess of $600 from any individual annual (1–31 to individual; 2–28 to Service)</td>
<td>Name and federal tax id # (SSN or TIN) of individual, business receiving and amount of mortgage interest in calendar year</td>
<td>Business recipient of mortgage interest</td>
</tr>
<tr>
<td>1099–A</td>
<td>To be filed when lender acquires an interest in or becomes aware of the abandonment of secured property</td>
<td>When conditions met (1–31 to individual; 2–28 to Service)</td>
<td>Name and federal tax id # (TIN or SSN) of secured party and borrower identification of property, and its value, and amount of debt satisfied</td>
<td>Secured Party</td>
</tr>
<tr>
<td>1099–DIV</td>
<td>To report the payment of dividends or other stock distributions to person in excess of $10</td>
<td>When conditions met (1–31 to individual; 2–28 to Service)</td>
<td>Name and federal tax id # (TIN or SSN) of payer and receiver and amount of distribution</td>
<td>Payor</td>
</tr>
<tr>
<td>1099–INT</td>
<td>To report the payment of interest to each person in excess of $10</td>
<td>When conditions met (1–31 to recipient; 2–28 to Service)</td>
<td>Name and federal tax id # (TIN or SSN) of payer and recipient and amount of interest</td>
<td>Payor</td>
</tr>
<tr>
<td>1099–MISC</td>
<td>To report payments to each person of rent, royalties and other payments more than $600, in the aggregate</td>
<td>When conditions met (1–31 to recipient; 2–28 to Service)</td>
<td>Name and federal tax id # (TIN or SSN) of payer and recipient and aggregate amount of payment</td>
<td>Payor</td>
</tr>
<tr>
<td>1099–OID</td>
<td>For corporation to report original issue discount of $10 or more</td>
<td>When conditions met (1–31 to recipient; 2–28 to Service)</td>
<td>Name and federal tax id # (TIN or SSN) of issuer and recipient and amount of discount</td>
<td>Payor</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
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<td>Information Required</td>
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</tr>
<tr>
<td>1099-PATR</td>
<td>For payer to report patronage dividends for each person to whom $10 or more has been paid</td>
<td>When conditions met (1-31 to individual; 2-28 to Service)</td>
<td>Name and federal tax id # (TIN or SSN) of payer and recipient and value or amount of dividend</td>
<td>Payor</td>
</tr>
<tr>
<td>1099-Q</td>
<td>For payer to report any distribution from Coverdell ESA or Qualified Tuition Program</td>
<td>When conditions met (1-31 to Individual; 2-28 to Service)</td>
<td>Name and federal tax id # (TIN or SSN) of payer and recipient and amount of distribution</td>
<td>Payor</td>
</tr>
<tr>
<td>1099-R</td>
<td>For payer to report lump sum distributions from profit sharing, retirement plans, IRA and insurance contracts</td>
<td>When conditions met (1-31 to individual; 2-28 to Service)</td>
<td>Name and federal tax id # (TIN or SSN) of payer and recipient and amount of distribution</td>
<td>Payor</td>
</tr>
<tr>
<td>1099S</td>
<td>To report proceeds of real estate transaction</td>
<td>1-31 to recipient; 2-28 to Service</td>
<td>Name and federal tax id # (TIN or SSN) of recipient of proceeds and amount of proceeds</td>
<td>Covered payor or distributor handling disbursement</td>
</tr>
<tr>
<td>1120</td>
<td>Tax return of domestic U.S. corporation</td>
<td>Annually; 3-15 unless on fiscal non-calendar year for tax purposes</td>
<td>Name and federal tax id # (TIN) of corporation and information to compute and report tax liability</td>
<td>Corporation</td>
</tr>
<tr>
<td>1120 REIT</td>
<td>To report income of real estate investment trust</td>
<td>3-15; Annually</td>
<td>Statement of income and expenses and computation of taxable income (loss) and underlying supportive documentation and schedules</td>
<td>Real estate investment trust</td>
</tr>
<tr>
<td>1120 RIC</td>
<td>To report income (loss) or regulated investment company</td>
<td>3-15; Annually</td>
<td>Statement of income and expenses and computation of taxable income (loss) and underlying supportive documentation and schedules</td>
<td>Regulated investment company</td>
</tr>
<tr>
<td>1120W</td>
<td>To compute and report and deposit corporate estimated tax</td>
<td>Quarterly</td>
<td>Taxable income information for worksheet computation</td>
<td>Corporation</td>
</tr>
<tr>
<td>1120 W(FY)</td>
<td>To compute and record corporation's estimated tax for fiscal year corporation</td>
<td>Annually; accompanies 1120</td>
<td>Name and federal tax id # (TIN) of corporation and information in making computation</td>
<td>Fiscal year corporation</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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<tr>
<td>1122</td>
<td>To obtain the consent of and authority from subsidiary corporation for inclusion in a consolidated income tax return</td>
<td>When parent corporation includes a subsidiary corporation in a consolidated income tax return</td>
<td>Name and federal tax id # (TIN) of parent and subsidiary corporation, and documentation of relationship and authority to consent and authorize</td>
<td>Parent corporation</td>
</tr>
<tr>
<td>1127</td>
<td>To apply for and obtain an extension of time to pay tax</td>
<td>When tax due cannot be paid and taxpayer would suffer undue hardship if not extended</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>1128</td>
<td>To obtain and effect a change in accounting period</td>
<td>On or before the last day of the short period required to make the change</td>
<td>Name and federal tax id # (TIN) of taxpayer, nature of change requested, supporting information and documentation justifying the application</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>1138</td>
<td>To obtain an extension of time to pay tax in anticipation of a net operating loss carry back</td>
<td>On or before the due date of a tax payment, the extension for payment of which is based on an anticipated net operating loss carry back</td>
<td>Name and federal tax id # (TIN) of taxpayer, amount of tax for which payment extension is sought, reason for extension, substantiating documentation and information with regard to the anticipated net operating loss to be carried back</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>1139</td>
<td>To obtain a tentative refund from a tentative carry back adjustment of a net operating loss carry back</td>
<td>When conditions met and taxpayer desires refund</td>
<td>Name and federal tax id # (TIN) of taxpayer, and underlying documentation supporting request (copies of return with loss reflected, election for carry back, 1120X’s for years carried back)</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>1120X</td>
<td>To amend a previously filed federal corporate tax return</td>
<td>When information discovered reveals error or when current filings alter historical filings</td>
<td>Name and federal tax id # (TIN) of taxpayer, nature of amendment of return, documentation of justification of return, amended return</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
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<tr>
<td>2039</td>
<td>To require the appearance of an individual and the production of documents in the course of an investigation, enforcement, or collection process</td>
<td>At the discretion of the Service</td>
<td>Name and federal tax id # (TIN or SSN) of recipient, location and date of appearance, description of documents requested</td>
<td>IRS</td>
</tr>
<tr>
<td>2045</td>
<td>To be used by certain transferee or successor corporations in regard to continuing tax obligations and benefits</td>
<td>When a transferee or successor corporation meets the requirements of IRC 6901</td>
<td>Name and federal tax id # (TIN) of respective entities and information required under IRC 6901</td>
<td>Corporation/Taxpayer</td>
</tr>
<tr>
<td>2210</td>
<td>To accompany income tax return when estimated taxes result in underpayment</td>
<td>When a fiduciary underpays estimated income tax</td>
<td>Name and federal tax id # (TIN or SSN) of estate or trust and fiduciary, amount of tax, amount of estimated tax amount of deficiency, basis upon which estimated tax determined</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>2220</td>
<td>To accompany income tax return when estimated taxes result in underpayment</td>
<td>When corporation underestimates income tax</td>
<td>Name and federal tax id # (TIN) of corporation, amount of tax, amount of estimated tax amount of deficiency, basis upon which estimated tax determined</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>2270</td>
<td>To require taxpayer to produce for examination all books and records</td>
<td>When IRS determines to audit taxpayer’s books and records</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer being audited, identification of books and records</td>
<td>IRS</td>
</tr>
<tr>
<td>2373</td>
<td>To identify IRS tax due as an expense of estate administration</td>
<td>When any estate tax or income tax due is preferred or desired to be treated as an expense of administration</td>
<td>Name and federal tax id # (TIN or SSN) of deceased, estate and fiduciary, determination of tax due and statement to be treated as expense</td>
<td>Estate</td>
</tr>
<tr>
<td>2431</td>
<td>To subpoena witnesses and documents for testimony and production under oath</td>
<td>When IRS requires testimony and production under oath, actions before tax court, Court of Claims, D.C. or in prosecutions</td>
<td>Name and if party to action federal tax id # (SSN) of party under subpoena, caption of action, description of production and place and time to appear</td>
<td>IRS</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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<tr>
<td>2430</td>
<td>To give notice that property has been or is about to be seized</td>
<td>When property has been seized</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer and description of property</td>
<td>IRS</td>
</tr>
<tr>
<td>2678</td>
<td>For an employer to appoint an agent, designating agent to perform acts required of an employer</td>
<td>When employer requires the appointment of an agent for these purposes</td>
<td>Name and federal tax id # (TIN or SSN) of employer and agent and designation of limits on agent’s authority</td>
<td>Employer</td>
</tr>
<tr>
<td>2725</td>
<td>To certify the delivery and receipt of documents</td>
<td>When documents are delivered receipt for which must be in writing</td>
<td>Identification of delivering and receiving party (name and federal tax id # (if applicable) and description of documents</td>
<td>Party receiving documents</td>
</tr>
<tr>
<td>2758</td>
<td>To obtain an extension of time to file fiduciary return (and certain other returns)</td>
<td>When fiduciary desires or requires an extension of time to file return</td>
<td>Name and federal tax id # of estate or trust and fiduciary, amount of tax estimated to be due, reason for extension</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>2769</td>
<td>To compute and report penalty for underpayment of estimated tax by deposit</td>
<td>When estimated tax deposits result in underpayment</td>
<td>Name and federal tax id # (TIN or SSN), amount tax due, amount of estimated tax deposits, amount of tax due</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>2848</td>
<td>To appoint representative and attorney in fact before the IRS</td>
<td>When taxpayer desires an employee/agent or an outside agent to execute and transmit any required filings on its behalf</td>
<td>Name and federal tax id # (TIN or SSN) of employer or principal, name of agent, any expressions of greater or lesser authority</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>3565</td>
<td>To order federal tax forms and booklets</td>
<td>When blank tax forms or publications are desired</td>
<td>Name and address of party, and identification of forms and publications desired</td>
<td>Requesting Party</td>
</tr>
<tr>
<td>3610</td>
<td>Audit statement</td>
<td></td>
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</tr>
<tr>
<td>3621</td>
<td>For an individual or corporate taxpayer to compute net operating loss</td>
<td>When taxpayer experiences a net operating loss</td>
<td>Name and federal tax id # (SSN) of taxpayer and information and supporting documentation with computations</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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<tr>
<td>3621-A</td>
<td>For an individual or corporate taxpayer to compute net operating loss</td>
<td>When taxpayer experiences a net operating loss</td>
<td>Name and federal tax id # (SSN) of taxpayer and information and supporting documentation with computations</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>3645</td>
<td>To document and compute any penalty for failure to file return or furnish information</td>
<td>When penalty imposed for such failure</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, reason for penalty, computation of penalty</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>3912</td>
<td>To resolve problems with SSN and name</td>
<td>When filing difficulties, or other difficulties, with taxpayer’s name and SSN are required</td>
<td>Name and federal tax id # (SSN) of taxpayer and nature of problem encountered, any historical names used by taxpayer</td>
<td>Taxpayer or others</td>
</tr>
<tr>
<td>4149</td>
<td>To correct information and invalid SSN</td>
<td>When incorrect information or invalid SSN requires correction</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, identification of incorrect information and correct information</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>4219</td>
<td>For lenders, sureties, and others incurring liability under IRC 3505 for withholdings</td>
<td>When lender, etc. incurs liability for withholding</td>
<td>Name and federal tax id # (TIN) of lender, identification of withholding liability and entity involved</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>4351</td>
<td>To document and compute deficiency and interest for estate-installment payment of taxes</td>
<td>When estate taxes are being paid in installments</td>
<td>Name and federal tax id # (TIN or SSN) of trust or estate and fiduciary, documentation of tax due, election of installment basis for payment and computation of payments and interest</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>4417-A</td>
<td>To obtain tax deposit coupons (8109) for use in depositing withholdings, estimated taxes or other interim tax payments</td>
<td>When required to make deposits of withholdings, estimated taxes or other interim tax payments</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, identification of deposit required, frequency and amount</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>4419</td>
<td>To apply to file returns by magnetic media</td>
<td>For some returns at discretion of taxpayer or reporter, for some returns mandatory upon certain volumes</td>
<td>Name and federal tax id # (TIN or SSN) of transmitter, identification of reports to be made by magnetic media and projected volume</td>
<td>Transmitter of returns</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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<tr>
<td>4421</td>
<td>To declare and certify executor’s commission (fee) and amount of attorney’s fees as expense of administration</td>
<td>When executor’s fee and attorney’s fees are to be deducted as administrative expense of estate</td>
<td>Name and federal tax id # (TIN or SSN) of executor and attorney’s amount of fees and certification</td>
<td>Executor</td>
</tr>
<tr>
<td>4562</td>
<td>To compute and document depreciation and amortization expense deductions</td>
