

Financial Alert

Management & Compliance Solutions for Financial Institutions

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Survey highlights technology trends

by Gary Farrar, BKD Technologies

nFinet Resources and the Independent Community Bankers of America recently released the results of their 2002 Community Bank Technology Survey. Responding to this survey were 952 financial institutions, resulting in two noteworthy findings.

Survey finding 1: online financial services here to stay

The survey's first important finding is that the Internet appears to be an accepted way for financial institutions to do business. Of the survey's respondents:

- ▲ 74% offer financial services on their web sites
- ▲ 84% report main and branch locations have Internet access
- ▲ 79% have purchased products or services on the Internet
- ▲ 97% are able to receive e-mail
- ▲ A significant number said they plan to evaluate e-mail customer service and statement delivery

Clearly, the Internet provides a delivery channel for financial services. It provides a communication vehicle, a productivity tool and a way to reduce expenses. This does not mean online services will eliminate the need for tellers, lenders and office staff.

It does mean the Internet has become more integral to the way financial institutions do business, and it will become even more

important as institutions find new uses for it.

Given the Internet's rapidly expanding role, financial institutions should ask several questions:

- ▲ How does the Internet support my institution's strategic plan?
- ▲ How are relationships maintained with customers who perform most of their routine banking functions online?
- ▲ Does management know enough about the Internet to make informed business decisions about its use?
- ▲ Are employees able to use the Internet effectively and assist customers who use it?
- ▲ Is my institution's Internet connection secure from hackers, viruses, etc.?
- ▲ Has risk management assessed Internet-based security threats?
- ▲ Are there policies for acceptable and unacceptable Internet use?
- ▲ Do the Internet service provider and Internet financial

services provider have adequate internal controls? Are they able to support growing Internet use?

- ▲ Does the disaster-recovery plan include Internet connectivity?



Survey finding 2: carefully select operating systems & upgrades

It's important to know computer hardware has a life expectancy of three to four years, but it also is important to know the lifespan of the operating system you use.

Thirty-seven percent of survey respondents use the operating system Windows 95, and 73% use Windows 98 on at least some computer workstations; however, Microsoft no longer provides mainstream support for these products.

In fact, Microsoft's stated policy is to terminate mainstream support for *all* operating systems five years after their initial availability on the market.

Many financial institutions are

in the process of upgrading to Windows 2000, an operating system that will no longer be supported by Microsoft in approximately two years.

Because the operating system is the first line of defense for network security, it is critical for financial institutions to be aware of Microsoft's policy and factor it into plans for upgrading hardware and software.

It is important for your financial institution to plan for the replacement of its operating system and know when they are no longer supported.

For more information, contact a BKD Technologies advisor in an office near you. □

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Split-dollar

life insurance arrangements may change in 2003

by Jeff Wilmes, Evansville

On July 3, 2002, the Internal Revenue Service (IRS) issued proposed regulations that make radical changes to the income, gift and employment tax consequences of split-dollar life insurance arrangements.

To mitigate some of the negative tax consequences, the proposed regulations and related revenue notices provide taxpayers the opportunity to take some actions by December 31, 2003.

Treatment of split-dollar arrangements

The proposed regulations, expected to become final in 2003, will apply to all split-dollar life insurance arrangements. How the split-dollar arrangement is treated depends on when the arrangement was set up.

Arrangements made before January 28, 2002, will have one set of rules. Arrangements made on or after January 28, 2002, but before the final regulations are published will have a second set of rules. Finally, arrangements made after the publication of the final regulations will be governed by a third.

Regulations address taxation of benefits

The IRS issued the proposed regulations to address what it perceived as inadequate rules relating to the taxation on the shifting of economic benefits from employer to employee, corporation to shareholder or donor to donee (as the case may be) in relation to split-dollar arrangements.

The regulations address the taxation of all benefits provided by the arrangement, including the value of current life insurance protection, the equity build-up in policies and the transfer of policies from one party to another.

Contract ownership affects taxation

The proposed regulations apply to all types of split-dollar arrangements: employer/employee; donor/donee; corporation/shareholder; etc. However, this article focuses on employer/employee arrangements.

Under the proposed regulations, how a split-dollar arrangement will be taxed depends on who "owns" the contract. If the employer owns the contract, and the employee or his/her beneficiary is to receive benefits under the arrangement (life insurance protection, cash value equity or some other benefit), then the arrangement is taxed under the *economic benefit regime*.

If the employee owns the contract, and the employer makes premium payments, then the arrangement will be taxed under the *loan regime*. If an employee owns a contract, but the arrangement provides that the employer is entitled to all cash value in the contract, then the arrangement will be taxed under the economic benefit regime as if the employer owned the contract.

