BANKING, TAXATION

BANK REGULATORS REQUIRE CHANGES TO TAX ALLOCATION AGREEMENTS

by John K. Lawrence

Acting in response to divergent results in recent court decisions, the Federal bank regulatory agencies have adopted an Addendum to their longstanding rules regarding income tax allocation agreements between insured depository institutions ("IDI") and their parent holding companies.[1] The Addendum requires holding companies and their IDI subsidiaries to review their existing income tax allocation agreements and to add a specified provision. The review and modifications must be effected as soon as reasonably possible, which the regulators expect to be prior to October 31, 2014.

Background

Most banks and thrift institutions holding deposits insured by the Federal Deposit Insurance Corporation ("FDIC") are subsidiaries in a holding company structure. The Federal and State income tax returns of these IDI, as members of a consolidated group, are usually filed by the holding company parent. Refunds and other tax benefits of the consolidated group attributable to the IDI subsidiaries received by a parent holding company must be allocated to the IDI subsidiaries.

Since 1998, the Board of Governors of the Federal Reserve System ("Board"), the Office of the Comptroller of the Currency, and the FDIC (collectively, the "Agencies") have applied uniform rules regarding such allocations. They are set forth in their Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure (the "Policy").[2]

The Policy generally mandates that inter-corporate settlements between an IDI and its parent holding company be conducted in a manner that is no less favorable to the IDI than if it were a separate taxpayer. It also establishes a supervisory expectation that a comprehensive written tax allocation agreement will be entered into between a parent holding company and its IDI subsidiaries.

Among other things, the Policy specifies that a parent holding company that receives a tax refund from a taxing authority holds such funds as agent for the members of the consolidated group. It also requires that neither the tax allocation agreement nor the corporate policies of the parent holding company should purport to characterize refunds attributable to an IDI subsidiary received from a taxing authority as being property of the parent.

Addendum to the Policy

In several holding company bankruptcies since 2008, the FDIC has been unsuccessful in recovering for IDI subsidiaries tax refunds received and held by the parent holding company. In those cases, the courts have interpreted the applicable tax allocation agreement as creating a debtor-creditor relationship between the parent holding company and its IDI subsidiaries.[3] Those courts have reached that result notwithstanding the Policy and its mandate that a parent holding company act as an agent for its IDI subsidiaries. Although other decisions have interpreted tax allocation agreements consistently with the Policy, the Agencies determined to modify the Policy and require additional action by holding companies and IDI with a view to avoiding such situations in future.

Under the Addendum to the Policy, each tax allocation agreement must be reviewed and revised to ensure that it explicitly acknowledges an agency relationship between the holding company and its subsidiary IDI with respect to tax refunds and does not contain any other language to suggest a contrary intent. A sample paragraph which the Agencies regard as sufficient is included in the Addendum.

The Addendum to the Policy also makes clear that tax allocation agreements are subject to the requirements of Sections 23A and 23B of the Federal Reserve Act. Among other things, this means that the parent holding company must promptly transmit tax refunds received from a taxing authority to its subsidiary IDI. An agreement that permits a parent holding company to hold and not promptly to transmit tax refunds owed to an IDI may be regarded by the Agencies as inconsistent with Section 23B, and may subject the holding company and IDI to supervisory action. Similarly, an agreement that fails to clearly establish the agency relationship between the parent holding company and its IDI subsidiaries may be treated as subject to the loan collateralization and other requirements of Section 23A.

Conclusion

The Addendum the Agencies have made to the Policy does not represent a change in supervisory approach to these issues. It is a clarification in light of adverse bankruptcy experience and constitutes a reaffirmation of the Policy. Parent holding companies and IDI subsidiaries should arrange for a review of their existing tax allocation agreements and the inclusion in those agreements of the provision specified in the Addendum to the Policy. Action is required as soon as reasonably possible, but in any event before October 31, 2014.

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[1] Board Press Release (June 13, 2014). The Addendum will be published in the Federal Register.
[2] 63 Fed. Reg. 64757 (Nov. 23, 1998).
[3] *See, e.g., FDIC v. Siegel (In re IndyMac Bancorp, Inc.)*, 2014 WL 1568759 (9th Cir., 2014).

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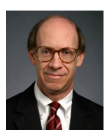

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