<td>When claiming such expenses as a deduction for income tax expenses</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, identification of basis (equipment, etc.), cost of acquisition, asset life, residual value, date of acquisition and other information</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>4598</td>
<td>To advise W-2, W-2P, and 1099 filers that information not received or incorrect, based on information from taxpayer</td>
<td>When information from taxpayer indicates that W-2, W-2P or 1099 s incorrect or has not been received</td>
<td>Name and federal tax id # (SSN or TIN) of taxpayer and filer, identification of information type, incorrect information, and responsible office for reply</td>
<td>IRS</td>
</tr>
<tr>
<td>4670</td>
<td>To request relief from having to pay withholdings not withheld</td>
<td>When employer fails to withhold but employee has reported income and paid tax</td>
<td>Name and federal tax id # (TIN or SSN) of employer and employee, wage and tax information and verification that income reported and tax paid</td>
<td>Employer</td>
</tr>
<tr>
<td>4768</td>
<td>For an estate to obtain an extension of time to file estate tax return or pay estate taxes</td>
<td>When extension required or timely reporting or payment not possible</td>
<td>Name and federal tax id # (TIN or SSN) of estate and fiduciary, nature and reason of extension and approximation of amount expected to be due</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>4789</td>
<td>To record and report certain currency transactions</td>
<td>When currency/transaction s met ($10,000 in currency transactions in banking day) or staging suspected</td>
<td>Name and federal tax id # (TIN or SSN) of reporting institution and currency transactor and identification information with respect to the transaction and those participating in it</td>
<td>Financial Institution</td>
</tr>
<tr>
<td>4800</td>
<td>To instruct reporter in use of magnetic media for reporting</td>
<td>When reporter desires to report by magnetic media</td>
<td>N/A</td>
<td>IRS</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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<tr>
<td>4802</td>
<td>To transmit multiple magnetic media returns</td>
<td>When transmitting multiple returns by magnetic media</td>
<td>Name and federal tax id # (TIN) of transmitter and identification of returns and #</td>
<td>Transmitter</td>
</tr>
<tr>
<td>4804</td>
<td>To transmit information returns by magnetic media to IRS</td>
<td>When transmitting information returns by magnetic media to IRS</td>
<td>Name and federal tax id # (TIN) of magnetic media transmitter and identification of type and # of returns transmitted</td>
<td>Transmitter</td>
</tr>
<tr>
<td>5227</td>
<td>To report split interest trust information (replaces 1041 (sch. PF))</td>
<td>Annually, March 15</td>
<td>Name and federal tax id # (TIN or SSN) of trust and fiduciary and beneficiaries</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>5300</td>
<td>To apply for determination of 401(k) and 501(a) qualification</td>
<td>For initial qualification or amendment of plan</td>
<td>Name and federal tax id # (TIN or SSN) of employer and plan administrator, copy of plan and amendments</td>
<td>Employer or Plan Administrator</td>
</tr>
<tr>
<td>5300 (Sch. T)</td>
<td>To be submitted with all 5300, 5301, 5303, 5307 and 6406 determination requests</td>
<td>To accompany listed forms</td>
<td>Supplementary information to listed forms</td>
<td>Employer or Plan Administrator</td>
</tr>
<tr>
<td>5301</td>
<td>To apply for determination for defined contribution plan (401K), (k) and 501(a), profit sharing stock bonus, and money purchase plans</td>
<td>When desiring letter determining qualification</td>
<td>Name and federal tax id # (TIN or SSN) of employer and plan administrator, and copy of plan with any amendments</td>
<td>Employer or Plan Administrator</td>
</tr>
<tr>
<td>5302</td>
<td>To record and document employee census</td>
<td>When enrolling employees under plan</td>
<td>Name and federal tax id # (TIN or SSN) of employer, plan administrator and employees</td>
<td>Employer or Plan Administrator</td>
</tr>
<tr>
<td>5303</td>
<td>To apply for determination of qualification of collectively bargained agreements under 401(a) and 501(a)</td>
<td>When plan is product of collective bargaining</td>
<td>Name and federal tax id # (TIN or SSN) of employer, plan administrator, bargaining unit, and copy of plan and any amendments</td>
<td>Employer or Plan Administrator</td>
</tr>
<tr>
<td>5305</td>
<td>For use in opening an individual retirement account</td>
<td>When opening an IRA</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer and institution and account information</td>
<td>Taxpayer with institution</td>
</tr>
<tr>
<td>5305-A</td>
<td>For use in opening an individual retirement account</td>
<td>When opening an IRA</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer and institution and account information for custodial account</td>
<td>Taxpayer with institution</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
</tr>
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</tr>
<tr>
<td>5306</td>
<td>To obtain approval for prototype and employer sponsored IRAs</td>
<td>When seeking approval of employer IRA as complying IRA</td>
<td>Name and federal tax id # (TIN) of employer or prototype IRA proponent and copy of plan</td>
<td>Plan Sponsor</td>
</tr>
<tr>
<td>5452</td>
<td>To report distribution of non-taxable dividends</td>
<td>At the end of calendar year of any non-taxable dividends</td>
<td>Name and federal tax id # (TIN or SSN) of corporation making distribution amount of distribution and basis for claiming exemption</td>
<td>Corporation</td>
</tr>
<tr>
<td>5498</td>
<td>To report IRA/SEP/Employer contributions received by IRA/SEP/pension plan</td>
<td>May 31 with respect to the prior tax year</td>
<td>Name and federal tax id # (TIN or SSN) of institution, account holder and, if different, beneficiary, amount of contributions during most recent tax year and value of account</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>5498-ESA</td>
<td>To report any contribution to Coverdell ESA</td>
<td>May 31 with respect to the prior tax year</td>
<td>Name and federal tax id # (TIN or SSN) of institution, account holder and, if any beneficiary, amount of contributions during most recent tax year and value of account</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>6123</td>
<td>To verify a fiduciary’s tax deposit</td>
<td>When fiduciary makes tax deposit</td>
<td>Name and federal tax id # of estate or trust and fiduciary, amount of tax deposit and verification by institution</td>
<td>Institution/ Fiduciary</td>
</tr>
<tr>
<td>6166</td>
<td>To certify that a tax return has been filed</td>
<td>Upon request when return filed</td>
<td>Name and federal tax id # (SSN or TIN) of taxpayer and name and office of certifying officer</td>
<td>IRS</td>
</tr>
<tr>
<td>6466</td>
<td>To transmit magnetic tape of W-4 with holding certificate</td>
<td>When transmitting W-4 by magnetic tape</td>
<td>Name and federal tax id # (TIN) of employer</td>
<td>Employer</td>
</tr>
<tr>
<td>6467</td>
<td>To transmit magnetic tape of W-4 with holding certificate from multiple employees</td>
<td>When transmitting W-4 by magnetic tape for multiple employers</td>
<td>Name and federal tax id # (TIN) of all employers represented and transmitting employer agent</td>
<td>Agent</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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</tr>
<tr>
<td>6494</td>
<td>To make correction of W-3 transmittal</td>
<td>When W-3 transmittal in error</td>
<td>Name and federal tax id (SSN or TIN) of payer/withholding agent, identification of incorrect information and correct information</td>
<td>Trustee/Payer</td>
</tr>
<tr>
<td>6559</td>
<td>To report transmittal of magnetic media filings</td>
<td>When filing effected by magnetic media</td>
<td>Name and federal tax id # (SSN or TIN) of transmitter, identification of type and quantity of transmittal</td>
<td>Institution/Payer</td>
</tr>
<tr>
<td>6560</td>
<td>To summarize W-2 magnetic media wage information</td>
<td>When filing by magnetic media</td>
<td>Name and federal tax id # (TIN or SSN) of employer and summary of wage and withholding</td>
<td>Employer</td>
</tr>
<tr>
<td>6561</td>
<td>To summarize W-2P magnetic media pension information</td>
<td>When filing by magnetic media</td>
<td>Name and federal tax id # (TIN) of payer and summary of pension and withholding information</td>
<td>Payer</td>
</tr>
<tr>
<td>6637</td>
<td>To obtain information to aid in the collection of taxes</td>
<td>When IRS determines to effect collection from taxpayer assets and lacks information</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, name of responsible agent and office</td>
<td>IRS</td>
</tr>
<tr>
<td>6638</td>
<td>To obtain information to aid in the collection process to review or generate an income tax return</td>
<td>When IRS desires additional information to review tax return</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, name of responsible agent and office, and identification of information or documentation desired</td>
<td>IRS</td>
</tr>
<tr>
<td>6639</td>
<td>To obtain financial records in course of collection process</td>
<td>When IRS determines necessary to process collection</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, name of responsible agent and office, and identification of financial records sought and name of party to deliver records</td>
<td>IRS</td>
</tr>
<tr>
<td>6735</td>
<td>To compute penalties</td>
<td>When required to pay a penalty</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, reason for penalty, computation of penalty</td>
<td>Taxpayer and IRS</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
</tr>
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</tr>
<tr>
<td>6847</td>
<td>To consent to the IRS’s release of tax information</td>
<td>When taxpayer desires IRS to release tax information</td>
<td>Name and federal tax id # (SSN or TIN) of taxpayer and identification of information to be released and to whom release is authorized</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>6863</td>
<td>To submit billing to IRS for responding to summons to produce</td>
<td>When financial institution or 3rd party desires reimbursement</td>
<td>Name and federal tax id # (SSN or TIN) of taxpayer and responding party and documentation and substantiation of billing for production of financial records</td>
<td>Financial Institution or 3rd Party Respondent</td>
</tr>
<tr>
<td>6868</td>
<td>To become qualified as appraiser by IRS</td>
<td>When IRS qualification desired</td>
<td>Name and federal tax id # (SSN or TIN) of appraiser, listing of qualifications and references</td>
<td>Applicant</td>
</tr>
<tr>
<td>7004</td>
<td>To obtain automatic extension of time to file corporate income tax return</td>
<td>When additional time required to prepare and file return</td>
<td>Name and federal tax id # (TIN) of taxpayer, estimate of tax due, substantiation of estimated tax deposits, remittance of balance</td>
<td>Corporate Taxpayer</td>
</tr>
<tr>
<td>7018</td>
<td>To obtain blank W-2, W-4, 940, 941a, 1096 and 1099</td>
<td>When required</td>
<td>Name, address and federal tax id # (SSN or TIN) of employer</td>
<td>Employer</td>
</tr>
<tr>
<td>8087</td>
<td>To request missing or incomplete W-2 or W-3 information</td>
<td>When necessary</td>
<td>Name and federal tax id # (TIN or SSN) of parties, employer, employees, etc.</td>
<td>Requesting Party</td>
</tr>
<tr>
<td>8109</td>
<td>To accompany tax deposit</td>
<td>When making tax deposit</td>
<td>Preinscribed</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>8109-B</td>
<td>To accompany tax deposit when 8109 not available</td>
<td>When making tax deposit</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, amount and type of deposit</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
</tr>
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</tr>
<tr>
<td>8210</td>
<td>To self-assess penalties for payers of interest or dividends for information returns either not supplied to payee, not filed on time, on magnetic media or with incorrect TIN</td>
<td>When required</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, information regarding basis of penalty and computation of penalty</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>8281</td>
<td>To provide information from issuer of publicly offered OID instruments</td>
<td>Upon issuance of publicly traded OID instruments</td>
<td>Name and federal tax id # (TIN or SSN) of issuer, amount of issuance, gross and expected net and return, and return and reporting duties</td>
<td>Issuer</td>
</tr>
<tr>
<td>8300</td>
<td>To report cash payments in excess of $10,000 received in trade or business</td>
<td>When trade or business receives cash payment of $10,000.00</td>
<td>Name and federal tax id # (TIN or SSN) of business or trade receiving payment and person or party and amount of payment</td>
<td>Business or Trade</td>
</tr>
<tr>
<td>8329</td>
<td>To be filed by any lender making loans that are certified indebtedness on any Mortgage Credit Certificates</td>
<td>Annually</td>
<td>Name and federal tax id # (TIN or SSN) of lender, amounts of loans and certificates</td>
<td>Issuer</td>
</tr>
<tr>
<td>8330</td>
<td>Quarterly information return for issuers of Mortgage Credit Certificates</td>
<td>Last day of first month following end of quarter</td>
<td>Name and federal tax id # (TIN) of issuer, description of issue, amount of issue and any distributions</td>
<td>Issuer</td>
</tr>
<tr>
<td>8396</td>
<td>Used by Mortgage Credit Certificate holders to figure interest credit and carryover</td>
<td>When reporting interest income derived from Mortgage Credit Certificate</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>8453-F</td>
<td>For fiduciary to file income tax return by magnetic media or electronic filing</td>
<td>When electing to file by magnetic media or electronic filing</td>
<td>Name and federal tax id # (TIN or SSN) of estate or trust and fiduciary and election</td>
<td>Fiduciary</td>
</tr>
<tr>
<td>Form #</td>
<td>Purpose</td>
<td>When Required</td>
<td>Information Required</td>
<td>Filing Party</td>
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</tr>
<tr>
<td>8508</td>
<td>To obtain a waiver from magnetic media filing requirements</td>
<td>When seeking waiver from magnetic media filing requirements for information returns</td>
<td>Name and federal tax id # (TIN or SSN) of taxpayer, type of returns for which waiver sought and # of returns, reason for requesting waiver and any documentation or substantiation</td>
<td>Payor/Reporter</td>
</tr>
<tr>
<td>8546</td>
<td>To obtain reimbursement for bank charges incurred due to erroneous levy</td>
<td>When reimbursement sought</td>
<td>Name and federal tax id # (SSN or TIN) of taxpayer, documentation of bank charge and substantiation of that levy in error</td>
<td>Taxpayer</td>
</tr>
<tr>
<td>8809</td>
<td>To obtain an extension of time to file information returns</td>
<td>When additional time required to file W-2, W-2P, 1098, 1099, 5498 and W-2G</td>
<td>Name and federal tax id # (TIN or SSN) of payer/reporter, type of return for which extension sought, reason for extension and substantiation and documentation in support</td>
<td>Payor/Reporter</td>
</tr>
<tr>
<td>8811</td>
<td>For Real Estate Mortgage Investment Conduit to report information</td>
<td>Annually, March 15</td>
<td>Name and federal tax id # (TIN) of conduit and necessary information and documentation to determine income and expenses and distributions of conduct</td>
<td>Real Estate Investment Conduit</td>
</tr>
</tbody>
</table>
Audit and Audit Committee Regulations