Under the economic benefit regime, the employee is taxed on all economic benefits received under the arrangement. This includes but is not limited to:

- ▲ The value of current life insurance protection

- ▲ The increase in cash value of the contract exceeding the amount to be repaid to the employer under the arrangement
- ▲ The equity received on "roll out" when the arrangement is terminated

Timing important

Arrangements entered into after January 27, 2002, will no longer be allowed to use PS 58 rates, and the ability to use the insurers' alternate rates will be limited in years after 2003.

Arrangements entered into after the final regulations are published will have to use a new IRS table (yet to be published) to value current life insurance protection.

Both regimes effect change

One of the most significant changes made by the proposed regulations occurs under the economic benefit regime: Increases in the cash value of contracts over and above the amount that must be repaid to the employer (crossover point) will be taxed to the employee as the buildup occurs, even before the policy is rolled out on termination of the arrangement. This change applies to arrangements entered into after the final regulations are published.

Under the loan regime, the employer is considered to have made a loan to the employee every time the employer pays a premium on the policy. If the employer doesn't charge an interest rate on the loan equal to or greater than the applicable federal rate (AFR) published by the IRS, then the loan will be considered a below-market split-dollar loan.

If the loan is a below-market loan because the AFR is greater than the interest actually being charged, then the employer will be deemed to have made a transfer of the forgone interest (difference between the AFR and the actual rate) in the form of taxable wages.

The employee will be deemed to have made a payment to the employer in the form of taxable interest income for the same amount as the deemed wages. The timing of the recognition of the wage income will depend on whether the loan is a demand loan or a term loan.

Revenue Notice 2002-8 provides relief for arrangements entered into before January 28, 2002. It also provides the employee will not be taxed on the equity built up in the contract provided:

- ▲ The employee is the owner of the contract
- ▲ The arrangement was entered into before January 28, 2002
- ▲ The arrangement is terminated before January 1, 2004, or for all periods beginning or after January 1, 2004
- ▲ All payments by the employer from inception of the arrangement are treated as loans

Given the opportunity to make changes on or before December 31, 2003, taxpayers should review all existing split-dollar arrangements to decide if they want to continue the arrangement as is, terminate the arrangement or begin treating employee-owned policies with employer-paid premiums as loans.

Transferring out the equity in employee-owned policies on a tax-free basis will expire December 31, 2003.

Contact your BKD tax advisor for more information. □

Flood determinations expire in 2003

by Sean Kulczycki, St. Louis

It's been almost 10 years since the flood of 1993 devastated the Midwest, causing economic damage in the billions. The waters have long since receded, but the high water mark of resulting regulation can still be seen; in 2003, we will be reminded of it again and again.

On January 2, 1996, the National Flood Insurance Reform Act of 1994 introduced the Standard Flood Hazard Determination Form (SFHDF), the act's most visible requirement.

The form is used to determine whether a designated flood hazard area is in the location of real property. The SFHDF is now routine for lenders that order or prepare loans secured by real property where a structure is located. Once a lender obtains an SFHDF form it can be reused but for how long?

Flood insurance regulations allow financial institutions to reuse

previously obtained flood determinations but only if prior SFHDF documentation exists.

Previous determinations not more than seven years old also can be used for future transactions provided flood map revisions have not affected the security property.

Do the math: Flood determinations will begin to expire in 2003. Lenders will no longer be able to routinely rely on previously obtained determination. Going forward, any time an existing loan is modified, extended or renewed, the date of the previously obtained determination will have to be checked to ensure it is not more than seven years old.

This also is true for refinancing and second-lien loans for which a SFHDF was already obtained. Commercial loans seem to carry the greatest potential for error because they are typically modified, extended or renewed frequently. Keep in mind that, while an SFHDF may expire after seven years, a new deter-

mination is not required unless triggered by one of the events above.

Enforcement of flood insurance regulations is at the top of the regulatory to do list. Assessment of civil money penalties, once a seldom-used deterrent, is now a recurring theme for both large and small institutions.

While civil money penalties can't be specifically assessed for flood determination violations, such violations may have an impact on

whether penalties will be assessed for other flood insurance violations.

We encourage you to be proactive by implementing appropriate measures to ensure ongoing compliance. Contact your BKD Financial Institutions Group advisor for more information. □



Use Form 1099-C with caution

by Doug Van Meter, Enid

When a debt is forgiven by a creditor, the person receives taxable discharge of indebtedness income (DOI) in the amount of indebtedness that was forgiven.

This DOI income must be reported to the Internal Revenue Service (IRS) on Form 1099-C by financial institutions and other entities that forgive debt.

For example, some businesses issue a Form 1099-C to induce customers to pay past-due debt to the vendor and threaten that if they refuse, they'll end up paying the IRS; however, this can backfire if the open balance is a disputed amount. The IRS will assume a tax bill is due while the debtor doesn't believe he/she owes any debt at all.

