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CLIENT ALERT:
Final Supplemental Guidance on Income Tax Allocation Agreements: Why It's Important to Act Now

Almost every bank and its holding company ("HC") conduct business with each other, typically through an agreement whereby one performs services for the other in return for some consideration. The bank, for example, may provide support services for employees of the HC (such as human resources or printing for board meeting materials), while the HC may file a consolidated tax return for itself and the bank and collect any refunds due. Agreements covering the latter practice, referred to as tax allocation agreements, have been previously highlighted by the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation (the "Banking Agencies") as posing particular risks and issues under the Federal Reserve Act (the "Act"). To comply with the "market terms"[1] requirement of §23B of the Act, such intercompany agreements in general establish the terms by which such services are to be provided. These agreements contain additional risks with respect to the "extension of credit"[2] requirements of §23A of the Act. The Agencies recently released an addendum[3] (the "Addendum") to their prior guidance, the "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure."[4] This Addendum suggests specific and immediate action in regards to such intercompany agreements, in particular with respect to the 23A and 23B issues present, and provides specific guidance on addressing those issues.

[1] 12 USC 371c-1 (2010) states that various transactions between a bank and its subsidiaries/affiliates, including "the furnishing of services to an affiliate under contract," must be on comparable terms to any such transactions, or other agreements, with nonaffiliates.
[2] 12 USC 371 (2010) sets out specific requirements for so-called "covered transactions" (including extensions of credit) from a bank to a nonbank affiliate; among those is a general requirement that such transactions "be on terms and conditions that are consistent with safe and sound banking practices."
[3] 79 FR 35228 (June 19, 2014).
[4] 63 FR 64757 (November 23, 1998).

SUMMARY: WHAT DOES THIS MEAN FOR BANKS AND HOLDING COMPANIES?

First and foremost, it demonstrates the significance of revenue allocation agreements between a holding company and any insured depository institution (IDI) subsidiary (ies). Building on the initial guidance issued in 1998, the Addendum explains that such agreements (in this instance, concerning tax payments) **must** be structured to reflect the agency capacity of an HC when receiving tax refunds for an IDI. Failure to do so may result in the determination that a 23A extension of credit requiring collateral[5] has been made to the HC by the IDI. In addition, the agreements must meet the "market terms" requirements of 23B with respect to the payment of any taxes from the IDI to the HC, as well as the forwarding by an HC of any refund received by the HC due the IDI. Such arrangements are required to be in writing and to not only a) address the services provided and the compensation received but also b) provide for a market rate of exchange for the bank - in other words, the agreement must be clear that the bank will be treated fairly by the HC. Regarding tax allocation agreements, that means that if the bank generates the tax refund, the bank is entitled to the refund and should receive it under the agreement.

Beyond that, it provides relatively clear guidance on how to avoid the additional 23A and 23B liability which may be triggered by incomplete or incorrect arrangements. The addendum provides the following specific language that the Agencies have indicated will provide some evidence of compliance with these requirements:

The [holding company] is an agent for the [IDI and its subsidiaries] (the "Institution") with respect to all matters related to consolidated tax returns and refund claims, and nothing in this agreement shall be construed to alter or modify this agency relationship. If the [holding company] receives a tax refund from a taxing authority, these funds are obtained as agent for the Institution. Any tax refund attributable to income earned, taxes paid, and losses incurred by the Institution is the property of and owned by the Institution, and shall be held in trust by the [holding company] for the benefit of the Institution. The [holding company] shall forward promptly the amounts held in trust to the Institution. Nothing in this agreement is intended to be or should be construed to provide the [holding company] with an ownership interest in a tax refund that is attributable to income earned, taxes paid, and losses incurred by the Institution. The [holding company] hereby agrees that this tax sharing agreement does not give it an ownership interest in a tax refund generated by the tax attributes of the Institution.[6].

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[5] *Supra* Note 2.
[6] *Supra* Note 3 *at* 35230.

NEXT STEPS FOR BANKS

The Agencies have indicated that they expect compliance with these requirements by **October 31, 2014.** In addition to the time needed for review and execution of the agreements, any internal processes utilizing the tax refunds received will need to be adjusted as well. In addition, it may be useful to review other nontax services covered by the agreement.

From a more global standpoint, there are many HCs who have no agreements in writing at all governing the relationship between the HC and its IDI(s). Given the newness of this guidance, examiners are likely to ask for these agreements and, if they are in place, scrutinize them for the issues noted above (and likely not just the tax provisions). Should you need assistance in drafting or revising any intercompany agreements or any corresponding policies and procedures to meet the Agencies' deadline, please let us know.

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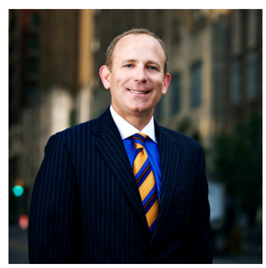

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