Summary
The Federal Deposit Insurance Corporation Improvement Act (FDICIA) required the FDIC to establish, by regulation, requirements for auditing banks’ financial and other statements and for audit committees in banks. Many banks that are subject to the audit and reporting requirements of the FDIC are also subject to the requirements of the Sarbanes-Oxley Act of 2002. See the chapter on Sarbanes-Oxley for more details.

In the FDIC’s regulation, all banks with assets of $500 million or more are subject to the major portions of the rules. In 2005, the FDIC proposed increasing the threshold to $1 billion for internal control assessments by management, attestations regarding such assessments by external auditors, and the requirement that members of the audit committee be independent of management. The rule became effective December 28, 2005. 12 CFR 363

Banks with assets of $3 billion or more (deemed to be “large” banks) are subject to more stringent requirements in terms of audit committee composition and access to counsel. All banks that are considered “small” today (under a half-billion in assets!) are totally exempted. Banks with half a billion to $3 billion in assets are subject to the major part of the regulation and “large” banks, which have $3 billion or more in assets, have additional requirements that their audit committees must meet.

Every institution covered by this set of rules is required to file with the FDIC, within 90 days after the end of the institution’s fiscal year, an annual report containing financial statements audited by an independent auditor. (Banks that are subsidiaries of bank holding companies are granted certain limited authority to file parent-company statements.

The independent auditor must (1) review and (2) attest to the effectiveness of the institution’s (a) internal controls and (b) compliance with designated regulations on safety and soundness. These regulations are the federal rules on loans to insiders and the federal and state rules on dividend restrictions.

Every bank covered by the audit rules is required to have an audit committee composed entirely of outside directors that reviews the audit findings with management and the independent auditor. Institutions having $3 billion or more in assets must have an audit committee whose members are not “large customers” of the institution, and two of the members of the audit committee must have banking or financial management experience. Furthermore, the audit committee at such an institution must have access to its own outside attorney.

Details
Within 90 days after the end of the first fiscal year during which the institution is covered by these rules, each covered institution will have to file with the FDIC (and with its primary federal bank regulatory agency if that is not the FDIC) two copies of each of the following documents:

- The bank’s annual report, which, in turn, must contain:
  - Audited financial statements
  - The independent public accountant’s report on those statements
  - Management’s statements and assessments regarding its responsibilities for financial reporting, internal control, and compliance with the regulations on insider loans and dividend restrictions
  - The independent public accountant’s attestation report on the bank’s internal control structure and procedures for financial reporting
Annual Report

The annual report financial statements must be prepared in accordance with Generally Accepted Accounting Principles (GAAP) and such other standards as the FDIC may prescribe. An institution that is a subsidiary of a bank holding company may utilize the holding company’s audited financial statements if the services and functions required by the regulation are provided at the holding company level and the institution itself has assets of less than $5 billion. If the institution’s assets are $5 billion or more, it may use its holding company’s financial statements only if it has a composite CAMELS rating of 1 or 2. The principal federal regulator of an institution with assets of over $9 billion may revoke this permission to use parent company statements by written notice to the institution. The audit itself must be performed in accordance with Generally Accepted Auditing Standards.

The annual report must contain a statement by management of management’s responsibility for establishing and maintaining an adequate internal control structure. It must also contain management’s assessment of the effectiveness of that structure, addressing each component of the structure. The FDIC recommends at least the following as components to be addressed:

- Internal control environment
- Risk assessment
- Control policies and procedures
- Communication and information systems
- Monitoring systems.

The bank’s independent auditor must attest to and report separately on management’s assertions in its report on internal controls. This attestation and report must be done according to generally accepted standards for attestation engagements. Management’s assertions about the effectiveness of the bank’s internal controls, and the CPA’s attestation in that regard, need only speak as of year-end. Management’s assessment of the bank’s compliance with the insider loan and dividend restriction laws, however, must address such compliance during the year. The FDIC has indicated that it will leave development of specific standards to the banks and their accountants.

The FDIC lists three documents as possible sources of guidance for banks in developing their own internal control standards:

- “Internal Control - Integrated Framework” by the Committee of Sponsoring Organizations of the Treadway Commission
- “Statement of Policy Providing Guidance on External Accounting Procedures for State Non-member Banks” by the Federal Deposit Insurance Corporation
- Statement on Auditing Standards No. 30, “Reporting on Internal Control” by the American Institute of Certified Public Accountants.

As to management’s reporting on the bank’s compliance with laws and regulations, the FDIC makes it plain that auditors have some self-education to accomplish. Not only must bankers know about compliance regulations, but since auditors must check bankers’ compliance with those regulations, auditors have to know them as well.

The FDIC has suggested certain procedures agreed to by the FDIC and the AICPA to enable independent auditors to attest to bank management’s statements. Refer to Schedule A to Appendix A of Part 363, “Agreed Upon Procedures for Determining Compliance with Designated Laws,” for more information.

The statute enacted by Congress states that management’s assessment of the bank’s compliance with the designated safety and soundness laws and regulations must speak “as of the end of the institution’s most recent
fiscal year.” The FDIC has gone well beyond that requirement. It requires that management’s assessment cover the entire period, not just “as of the end” of the period. The FDIC’s argument in favor of regulating beyond Congress’ grant of authority is that under the FDIC’s rule, banks will not be able to accomplish any year-end “window dressing” with respect to the compliance function.

Each bank’s annual report must be “available for inspection” by the public.

Audit Committee

Membership. Each institution with assets of between $500 million and $3 billion must have an audit committee composed entirely of outside directors who are “independent persons.” The original proposal defined the term to mean that each member must not be (and within the previous three years must not have been) a/an:

- Officer
- Employee
- Affiliate
- Associate
- Member of the immediate family of an officer or employee
- Promoter or underwriter
- Trustee for a pension or profit-sharing plan for officers or employees of the institution or any of its affiliates, or
- Holder of five percent or more direct financial interest in the institution.

In certain circumstances, the bank may be permitted to include up to two non-outsiders on its audit committee. If the bank has encountered hardships in recruiting a sufficient number of competent outside directors to serve on the audit committee, then the bank may be allowed to recruit non-outsiders with the approval of the bank’s regulator.

The preamble to the final regulation only states that the FDIC “expects boards of directors to determine if an outside director meets audit committee requirements” and says that any such determination “will be subject to review by examiners.” Based on this approach by an agency that has the power unilaterally to impose civil penalties of up to $1 million per person per violation per day, we recommend that banks’ boards of directors still give serious and well-documented consideration to the factors listed in the proposal.

For banks with assets of $3 billion or more, the audit committee must meet all the above requirements, and in addition must not have any “large customers” on it. When such a bank is a subsidiary of a bank holding company, and uses the holding company’s audit committee, that committee must not have any large customers of that bank on it. Again, the definition of this term contained in the proposal has been dropped from the final regulation, but still provides useful guidance. Under the proposal, “customer” included the director and his or her affiliates and associates, and meant that they have deposit, borrowing, or other significant relationships (such as supplying legal or insurance services, selling goods or the like) with the bank and its affiliates. “Large” meant that the dollar amount of that relationship during the immediately previous fiscal year exceeded the lesser of 15 percent of the bank’s total risk-based capital or $50 million.