Similarly, if a Form 1099-C is

filed while a debtor is still willing to negotiate a settlement, there may be no agreed amount of indebtedness between debtor and creditor, yet the IRS will attempt to tax a debt forgiveness.

Finally, even if there is a formal debt discharge and a Form 1099-C is filed, it may not properly reflect the year in which the debt became uncollectible, which is the year in which the income should be taxed. This error could affect the amount of tax due. □

Check out. . .

Financial *Alert*

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BKD stands for PRIDE values

You care about what your accountants and consultants stand for. Values matter.

BKD's most valuable asset has always been our people. Their collective values of **passion, respect, integrity, discipline** and **excellence** have become the firm's values of **PRIDE**.

You see our partners and employees "**living the PRIDE**" everyday as they provide solutions to your business and financial needs.

Here is a synopsis of what our values mean for our clients. For a more complete explanation, ask your BKD advisor for details or for a copy of our values information sheet.

Passion - BKD's mission is to first "strive for excellence in providing services to clients." This commitment drives our practice and accounts for the dedication of our partners and staff to meeting your deadlines and needs. Consistent with our values, we are enthusiastically committed to making tomorrow better than today by helping you make informed decisions to improve business and financial outcomes.

Respect - BKD respects

diversity. You benefit from our diverse client service teams, which bring a broad mix of skills and approaches to bear on your needs.

Integrity - "Do the right thing" has been the tone from the top of BKD since our founding. You and your stakeholders and customers rely on our integrity and objectivity to help you make smart—but right—business decisions. We are committed to telling you what you need to know vs. what you want to hear.

Discipline - Discipline is a hallmark of BKD, and you benefit from our well-established and successful protocols, standards and processes.

Excellence - We are committed to lifelong learning to continually improve the technical and analytical skills we apply to your needs. Our desire to "be the best" means we seek to consistently surpass your expectations. □



Marketing audits can lead to success

by Dr. Bill Carner, the Red McCombs School of Business, University of Texas at Austin

Every year, community financial institutions prepare a marketing plan as part of next year's budget. To develop a plan, the previous year's performance is reviewed, and advertising and sales promotion campaigns are developed for the coming year.

Sometimes, shaping a successful plan can be complicated. For instance, there may be a particularly "hot" product or service that requires more attention and a larger portion of the budget. Will a study of last year's costs provide the information you need to budget additional expenses such as these?

Begin with a plan

To write a successful marketing plan, do some research. Of last year's campaigns, which were most successful? Which competitors are your biggest threats, and which markets potentially offer the most business and profits?

As you construct a marketing plan, you also will put together a

financial plan, which, unlike most marketing plans, is supported by financial information. A marketing audit also could assist in the development of both plans.

Marketing audits perform the same functions as a financial audit but from a marketing perspective. Because it analyzes an institution's environment and assess its marketing functions, a marketing audit can help strengthen marketing programs.



Monitor marketing efforts

An audit evaluates a financial institution's products, services, pricing and the relationship of personnel to marketing functions. It helps assess market demand and the needs of current customers.

A marketing audit examines the marketing function, its programs and activities:

- ▲ Is there a sales training program?
- ▲ Does the institution have an officer call program with well-trained sales personnel?
- ▲ Is customer contact personnel trained and performing cross-selling functions?
- ▲ Do advertising and sales pro-

motion campaigns meet goals and objectives, or are they continued out of tradition?

External audits study marketplace

The audit moves from the internal to the external environment to study the marketplace where the institution operates and the competition it faces:

- ▲ Is the marketplace changing?
- ▲ Do the institution's products and services fit market changes or expansion?
- ▲ Does the institution miss significant segments of the marketplace? If so, is it from lack of recognition, lack of products and services for this segment or a combination?
- ▲ Who is the primary competition?
- ▲ Are they more conveniently located or is their pricing different?
- ▲ What is their image, and what is yours?

The answers to these questions will help you attract the customers you want.

Study customers & competitors

Do your pricing strategies fit your customers' needs? An audit

compares your pricing practices to those of your competitors', revealing areas where you are competitive and those that require attention.

Practice competitive pricing. Knowing the pricing strategies of competitors helps an institution stay alert to market changes and helps its products stay current.

Today, marketplace appraisals require knowledge of every competitor, from the Edward D. Jones office next door to Lending Tree Online. To prosper, community financial institutions must continually evaluate a changing marketplace.

It's just as important to monitor regional and national rates as it is to monitor the rates, policies, and promotions of local institutions.

A marketing audit is an in-depth study of customer demographics. For insight into missed opportunities or to know which customers are your best, compare the audit's findings with local market demographics.

Periodic marketing audits can help your financial institution know if it's moving in the right direction. □

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