Furthermore, at banks with assets of $3 billion or more, at least two members of the audit committee must have what the regulation refers to as “banking or related financial management expertise.” The final regulation leaves this judgment up to the board members, giving them no standards other than requiring that a candidate’s experience in such matters must be “significant.” Again, the proposed regulation gave specifics that are still useful, defining the required expertise as follows:

- Employment for three or more years that is financial-, accounting-, or
banking-related at an executive or professional level in:

- Business
- An institution of higher learning
- A federal or state financial institution regulatory agency

or

- Service for five or more years on:
  - The board of directors of a company in the financial services industry
  - The board of directors of an insured depository institution
  - The audit committee of any corporation, whether or not in the financial services industry.

Access to Counsel. The audit committee of a large bank, (acting as a whole body, not just the members individually) must have authority to retain its own outside counsel without obtaining approval of the bank’s board or management. The bank’s management may wish to ask the audit committee to give management an estimate of the fees of such counsel for purposes of sound budgeting for the bank as a whole, but no one is allowed to interfere in the relationship between the audit committee and its outside counsel.

Law and regulation citations:

12 USC 1831m & 12 USC 1831n
12 CFR 363

Sarbanes-Oxley

The banking industry worked under the rules described above for a number of years, with little in the way of turmoil. Then the corporate scandals of the late 1990s hit (Enron, WorldCom, etc.) and Congress felt it had to be seen “doing something” about them. The result was the Sarbanes-Oxley Act of 2002, which has now placed yet another layer of requirements on some of the financial institutions covered by the requirements described above. The institutions with the additional burdens are those that are publicly held and their subsidiaries. That is, the bank or its holding company has a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or is otherwise required to report under Section 15(d) of that Act. Only publicly held institutions are subject to Sarbanes-Oxley, but the bank regulators say they “encourage” other institutions to review the S-O requirements to see if complying with them would be beneficial in those other institutions. S-O’s requirements for publicly held institutions deal with audits, reporting, conflicts of interest, and corporate governance. The principal requirements are summarized below.

Independence. The law creates a Public Company Accounting Oversight Board and requires accounting firms that want to audit financial statements of public companies to register with it, and be audited by that board. It also imposes new requirements an accounting firm must meet to be considered “independent” of a public company, and therefore permitted to audit that client. The accounting firm is not allowed to provide that client contemporaneous nonaudit services of the following types:

- Bookkeeping or other services related to accounting records or financial statements
- Financial information systems design or implementation
- Appraisal, valuation, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing
- Management or human resources work
- Broker, dealer, investment advice, investment banking
- Legal and other services unrelated to the audit

Other (permitted) nonaudit services must be approved in advance by the audit client’s
audit committee. In fact, the client’s audit committee must approve all audit and nonaudit services in advance, as we will discuss shortly.

An accounting firm must rotate the lead and concurring audit partners at specified intervals, and keep them off that assignment for specified periods (“rotation” and “time-out” requirements). The purpose of this provision is to prevent such a partner from getting too close to the client, and perhaps letting things slip by that ought not to be allowed.

Conflicts of interest are partially addressed by a provision that says the accounting firm is not “independent” if certain officers of the client company were employed by the accounting firm and participated in the audit within the past 12 months. The relevant officers are: CEO, CFO, chief accounting officer, controller, or their equivalents, however titled.

**Audit Committee.** The public company’s audit committee must handle the appointment, compensation and oversight of the accounting firm on the audit. Each member of the audit committee must be “independent.” For this purpose, “independent” is defined as not taking any consulting, advisory, or other fee or compensation from the public company (except in his capacity as a director) and not being an officer, employee, or holder of 5% of the voting securities of the company or any of its subsidiaries.

S-O also requires a public company to disclose whether its audit committee has at least one member who is an “audit committee financial expert” and if it does not, why not. This level of expertise is defined as follows:

- Understands Generally Accepted Accounting Standards (GAAP) and financial statements
- Can assess the application of GAAP in connection with estimates, accruals, and reserves
- Has experience in preparing, auditing, analyzing, or evaluating financial statements comparable to those of this company, or has actively supervised those who do
- Understands internal controls and procedures
- Understands audit committee functions.

**Certifications.** A public company’s CEO and CFO must certify in each annual and quarterly report filed by the company that:

They have reviewed the report

- It does not contain any untrue statement of a material fact, nor does it fail to state a material fact
- The report fairly presents in all material respects the company’s financial condition, results of operations, and cash flows
- They are responsible for maintaining disclosure controls and procedures for the company; they have designed them and evaluated their effectiveness; and they have reported on the same and any changes
- They have disclosed to the auditor and audit committee any significant weaknesses in the controls and any fraud involving people involved in the controls.

**Manipulation.** S-O also prohibits insiders from misleading, coercing, manipulating, or otherwise influencing wrongly the audit firm. (All of these things were already federal and state felonies, but Congress always wants the voters to think a new law will fix a problem.)

**Corrections.** Filed financial reports must reflect any material correcting adjustments identified by the audit firm, as well as all material off-balance-sheet activities that might have a material effect on the company currently or in the future, and similar relationships with unconsolidated entities or persons.
Insider loans. S-O contains restrictions on loans to directors and executive officers. Those provisions do not apply, however, to loans that are subject to Federal Reserve Regulation O. Banks and their affiliates should continue their Regulation O compliance programs and ignore S-O on this issue.

Internal controls. A public company must include in its annual reports a statement by management that it is responsible for maintaining adequate internal controls and assessing their effectiveness. The external auditor must attest to, and report on, management’s assessment.

Reimbursement. If a public company is forced to restate its financial statements because of misconduct, the company’s CEO and CFO must reimburse the company for certain incentive compensation and stock trading profits they made based on the erroneous financial statements.

Insider trading. Executive officers and directors of public companies are forbidden to trade in the company’s stock during any period when the company’s pension fund is blocked from trading. Public companies must have procedures to notify the covered insiders when such periods approach. Insiders are also required to report to the company their trades in the company’s shares within two business days after the trade. The company, in turn, reports this information to the regulators. Electronic filing of such reports will become mandatory soon.

Code of Ethics. Bank regulators have long bullied banks into adopting these things, mostly to set the dollar threshold for a bribe under the Bank Bribery Act. Any publicly held financial institution that does not have one already will be nagged further about it. Each public company must disclose in its filed financial reports whether it has a code of ethics, and, if it does not, why not.

A sample policy can be found in our Policy Manual.
Index
Metavante Regulatory Services

Index

A
Abundance of Caution, 4.8
Access Device, 2.112
Access to Bank Services, 5.49
Accommodations, 5.56
Account Disclosure, 2.306
Account History, 4.133
Account Number, 2.201
Account, 2.281, 2.294, 3.37
Accounting, 6.1, 6.92
Accruals, 6.2
ACH Debits, 2.101
Acknowledgement, 5.19, 5.57
Acquisition or Abandonment of Secured Property, 6.41
Active Duty Alerts, 4.61
Activity Fee, 5.28, 5.38
Acts of God, 5.70, 5.77
Actual Damages, 2.26
Actuarial Tables, 3.114
ADA, 5.46
Adjustable Rate Mortgage, 2.240, 4.170
Adjustment Credit, 1.3
Administrative Procedures Act, 5.16
Adoption Taxpayer Identification Number, 6.64
Adverse Action, 2.17, 4.53, 4.54
Adverse Effect, 5.75
Advertisement, 5.26, 5.28
Advertising Regulations, 5.26
Advertising, 2.303, 2.244, 4.80, 5.15, 5.146
Advisory Opinions, 3.94
AfBA, 4.110
Affiliate, 2.154, 2.192, 2.217, 2.161, 2.270
Affiliate Marketing, 4.51, 4.59, 4.60, 4.63
Affiliate Sharing, 4.59
Affiliated Business Arrangement Disclosure, 4.126
Affiliated Business Arrangements, 4.106, 4.109
Affiliates, 4.59

Affordable Housing, 2.269
African Development Bank, 6.36
Age 59 1/2, 3.109, 3.114
Age 70 1/2, 3.109
Age, 2.1
Agent, 3.93
Aggregate Accounting Adjustment, 4.115
Aggressive Growth, 5.13
Agreed Upon Procedures for Determining Compliance with Designated Laws, 6.93
Agreement, 4.109
AICPA Practice Bulletin 7, 6.25
AIDS, 5.46
Aliases, 3.34
Aliens, 6.47
Alimony, 2.4
Allowance for Loan and Lease Losses, 6.28
American Bankers Association, 1.15
American Institute of Certified Public Accountants, 6.25, 6.93
American Stock Exchange, 3.12
Americans with Disabilities Act, 5.46
Amortization, 6.2
Annual Analysis, 4.117
Annual Audit, 6.98
Annual Budget and Review, 5.7
Annual Escrow Account Disclosure Statement, 4.131
Annual Escrow Account Statement, 4.119
Annual Percentage Rate, 2.245, 5.33
Annual Percentage Yield Earned, 2.310
Annual Percentage Yield, 2.304, 5.29, 5.30
Annual Report, 5.28, 6.92
Anti-Money Laundering (AML) Programs, 3.44, 3.87
Anti-Tying Disclosures, 5.18, 5.25
Anti-Tying Provisions, 5.98
Anything of Value, 5.56
APO, 3.37
Application Fees, 2.223
Application, 2.44, 2.59
Appraisals, 1.3, 2.23, 2.44, 2.134, 2.224, 4.7, 4.80
Appraiser Engagement Letter, 4.49
Appraiser Standards, 4.7
Appraisers, 4.31
APY, 2.304
Area Median Income, 2.267
Armed Forces, 4.151
Article 5, 3.145
Article 8, 3.146
Article 9, 3.147
Asian Development Bank, 6.36
Assessment Area, 2.266
Asset Growth, 5.68
Asset Liability Management, 6.17, 6.32
Asset/Liability Risk, 6.10
Assignment of Wages, 2.258
Associate, 6.94
ATM, 2.107, 2.281, 2.308, 5.9, 5.70
Attorney Fees, 2.27
Attorney, 5.56, 6.92
Audit Committee Regulations, 6.92
Audit Committee, 3.51
Audit Report, 3.51
Audit, 1.2, 6.92, 6.93
Auditor, 6.5
Authorized Agents, 3.138
Automated Clearing House, 2.290, 3.153
Automatic Renewal, 2.103
Availability, 2.299
Available For Withdrawal, 2.290
Available-For-Sale Securities, 6.10
Average Daily Balance Method, 2.304
Award, 5.57, 6.60

B
Backup Arrangements, 5.79
Backup Withholding, 6.63, 6.64, 6.65, 6.66, 6.68
Bad Debt Expense, 6.7
Balance Sheet, 6.8
Balloon Payment, 5.35, 5.41
Bank Borrowing Policy, 5.7
Bank Bribery Act, 5.56
Bank Checks, 2.282
Bank for International Settlements, 6.16
Bank Holding Company Act, 5.98
Bank Holding Company, 2.218
Bank Policy, 5.6
Bank Protection Act, 5.2
Bank Secrecy Act (BSA) Officer, 3.51
Bank Secrecy Act, 3.1, 3.51
Bank Security and Protection Policies, 5.7
Bank Security Officer, 5.2
Bank Security, 2.136
Bank Service Company Act, 5.145
Banker’s Acceptances, 6.23
Banking Day, 2.281
Banking or Financial Management Experience, 6.92
Bankruptcy Trustee Accounts, 3.95
Bankruptcy, 3.95
Basel II, 6.21
Basic Banking Functions, 5.122
Basic Financial Services, 3.150
Beneficiary, 3.18, 3.92, 3.124
Beneficiary’s Bank, 3.18, 3.22, 3.124
Benefits, 5.68
Billboards, 5.18, 5.30
Billing Errors, 2.226
Birth-Given Surname, 2.5
BIS Capital Ratios, 6.16
Blocking, 5.120
B-Notice Model Text, 6.69
B-Notices, 6.63
Board Meetings, 5.6
Board Notification, 3.34
Board of Directors, 5.1, 5.2
Board Package, 5.6
Bona Fide Collection Activity, 6.43
Bona Fide Personal Financial Emergency, 2.243
Bond, 3.144
Bonds, 5.14
Bonus, 2.304, 2.308, 5.29, 5.39, 6.47
Book-Value, 6.8
Branch Closings, 5.70
Branching, 1.3, 2.132
Metavante
Regulatory Services

Breakpoint, 5.15
Bribery, 5.56
Bridge Loan, 2.254
Broadcast Media, 5.29
Brochure, 5.15
Broker Rule, 2.61
Broker, 4.107
Brokered Deposits, 3.97
BSA Officer, 3.53
Business Associates, 5.137
Business Day, 2.111, 2.222, 2.253, 2.281, 2.304, 3.2
Business Judgments, 5.5
Business Necessity, 2.14
Business Purpose, 4.103

C
Call Report, 4.181, 6.17
CAMEL Rating, 5.130, 6.17, 6.93
Campaign Committee, 2.154
Canada, 6.37
Canadian Residents, 6.48
Cancellation Date, 4.170
Cancellation of Debt, 6.42
Cancellation, 4.173
CAN SPAM, 5.45.2
Capital Adequacy, 2.132
Capital Weights, 6.18
Capital, 1.3
Carrying Credit, 2.206
Case-by-Case Exceptions, 2.287
Cash Flow, 6.11
Cash, 2.283
Cash-Back, 3.52
Cashier's Check, 2.290, 3.143
Cashiers, Certified or Teller's Checks, 2.283
Cash-Intensive Businesses, 3.44
Casualty Insurance, 2.224
Cease-and-Desist Order, 5.95
CERCLA, 4.18
Certificated, 2.211
Certified Inspectors, 4.163
Challenge Procedure, 2.147
Change in Terms Notice, 2.234, 2.309
Change of Address, 4.64

Charge-off, 4.181
Charges, 6.47
CHARM Booklet, 2.240
Check 21, 2.292
Check Cashing Services, 3.47
Check Charges, 5.28
Check Reorder, 5.28
Check, 2.290
Check-Printing Fees, 2.308
Check-Processing Region, 2.290
Checks Processed, 3.27
Checks, 1.4
Child Support, 2.4
Children's Online Privacy Protection Act, 5.148
CIP, 3.37
Citation Table, 4.1
Civil Money Penalties, 5.96
Claims and Defenses, 2.246
Classify, 4.182
Closed-End Lease, 2.149
Closed-End Loans, 4.181
Closed-End, 4.181
Closing Branches, 2.270
Closing Statement, 4.106, 6.52
Club Accounts, 2.314
CMIR, 3.40
Co-Applicant, 4.54
Coastal Barrier Resources Act, 4.42
Code of Ethics, 6.97
Cod of Federal Regulations, 1.18
Collateral, 3.117, 3.147
Collection Agency, 4.74
Collection Practices, 2.3
Collection, 2.144
Collective Investment Funds Policies, 5.7
Color, 2.1, 4.79
Commercial Letters of Credit, 6.24
Commercially Reasonable, 3.125
Commingled Funds, 3.15
Commitment Fee, 6.1
Commitment, 6.4
Committee of Sponsoring Organizations, 6.93
Metavante
Regulatory Services

Committee on Uniform Securities Identification Procedures, 2.213
Common Stock, 5.14, 6.4
Common Stockholder Equity, 6.18
Communication Equipment, 5.78
Community Development Corporations, 2.269
Community Development Loans, 2.268
Community Development, 2.269
Community Reinvestment Act, 2.266, 5.11
Comparative Negligence, 2.297
Compensation, 5.68
Compliance Calendar, 1.22
Compliance Committee, 1.45
Compliance Manager, 1.29
Compliance Officer, 1.28, 5.11
Compliance Risk, 5.127, 5.142
Compliance, 5.1
Compounding, 2.309, 2.313
Comprehensive Environment Response, Compensation, and Liability Act (CERCLA), 4.18
Comptroller of the Currency, 5.71
Compulsive Gambling, 5.46
Computer Intrusion, 3.34
Computer Loan Origination (CLO) Systems, 4.109
Computer Operations, 5.77
Concentration Accounts, 3.86
Concentration of Credit Risk, 5.67
Condominiums, 4.34
Confession of Judgment, 2.257
Confidential Treatment, 5.72
Confidentiality, 3.34
Conflicts of Interest Policy, 5.8
Conservator, 3.93
Construction Loans, 4.30
Construction, 4.30
Consumer Account, 2.290
Consumer Leasing, 2.149
Consumer Loans, 2.269, 2.275
Consumer Price Index, 4.115
Consumer Purpose, 4.155
Consumer Report, 4.52, 4.60
Consumer Reporting Agency, 4.52
Consumer, 2.191, 2.221, 2.256, 2.294, 2.303, 4.51, 5.17
Contingency Planning, 5.77
Contribution Limits, 3.108, 3.110, 3.111, 3.112
Conversion Ratios, 6.18
COPPA, 5.148
Core Deposit Intangibles, 6.4
Corporate Bond, 5.13
Correspondent Accounts, 3.76, 3.83, 3.85
Correspondent, 2.131
Cosigner, 2.258
Cost/Benefit Analysis, 5.78
Counsel, 6.94
Counteroffer, 2.18
Coupon Book, 2.255
Court Order, 5.85
Coverage, 4.73, 4.102, 4.151
Coverdell Education Savings Account (ESA), 3.110, 6.63, 6.58
Covered Person, 5.17
Covered Transaction, 2.217
CRA Assessment Factor G, 5.72
Credit Balance, 2.254
Credit Bureau, 4.58
Credit Card, 2.155
Credit Exposure, 2.124
Credit History, 2.6
Credit Life, 2.224
Credit Line, 2.155
Credit Policies, 2.13
Credit Report, 2.224
Credit Reporting Agency, 2.19
Credit Risk, 5.127, 5.141
Credit Sale, 5.41
Credit Score, 4.62
Credit Scoring System, 2.6
Credit Underwriting, 5.66
Crediting, 2.313
Creditworthy Co-Guarantors, 2.10
Creditworthy Cosigner, 2.8
CTR Exemptions, 3.50
CTR, 3.1
Cuba, 5.120
Cumulative Gap, 6.32
Cumulative Preferred Stock, 6.16
Currency Transaction Reporting, 3.1
Current Market Value, 2.206
Cushion, 4.113
CUSIP Numbers, 2.213
Custodial Accounts, 3.107
Custodian, 3.92, 3.93
Customer Confidentiality, 5.88
Customer Consent, 5.84
Customer Identification Program, 3.1, 3.36, 3.73
Customer Not Present, 3.60, 3.80
Customer Taxpayer Identification Number, 6.63
Customer, 2.191, 5.17
Cutoff Hour, 2.146
Cyber-Terrorists, 5.145

D
Data Files, 5.79
Date of Birth, 3.37
Death of a Depositor, 3.91
Death, 3.115, 6.58, 6.60
Debit-Card Transactions, 2.112
Debt Collector, 4.73
Debt Previously Contracted, 2.218
Debt Securities, 2.211
Deceptive, 1.5
Decimal Places, 2.327
Declaration of Loss, 3.144, 3.149
Deferred Compensation, 6.4
Deferred Fees, 6.2
Deferred Sales Charges, 5.15
Deferred, 4.182
Deficiency, 4.113, 4.118
Definitions, 4.51
Deliberation, 5.5
Delineated Community, 2.267
Delinquent, 4.155
Demand Deposit, 1.4, 2.202, 3.94
Demand Provision, 2.188
Department of Housing and Urban Development (HUD), 4.102, 4.155
Department of Justice, 5.46
Dependents, 4.151
Deposit Advertisements, 5.39
Deposit Insurance, 5.15, 5.26
Deposit Liabilities, 6.4
Deposit Slips, 2.286
Depository Bank, 2.145
Deposits, 5.26
Depreciation, 6.1
Designation of Exempt Person Form, 3.55, 3.54
Designation of Exempt Person, 3.13
Destroyed, 3.144
Determinations, 4.31
Diligent, 5.5
Directors' Audit, 5.7
Directors' Oaths and Qualifications, 5.8
Directors, 1.44, 2.154
Disability, 6.60
Disagreements, 6.99
Disaster Recovery Plan, 5.2
Disaster Recovery, 5.7, 5.77
Disaster, 5.72, 5.77
Disbursement, 4.115
Discharge of Debt, 6.43
Disclosure Errors, 2.314
Discount Brokerage Supervisory Policy, 5.7
Discount Window, 1.3
Discounting Method, 6.7
Discounts, 5.56
Discourage, 2.3
Discouraging Applications, 4.80
Discriminate, 1.3
Discrimination in Services, 5.49
Discrimination, 2.3, 2.45, 4.79, 5.32, 5.72
Disparate Effect, 2.3
Disparate Impact, 2.3, 2.14
Disparate Treatment, 2.3, 2.11
Distribution, 6.58
Diversification Requirements, 6.38
Diversification, 5.14
Dividends and Distributions, 6.45
Dividends, 2.132
Divorced, 2.1
Document Preparation, 2.224
Documentation, 5.79
Dollar Thresholds, 3.30
Domestic Banks, 3.12
Domestic Violence, 5.17
Do Not Call List, 5.45.2, 5.45.6
Do Not Call Fax Rules, 5.45.2, 5.45.8
Dormancy Period, 4.64
Dormant, 4.64
Double Tax-Exempt Funds, 5.13
Doubtful, 4.183
Down Payment, 5.35
Drawee Bank, 2.145
Duration Analysis, 6.33
Dwelling, 2.57, 2.221

E
Early Truth-In-Lending Disclosures, 2.254
Early Withdrawal Penalty, 2.102, 2.315, 5.30, 6.47, 6.48, 6.51
Early Withdrawal, 2.309
Earthquake, 5.70, 5.77
ECOA, 4.79, 5.146
e-Commerce, 5.140
Economic Growth and Tax Relief Reconciliation Act of 2001, 3.107
Edge Corporations, 1.4
Educational IRA, 3.106
Educational Savings Account, 3.119
Effective Date, 4.112
Electronic Debits, 2.292
Electronic Fund Transfer Act, 2.111
Electronic Fund Transfers, 1.3
Electronic Payment, 2.282, 2.283, 2.290
Eligibility, 3.108, 3.109, 3.110, 3.112
Eligible Organizations, 3.102
Emergency, 2.282, 2.300
Employer Identification Number, 6.64
Employer Sponsored IRAs, 3.120
Employment Application, 5.48
Employment References, 3.87
Employment, 5.47
Encoding, 3.142
Enforcement, 5.73
Entertainment, 5.56, 5.59
Environmental Protection Agency (EPA), 4.158
Epilepsy, 5.46

Equal Credit Opportunity Act, 2.1
Equal Employment Opportunity Commission, 5.48
Equal Housing Lender Logo and Legend, 5.32
Equal Housing Lender Notice, 5.8
Equal Housing Lender, 4.81, 5.32
Equity Instruments, 6.4
Equity Investments, 6.4
Equity Securities, 2.211
Error Resolution, 2.115
Escrow Account, 3.102, 4.113
Escrow Analysis, 4.114
Escrow, 2.224, 4.37
E-Sign Act, 5.147
Essential Functions of Each Job, 5.47
Established Customers, 3.21
Estate Lending Standards, 4.90
Estates, 5.122
Evaluation, 4.7, 4.12
Examination Frequency, 2.134
Examination Review, 5.7
Examiner Trainees, 1.43
Examiners, 1.42
Exception Hold, 2.284
Exception Procedure, 6.40
Excess Capacity, 5.79
Excess Contributions, 6.60, 6.61
Excess Transactions, 2.101
Excise Tax, 3.114
Exclusions, 3.34
Executive Officers, 2.153
Exempt Functions, 4.73
Exempt List, 3.13
Exemptions, 4.8, 4.103
Exhibitionism, 5.46
Existing Customers, 3.39
Expedited Funds Availability Act, 2.281
Expedited Recredit, 2.297
Extended, 4.182
Extension of Credit, 2.155

F
Facilities, 5.78
Failure of Equipment, 2.300
Fair and Accurate Credit Transactions Act of 2003 (FACT Act), 4.51, 4.60
Fair Credit Billing Act, 2.255
Fair Credit Reporting Act, 4.51
Fair Debt Collection Practices Act, 4.73
Fair Housing Act, 4.79, 5.32, 5.146
Fair Housing Home Loan Data System (FHHLDS) Worksheet (National Banks), 4.88
Fair Housing Poster, 4.81
Fair Lending, 2.34
Fair Market Value, 6.42
Fair Value, 6.3, 6.9, 6.11
Familial Status, 4.79
Family, 5.32
Fannie Mae, 3.12, 4.9
FAS 107, 6.3
FAS 114, 6.6
FAS 115, 6.8
FAS 122, 6.11
FAS 15, 6.6
FAS 5, 6.6
FATF, 3.44
FDIC, 4.51
FDIC Improvement Act, 4.90, 5.5, 5.63
FDIC Insurance Certificate Number, 4.39
FDIC Insurance, 2.103, 3.88, 5.146
FDIC Logo, 5.15
FDIC Sign, 5.9
Federal Consumer Credit Protection Act, 2.1
Federal Deposit Insurance Corporation Improvement Act, 2.163
Federal Deposit Insurance Corporation, 5.71
Federal Emergency Management Agency (FEMA), 4.29
Federal Financing Bank, 6.37
Federal Home Loan Bank, 6.37
Federal Register, 1.18
Federal Reserve Act, 2.164
Federal Reserve System, 5.71
Federal Trade Commission (FTC), 4.51
Fee, 2.308
FFIEC Form 004, 2.161
FHLMC, 4.9
Fiduciaries, 4.19
Fiduciary Accounts, 3.92
Fiduciary, 3.92
Filing Time Frames, 3.33
Finance Charge, 2.222, 5.34
Financial Accounting Standards, 6.1
Financial Institution, 2.192
Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 2.55, 4.7
Financial Institutions, 3.28
Financial Instrument, 6.3
Financial Privacy, 5.84
Financial Record, 2.203
Financial Reporting, 6.92
Financial Resources, 5.53
Financial Status, 5.14
Financial Subsidiaries, 2.134
FinCEN, 3.26, 3.27
FINS Number, 2.212
Fire, 5.77
FIRREA Enforcement and Civil Penalty, 5.95
First Mortgage, 6.24
Fiscal Years, 6.10
Fixed Rate Loans, 4.171
Fixed-Rate Account, 2.304
Floating-Rate Loans, 6.7
Floating-Rate Note, 3.141
Flood Hazard Determination Form, 4.31
Flood Insurance Determinations, 2.224
Flood Insurance, 1.3, 1.7, 2.133, 4.29
Flood Map, 4.29
Flood-Hazard Area, 4.29
FNMA, 4.9
Forced or Liquidation Sale, 6.3
Force-Placed Insurance, 4.36
Foreclosed Assets, 6.26
Foreclosure Sales, 4.162
Foreclosure, 6.41
Foreign Asset Control Regulations, 5.120
Foreign Branches, 5.74
Foreign Correspondent Banking, 3.45
Foreign Exchange Risk, 5.128, 5.142
Metavante
Regulatory Services

Foreign Tax, 6.46
Forfeited Interest, 6.47
Forgeries, 3.141
Form 1042-S, 6.48
Form 1098-E, 6.56
Form 1099-A, 6.41
Form 1099-B, 6.42
Form 1099-C, 6.42
Form 1099-DIV, 6.45
Form 1099-G, 6.46
Form 1099-INT, 2.202, 6.46
Form 1099-MISC, 6.49
Form 1099-OID, 6.51
Form 1099-PATR, 6.52
Form 8606, 3.115
Form W-7, 6.64
Form W-8, 6.47
Formal Requests, 5.84
Forward Collection, 2.144
Forward-Collection Test, 2.147
FPO, 3.37
FR U-1, 2.208
Fraud Alerts, 4.60
Fraudulent Loans, 4.181
Freddie Mac, 3.12, 4.9
Free Copy, 4.63
Free Money, 5.35
Free Ride Period, 2.225
Free, 5.28
Freezing, 5.120
Fringe Benefits, 6.1
FTC Telemarketing Rules, 5.45.2
Funding Strategy, 6.36
Funds Transfer Agreement, 3.131
Funds Transfer Records, 3.26
Funds Transfers, 3.1, 3.18, 3.123
Good Faith, 2.297, 3.141
Good Payment History, 4.171
Goodwill, 6.18
Government Agency Securities, 6.16
Government Checks, 2.283
Government Entity, 3.94
Government Guarantee, 5.12
Government Monitoring Information, 2.63
Government Payments, 6.46
Government Securities, 2.125
Governmental Units, 3.102
Grace Period, 2.304, 2.310
Gramm-Leach-Bliley Act, 1.4, 1.7
Grantor, 3.92
Gross Revenues, 2.275
Growth Stock, 5.13
Guarantees, 2.9, 2.150
Guaranties, 6.4
Guarantor, 4.54, 4.55, 6.45, 6.72
Guardian, 3.92

H
Handicap, 4.79
Handicapped, 5.33
Hardware, 5.77
Hazardous Waste, 4.20
Health Care Clearinghouses, 5.138
Health Insurance Portability and Accountability Act of 1996, 1.7, 5.137
Held-to-Maturity Securities, 6.8
High Risk Customers, 3.44
High Risk Loans, 4.171
High Risk Transactions, 3.44
High-Risk Investments, 5.13
Historical Cost, 6.3
Historical Example, 2.240
Historical Loss Rate, 6.29
Historical Perspective, 6.8
HIV, 5.46
HMDA Help Line, 2.267
Holder-In-Due-Course, 2.246, 3.140
Holding Company, 5.98
Home Equity Booklet, 4.104
Home Equity, 4.181
Home Improvement Loan, 2.58

G
Gains Trading, 6.8
Gap Analysis, 5.68, 6.32, 6.34
General License, 5.121
Generally Accepted Accounting Principles (GAAP), 6.1, 6.5
Geographies, 3.44
Gifts, 5.56, 5.58
Global Certificate, 2.211
Good Faith Estimate (GFE), 4.104

Metavante
Metavante
Regulatory Services

Investments, 2.133
IRA, 2.103
Irrevocable Trust, 3.92, 3.93
IRS Filings and Reports, 6.73
IRS Form 1098, 6.53, 6.54
IRS Form 1099, 6.41
IRS Form 1099-Q, 6.58
IRS Form 1099-R, 6.59
IRS Form 5498, 6.61
IRS Form 5498-ESA, 6.63
IRS Form W-9, 6.65

J
Job Descriptions, 5.63
Joint Accounts, 3.89, 3.142, 5.123
Joint Applicants, 2.10, 2.19
Joint Borrowers, 6.53
Joint Payees, 3.141
Joint Tenants, 2.9
Jointly and Severally Liable, 6.44

K
Keogh, 2.103
Key Factors, 4.62
Kickbacks, 4.107
Kleptomania, 5.46
Know Your Customer, 3.69
Knowledge, 3.2, 3.17
Known to Us, 3.39

L
Large Customers, 6.92, 6.94
Large Deposits, 2.285
Late Charges, 2.257, 2.259
Late Fees, 6.54
Lead-Based Paint, 4.158
Leap Year, 2.327
Leases, 6.52
Leasing, 1.4
Ledger Balance, 2.312
Legal Equivalence Legend, 2.295
Legal Risk, 5.143
Legally-Equivalent Substitute, 2.292
Legitimate Business Purpose, 4.55
Lender-Paid Private Mortgage Insurance, 4.175
Lending Limit, 2.157
Lending Policies and Limits, 5.3
Lending Test, 2.268
Less Favorable Terms, 4.62
Lessee, 4.159
Letter of Map Amendment (LOMA), 4.31
Letter of Map Revision (LOMR), 4.31
Letters of Credit, 2.133, 3.145
Leverage Ratio, 2.126, 6.17
Libya, 5.120
Licensed, 4.8
Licenses, 5.122
Licensing, 5.20
Life Estates, 6.52
Life Expectancy, 3.114
Life of Loan, 4.34
Liquidation Distributions, 6.46
Liquidation Values, 6.25
Liquidity Risk, 5.127, 5.141
Liquidity, 6.10, 6.38
List, 4.105
Loan Administration, 5.66
Loan and Lease Loss, 6.28
Loan Application Register, 1.3, 2.64
Loan Application, 5.66
Loan Commitments, 6.24
Loan Demand, 6.36
Loan Documentation, 5.63, 5.65
Loan Fee, 5.41, 6.1
Loan Files, 2.45
Loan Modification, 4.104
Loan Portfolio Management Policy, 5.7
Loan Purchases, 6.2
Loan Sales, 6.2
Loans, 5.31
Loan-To-Deposit Ratio, 2.271
Loan-to-Value Limits, 4.92
Loan-to-Value, 4.92, 4.182
Lobby Boards, 5.28, 5.30
Local Check, 2.281, 2.284, 2.290
Lockbox, 2.283, 3.141
Logical Verification, 3.38
Long Positions, 6.40
Loss of Eligibility, 3.98
Loss of Hearing and/or Vision, 5.46
Loss Reserves, 6.16
Metavante
Regulatory Services

Loss, 4.183
Lost, 3.144
Lotteries, 5.45.1
Low- and Moderate-Income, 5.72
Low-Income, 2.267, 4.80

M
Magnetic Media, 2.70, 6.44, 6.56
Maiden Name, 2.5
Maintenance Charges, 5.28
Major Life Activities, 5.46
Major Policy-Making, 2.153
Management and Supervision, 5.2
Management Fee, 5.13
Management Interlock, 1.4
Mandatory Distribution Rules, 3.114
Manipulation, 6.96
Manufactured Home, 2.57
Margin Call, 2.207
Margin Stock, 1.4, 2.206
Marital Status, 2.1
Market Value Measurement, 6.3
Market Value, 6.3
Marketing, 2.315
Mark-to-Market Accounting, 6.3
Match, 3.27
Material Discrepancies, 3.38
Matricula Consular (MC) Cards, 3.37
Maturity Date, 2.309
Maturity, 6.38
Maximum Annual Contributions, 3.107
Maximum Loan Value, 2.206
Meals, 5.56, 5.59
Medical Examination, 5.48, 5.53
Medical Information, 4.63, 5.48
Merger, 5.70
Metropolitan Area, 2.55
Metropolitan Statistical Area, 2.55, 2.276
MICR Band, 2.292
Middle-Income, 2.267
Midnight Deadline, 2.148
Migration Analysis, 6.29
Military Base Branches, 5.74
Minimum Average Daily Balance, 2.308
Minimum Balance, 2.307

Minimum Daily Balance, 2.308
Minimum Opening Deposit, 5.30
Minority Areas, 5.72
Miscellaneous Income, 6.49
MMDA, 2.101, 2.107
Mobile Branches, 5.75
Mobile Home, 2.57, 4.29, 6.54
Model Language, 3.97
Model Notices, 4.61
Moderate-Income, 2.267
Monetary Instruments, 3.1, 3.27, 3.53, 3.68
Money Laundering, 3.28, 3.31, 3.81, 3.87
Money Market Account, 2.101, 2.107
Money Market, 5.13
Money Services Businesses (MSBs), 3.46
Money Transmission Services, 3.47
Monitoring Information, 2.22, 2.44, 2.63
Monitoring Systems, 6.93
Monitoring, 5.124
Moody's, 6.37
Mortgage Broker, 4.107
Mortgage Escrow, 4.113
Mortgage Interest Reporting, 6.53
Mortgage Servicing Rights, 6.11, 6.12
Mortgage Servicing Transfer, 4.111
Mortgage Subsidiary, 4.110
Mortgage-Backed Bonds, 6.22
Mortgage-Backed Securities, 6.36
MPPP, 4.37
Multifamily, 4.161
Municipal Bond, 5.13
Municipality, 6.38
Mutual Funds Sales, 5.12
Mutual Funds, 5.12

N
NACHA, 2.113
NASDAQ Rules of Fair Practice, 5.12, 5.14
NASDAQ, 3.12
National Association of Securities
Dealers (NASD), 5.12, 5.14
National Automated Clearing House
Association, 2.113
Metavante
Regulatory Services

National Bank Act, 2.164
National Flood Insurance Program (NFIP), 4.29
National Origin, 2.1, 4.79
National, 5.121
Natural Risks, 5.77
Negative Amortization, 2.235
Negative Balance, 2.308
Negative Verification, 3.38
Netting, 1.5
New Account, 2.282, 2.299, 3.39
New York Stock Exchange, 3.12
Newspapers, 5.28
NFIP Community Name, 4.40
NFIP Community Number, 4.40
NFIP Map Panel, 4.41
Night Depositories, 5.9
Nighttime Depository, 2.281
No Closing Costs, 5.35
No Cost, 5.28
No Down Payment, 5.34
No-Load Funds, 5.13
Nominee, 3.93
Nonaffiliated Third Party, 2.193
Nonapplicant Co-owners, 2.9
Nonaudit Services, 6.95
Nonbank Subsidiary, 2.218, 5.98
Noncash Deposits, 2.308
Noncash Items, 2.147
Nonconforming, 4.93
Noncumulative Perpetual Preferred Stock, 6.16
Nondeductible Contributions, 3.115
Non-Documentary Verification, 3.38
Non-Established Customer, 3.21
Non-Governmental Organizations, 3.44
Nonindividuals, 3.101
Noninsured Investments, 5.14
Nonlisted Businesses, 3.14, 3.56
Nonlocal Check, 2.281, 2.284, 2.290
Nonpayment Testing Period, 6.43
Nonpublic Personal Information, 2.190
Nonrecourse, 2.247
Non-Resident Aliens, 6.48, 6.66
Normal Distribution, 6.60
Notary, 2.224
Not-for-Profit Corporation, 3.101
Notice Before Maturity, 2.309
Notice of Negative Information, 4.61
Notice, 3.39, 4.34, 5.70, 5.71, 5.85
Notification, 4.175, 5.85
Notified Payee Underreporting, 6.68
NOW Account Eligibility, 3.101
NOW Account, 2.106
Number of Payments, 5.34

O

OAEM, 6.29
Occupancy Costs, 6.1
OFAC, 3.44
Off-Balance-Sheet Items, 6.16
Office of Foreign Assets Control (OFAC), 3.38, 3.44, 5.120
Office, 5.17
Officer Appointments and Authority, 5.7
Official Advertising Statement, 5.26
Official Bank Sign, 5.26
On Behalf Of, 5.17
One-Family Principal Dwelling, 4.155
One-to-Four-Family, 4.181
On-Us Checks, 2.282
Open-End Credit, 2.222, 2.225
Open-End Lease, 2.149
Open-End Line of Credit, 2.245
Open-End Triggering Term, 5.35
Open-End, 4.181
Operational and Regulatory Reports, 5.64
Opt Out, 2.196
Opt-Out Notice, 4.59
OREO, 4.81, 6.27
Organizational Chart, 5.63
Original Check, 2.292, 2.294
Original Issue Discount, 6.51
Original Value, 4.171
Origination Fees, 6.1
Originator, 3.18, 3.124
Originator’s Bank, 3.19, 3.20, 3.124
Other Real Estate Owned (OREO), 4.158, 5.99
Outhouse Logo, 5.32, 5.45
Outside Directors, 6.92

IN.12 5/15/08
Metavante
Regulatory Services

Overdraft, 2.101, 2.156
Overt Discrimination, 2.3
Over-The-Limit Charges, 2.227
Owner, 4.159
Owner-Occupied Rental Property, 2.221

P

Pamphlet, 4.160
Par Value, 6.36
Paralysis, 5.46
Partial Liquidation, 6.45
Participation Fee, 5.35
Part-Time Mortgage, 6.56
Pass-Through Coverage, 3.90
Pass-Through, 3.97
Pattern or Practice, 2.52
Payer of Record, 6.55
Paying Agent, 6.48
Payment of Interest, 2.312
Payment Order, 3.18, 3.124
Payment Shock, 4.118
Payment Terms, 5.34
Pay-On-Death, 2.303
PC Banking System, 2.101
Penalties for Noncompliance, 3.24
Penalties, 5.124
Penalty Free Withdrawals, 3.114
Pension Funds, 3.102
Perfect, 3.147
Period of Repayment, 5.34
Periodic Statement, 2.226, 2.305, 2.310
Permanent Foundation, 4.30
Permanent Loan, 2.254
Permissible Purpose, 4.54
Perpetual Preferred Stock, 6.19
Personal Dishonesty, 5.95
Personal Property, 4.30, 6.42
Personally Identifiable Financial Information, 2.190
Phase I Review, 4.21
Phase II Audit, 4.21
Physical or Mental Impairment, 5.46
PKI, 5.154
Plan Sponsors, 3.107
Pledging, 6.36
POC (Paid Outside of Closing), 4.105
Point-of-Sale Card, 2.101
Points and Fees, 2.245
Policy, 1.1, 5.57
Portfolio Size, 6.36
Positive Intent and Ability, 6.8
Positive Verification, 3.38
Post-Dated Checks, 3.143
Post-Employment Benefits, 5.69
Poster, 5.32
Practicable, 6.4
Pre-Accrual, 4.113
Preauthorized Transfers, 2.111, 2.113
Premium Initial Rates, 2.233
Premium Rates, 5.41
Premium, 2.202, 6.7, 6.47
Prepaid Interest, 6.54
Prepayment Penalties, 2.245
Preponderance of the Evidence, 5.96
Prescreening, 4.58
Present Value, 6.7, 6.12
Price Risk, 5.127, 5.128, 5.141, 5.142
Principal Dwelling, 2.237, 2.242
Principal Federal Regulator, 5.70
Principal Residence, 2.254, 4.155
Principal Shareholder, 2.154
Print Media, 5.30
Prioritization of Your Work, 1.34
Prioritized Objectives, 6.36
Privacy Notice, 2.194
Privacy, 2.19, 2.190, 5.93 5.137, 5.140, 5.148
Private Banking Account, 3.77, 3.84
Private Banking, 3.76, 3.83
Private Mortgage Insurance - Cancellation, 4.169
Private Mortgage Insurance (PMI), 2.222, 4.169
Private Placement Activity Policy, 5.7
Prizes, 6.50
Procedure, 1.1, 3.58, 5.57
Proceeds from the Sale or Exchange of Reportable Real Estate, 6.52
Processing Systems, 5.78
Profit, 5.28
Profitability, 5.74
Prohibit, 5.95
Metavante
Regulatory Services

Prohibited Activities, 5.121
Prohibited Bases, 4.79
Prohibited Practices, 5.19
Projections for Coming Year, 4.132, 4.134
Promissory Notes, 6.41
Promotional Material, 5.56, 5.59
Prompt Corrective Action, 2.134
Property, 5.120, 5.121
Proposed Closing Date, 5.71
Protected Health Information, 5.137
Prudent, 5.5
Public Accountant Attestation, 6.92
Public Assistance, 2.1
Public Company Accounting Oversight Board, 6.95
Public Key, 5.154
Publicly Available Information, 2.190
Punitive Damages, 2.26
Purchase and Sale of Loans, 6.2
Purchase Options, 2.151
Purchase, 5.17
Purchased Mortgage Servicing Rights, 6.16
Purpose Credit, 2.206
Pyromania, 5.46

Q
Qualified Employer Retirement Plan, 3.116
Qualified Mortgage, 6.53
Qualified Written Request, 4.112
Qualifying Capital, 6.18
Quality Asset, 2.125

R
Race, 2.1, 4.79
Radio, 5.28
Range of Balances, 5.41
Rate Cap, 4.151
Rate of Return, 5.29
Rate Sheets, 5.28
Readdressed Appraisals, 4.15
Readily Achievable, 5.49
Readily Marketable Collateral, 2.125, 6.38
Re-aged, 4.182
Real Estate Investment Trust, 6.45
Real Estate Loan-to-Value Ratios, 2.134
Real Estate Settlement Procedures Act and Regulation X, 1.7, 2.240, 4.102
Real Estate, 2.221, 4.7, 4.29
Realized Gains, 6.8
Rebates, 5.56
Rebuttable Presumption, 6.43
Recharacterized Contributions, 6.62
Recharacterized IRA Contribution, 6.61
Recognizing Estimated Losses, 6.6
Reconverting Bank, 2.294
Record Retention, 3.24, 4.38, 5.31, 5.102
Recording Fees and Taxes, 2.224
Records of Monetary Instruments 3.16
Recourse, 2.188, 6.42, 6.57
Recovery Operations Center (ROC), 5.79
Red Flag Guidelines, 4.63
Redeposited Checks, 2.285
Red-Lining, 4.80
Referrals, 5.19
Refinancing, 2.58, 2.241, 2.245, 2.275
Refreshments, 5.56, 5.59
Refund Claims, 2.293
Registered Securities Dealer, 6.45
Regulation B, 2.1, 4.79
Regulation C, 2.55
Regulation D, 2.101
Regulation E, 2.111, 5.147
Regulation F, 2.123
Regulation H, 2.132
Regulation J, 2.144, 3.124
Regulation M, 2.149
Regulation O, 2.153
Regulation P, 2.190, 5.63
Regulation Q, 2.101, 2.202
Regulation S, 2.203
Metavante Regulatory Services

- Regulation U, 2.206
- Regulation W, 2.163, 2.217
- Regulation Z, 2.221, 5.146
- Regulation AA, 2.257
- Regulation BB, 2.266
- Regulation CC, 2.281
- Regulation DD, 2.303, 5.146
- Regulatory Supervision, 5.4
- Related Interest, 2.154
- Relationships, 5.56
- Reliance on Others, 3.40
- Religion, 2.1, 4.79, 5.57, 5.59
- Relocation, 5.70
- Remainders, 6.52
- Remote Deposit Capture, 3.173
- Remove, 5.95
- Renew Automatically, 2.309
- Renewal Notice, 2.327
- Renewal Option, 6.52
- Renewed, 4.182
- Rents, 6.50
- Repeat Overdraft, 2.282, 2.299
- Repetitive Transfers, 3.138
- Replacement Cost, 4.34
- Report of International Transportation of Currency or Monetary Instruments, 3.40
- Reportable Real Estate, 6.52
- Reporting Lines, 1.29
- Reports of Condition and Income Call Reports, 5.123, 6.28
- Repricing Categories, 6.32
- Repurchase Agreement, 2.108
- Repurchase, 6.36
- Reputation Risk, 5.143
- Required Minimum Distributions (RMDs), 3.115
- Required Providers, 4.105
- Requiring Significant Difficulty or Expense, 5.47
- Rescission, 2.242
- Reserve Requirements, 1.3
- Reserve, 4.113
- Residential Mortgage Transaction, 2.222, 4.169
- Residential Mortgage, 4.169
- Residential Real Property, 4.37, 4.102
- Residential, 4.155, 4.158, 4.181
- RESPA, 4.102
- Restrictions on Holdings, 6.36
- Restructured Debt, 6.6
- Retail Banking Services, 2.270
- Retained Earnings, 6.18
- Retention, 3.39, 4.121
- Retirement Accounts, 3.90
- Retirement, 5.56, 5.59
- Return, 2.144
- Revaluation Reserves, 6.19
- Revenue Bonds, 6.22
- Reversions, 2.299
- Reverse Mortgages, 2.235, 2.245
- Reversions, 6.52
- Rewritten, 4.182
- Right of Redemption, 6.41
- Right to Financial Privacy Act, 1.4, 1.7
- Right to Financial Privacy, 2.203, 5.91
- Right to Rescind, 2.253
- Risk Analysis, 5.141
- Risk Assessment, 4.159, 5.63, 6.93
- Risk Limits, 6.34
- Risk Management, 5.127, 5.128
- Risk Measurement, 5.129
- Risk Weights, 6.21
- Risk-Based Capital, 6.10
- Risk-Based Deposit Insurance, 6.18
- Risk-Based, 3.37
- Risk-Measurement, 6.34
- Risks in Foreign Exchange, 6.18
- Risks, 6.36
- Robert Morris Associates, 1.15
- Rollover, 3.116, 6.60
- Rotation, 6.95
- Roth IRA, 3.109, 3.119, 6.60, 6.61, 6.62
- Roth, 3.106
- Royalties, 6.50

S
- Safe Deposit Box, 2.188, 3.26
- Safe Harbor, 3.29, 3.36, 5.98
- Safe-Deposit Boxes, 5.122
- Safe-Deposit Business, 2.218
Metavante
Regulatory Services

Safekeeping Transactions, 6.46
Safety and Soundness, 2.135, 5.63
Sale and Repurchase Agreements, 6.22
Sale Credit, 5.34
Sales Load, 5.13
Sales with Recourse, 6.22
Same-Day Settlement, 2.287
SAR, 3.49
Sarbanes-Oxley, 6.95
Savings Account, 2.101, 6.46
Savings Deposits, 3.94
SCRA, 4.151
Search Warrant, 5.85
Second B-Notice in Three Calendar Years, 6.67
Second Mortgage, 6.24
Secondary-Market, 4.9
Section 32 Mortgages, 2.244
Section 326, 3.36
Secured Debt, 4.153
Secured Transactions, 3.147
Securities Activities, 2.133
Securities Brokerage, 5.99
Securities Dealers, 6.38
Securities Information Center, 2.212
Securities Inquiries, 2.211
Securities Trading Policy, 5.7
Securities, 6.14
Securitized, 6.8, 6.39
Security Interests, 3.147
Security Procedures, 3.124
Security, 1.3, 6.8
Segregated Noncapital Reserve, 6.17
Segregation of Functions, 5.19
Senior Foreign Political Figure, 3.84
Senior Programs, 2.2
Separate Maintenance, 2.4
SEPs, 2.303, 3.112, 3.120
Service Fees, 6.47
Service Member's Civil Relief Act, 1.8, 4.151
Service Test, 2.270
Servicer, 4.113
Servicing Transfer Disclosures, 2.254
Servicing Transfer, 4.112
Setoff, 2.147
Settlement Service, 4.105
Settlement Statement, 4.105
Settlement, 2.146
Sex, 2.1, 4.79
Sham Affiliated Business Arrangements, 4.110
Sham Arrangements, 4.109
Shared Use Exception, 4.53
Shareholder Equity, 6.8
Shell Banks, 3.85
Short Positions, 6.38
Shortage, 4.113, 4.118
Short-Term Leases, 4.162
Sign, 5.26
Signature Cards, 3.27
Signature Rules, 2.8
Significant Credits, 6.28
SIMPLE IRAs, 3.107, 3.113, 3.121
Simplified Employee Pension Plans (SEPs), 3.107
Single-Credit Rule, 2.207
Single-Ownership, 3.89
Sinking Fund, 6.37
Site Inspection, 4.20
Small Banks, 2.270
Small-Business and Small-Farm Loans, 2.268, 2.274
Social Security Number, 3.37
Software, 5.79, 5.81
Soldiers' and Sailors' Civil Relief Act, 4.151
Sole Proprietor, 2.58
Sole Proprietorship, 6.50
Special Flood Hazard Area, 4.34
Special Information Booklet, 4.104
Specially Designated National (SDN), 5.121
Specific License, 5.121
Speech Impediments, 5.46
Spousal IRA, 3.115
Spread Account, 6.17
SS-4, 3.41, 6.64
SS-5, 3.41
Staff Opinion Letters, 4.51
Stale Checks, 3.143
Standard and Poor's, 6.37
Standby L/Cs, 6.30
State Income Taxes, 6.51
State-Certified, 4.8
Statement on Auditing Standards No. 30, 6.93
Statement, 5.26
Statute of Limitations, 6.42
Stepped-Rate Account, 2.305
Stock Option, 6.4
Stolen, 3.144
Stop Payment, 2.113
Strategic Plan, 2.271
Strategic Risk, 5.128, 5.143
Street Address, 3.37
Structured Transactions, 3.15
Structuring, 3.48
Student Loan Marketing Association, 6.36
Subordinated Debt, 6.16
Subpoena, 3.33, 5.84
Subrogation, 2.297
Subsequent Disclosures, 2.226
Substandard, 4.181, 4.183, 6.29
Substantive Violations, 2.51
Substitute Check, 2.292, 2.294
Sufficient Copy, 2.294
Suitability, 5.13, 5.14
Superfund Amendments and Reauthorization Act (SARA), 4.18
Supervisory System, 5.16
Supplementary Capital Instruments, 6.19
Surplus, 4.113, 4.118, 6.38
Survey, 2.224
Surveyors, 4.31
Suspend, 5.95
Suspension of Payments, 2.300
Suspension, 5.95
Suspicious Activity Reporting, 3.1, 3.30
Suspicious Activity Reports, 3.13
Suspicious Conduct, 3.71
Sweep Accounts, 2.106
Symbol, 5.26

Tangible Economic Benefit, 2.155

Target Balance, 4.114
Tax Deductibility, 3.108
Tax Identification Numbers, 3.41
Tax Status, 5.14
Tax-Exempt Organization, 6.47
Teaser Rate, 2.232, 5.35
Technical Risks, 5.77
Technical Violations, 2.51
Telephone, 2.5
Television, 5.28
Teller’s Check, 2.290
Temporary Financing, 2.59, 4.103
Tenants by the Entirety, 2.9
Tenants in Common, 2.9
Tennessee Valley Authority, 6.36
Termination Date, 4.170
Termination, 4.174
Terms of Repayment, 2.244, 5.35
Terrorist Activities, 3.28
Testamentary Accounts, 3.91
Testing, 5.80
The BSA Officer, 3.42
The Checkers Bank, 5.147
The Travel Rule, 3.23
Thing of Value, 4.109
Third-Party Collectors, 4.74
Third-Party Providers, 4.31
Three-Pronged Method, 2.268
Thrift Financial Report, 4.181
Tier 1 - Capital, 6.16
Tier 1 - Core Capital, 6.18
Tier 1 Penalties, 5.97
Tier 1, 5.96
Tier 2 - Supplementary Capital, 6.18
Tier 2 Penalties, 5.97
Tier 2, 5.96
Tier 3 Penalties, 5.97
Tier 3, 5.97
Tiered-Rate Account, 2.305, 5.30
Time Account, 2.305
Timely Payments, 4.121
Time-Out, 6.95
Timing, 4.34
TIN, 3.41, 6.64
Title Insurance, 2.224
Tolerance, 2.241
Metavante
Regulatory Services

Toll-Free Telephone Number, 4.112
Total Annual Loan Cost Rate, 2.247
Trade Accounts, 6.4
Trading Securities, 6.10
Trading With the Enemy Act, 5.120, 5.124
Traditional Bank Products, 5.98, 5.99
Traditional IRA Accounts, 3.108
Traditional IRA, 3.118
Traditional, 3.106
Training, 1.37, 3.43, 5.80
Transaction Information, 4.59
Transaction Risk, 5.128, 5.142
Transfer of Servicing, 4.120
Transfer Risk, 6.30
Transmittal Order, 3.18
Transsexuality, 5.46
Transvestism, 5.46
Travel, 5.56, 5.59
Treadway Commission, 6.93
Treasury Checks, 2.283
Treasury Obligations, 6.38
Trigger Terms, 5.29
Triggered Terms, 2.244, 5.34
Triggering Terms, 2.152, 2.244, 5.34
Troubled Debt, 6.6
Troubled Real Estate Loans, 6.26
True Identity, 3.38
Truncate, 2.295
Trust Accounts, 2.112, 3.107, 5.123
Trust Department, 3.26
Trust Funds, 3.102
Trustee, 3.93
Trustee-to-Trustee Transfer, 3.117
Truth in Savings Act, 2.303
Truth-in-Lending, 2.221, 2.247
Two-day/Four-day Test, 2.147

U

U.S. Savings Bond, 6.48
UCC Amendments, 3.140
UCC Article 4A - Funds Transfers, 3.123
UCC Article 4A, 3.123
UCC-1, 3.147
Unauthorized EFT, 2.116
Unauthorized Payment Orders, 3.125
Unauthorized Transfers, 2.112
Uncertificated Security, 2.211, 3.146
Understanding, 4.109
Underwriting, 4.90, 6.1
Undue Burden, 5.49
Unearned Fees, 4.107
Unfair or Deceptive Practices, 2.257
Unfair, 1.5
Uniform Bank Performance Report, 2.271
Uniform Settlement Statement, 6.52
Uniform Standards of Professional Appraisal Practice (USPAP), 4.7
Unimpaired Capital, 2.188
Unimpaired Surplus, 2.188
United States Government Securities, 6.16
United States, 6.38
Unsafe or Unsound Practice, 5.95
Upper-Income, 2.267
USA PATRIOT Act, 1.8, 3.1, 3.76, 3.83

V

Vacant Land, 6.52
Vacation, 5.119
Variable Rate, 5.30, 5.35
Variable-Rate Account, 2.305
Variable-Rate Loan, 2.239, 6.2
Verification, 3.38
Voice-Response, 2.101
Volatile Liability Dependence, 6.38
Voluntary Escrow, 4.135

W

W-8BEN, 6.47, 6.66
W-9, 6.66
Waiver of Exemption, 2.257
War, 2.300
Warranties, 2.150, 2.295
Warranty, 6.4
Weighted Assets, 6.23
Welfare Investments, 2.133
Wholesale or Limited Purpose Institution, 2.272
Window Dressing, 6.93
Wire Transfer, 2.111, 2.291, 3.58, 3.123
Workout, 2.3
Written Agreements, 3.124

Z
Zero Balance, 2.308
Zero-Coupons, 6.38

NUMBERS
15-Year Table, 2.233
366-Day Year, 2.327