

FED NOTES: Originally published in the Autumn 2014 edition of *Bank Owner* magazine.

Talking Taxes: New Addendum to the Interagency Policy Statement on Income Tax Allocations

By Leanne Kelly

The 1998 Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure and the June 19, 2014, Addendum to the Policy Statement provide guidance to banks on tax payments made as a member of a consolidated group. Holding companies and banks are expected to ensure that their tax allocation agreements comply with the Policy Statement and are updated for the Addendum, and tax payments and refunds are handled consistent with supervisory guidance. (Note that because the Policy Statement and Addendum only apply to banks filing as part of a consolidated group, they do not apply to Sub Chapter S institutions). This article begins with a discussion of the Policy Statement and Addendum requirements and concludes with an action plan for holding company organizations to ensure compliance by the Oct. 31, 2014, deadline in the Addendum.

Policy Statement and Addendum Requirements

In general, the Policy Statement requires that for each bank, the applicable income taxes should be calculated as if the bank had filed on a separate entity basis and the amount and timing of payments or refunds should be no less favorable to the bank than if it were a separate taxpayer. The Policy Statement encourages holding companies and their subsidiaries to enter into written, comprehensive tax allocation agreements that require the bank to compute its income taxes on a separate entity basis. The agreement should also address the timing of the bank's payments for current tax expense, reimbursements to the bank when it has a loss for tax purposes, and prohibition of the payment or other transfer of deferred taxes by the bank to another member of the consolidated group.

Although the Policy Statement sets out parameters on the treatment of a bank's tax refunds, there have been disputes between holding companies in bankruptcy and their failed subsidiary banks regarding the ownership of tax refunds generated by the bank. In these disputes, some courts have found that tax refunds generated by the bank were the property of its holding company based on certain language contained in their tax allocation agreement. These courts interpreted this as the creation of a debtor-creditor relationship instead of an agency relationship contrary to the intent of the Policy Statement.

The Addendum clarifies and supplements the Policy Statement with regard to tax allocation agreements and ownership of refunds. The Addendum requires that agreements expressly acknowledge an agency relationship between a holding company and its bank and discusses application of certain requirements of sections 23A and 23B of the Federal Reserve Act. Overall, the Policy Statement and Addendum provide supervisory guidance for holding companies and banks regarding policies and practices that will ensure that a bank is not paying more than it would pay if it filed a separate return and that any tax refund attributed to the bank receives appropriate treatment.

The Addendum further instructs banks and their holding companies to ensure that the tax allocation agreement is consistent with the requirements of sections 23A and 23B of the FRA. The Addendum clarifies that section 23B of the FRA requires a holding company to promptly transmit tax refunds received from a taxing authority to its bank. In cases where the tax allocation agreement does not clearly acknowledge that an agency relationship exists or allows the holding company to hold and not promptly transmit the tax refund, the bank may be subject to additional requirements under section 23A of the FRA regarding collateral requirements as this would create an extension of credit from the bank to its affiliated parent company.

Holding Company Actions Required

The guidance and the regulators ask that you take a fresh look at your tax allocation agreement. As a holding company you need to act as a source of strength to your bank. Holding company management and directors need to ensure that they and the holding company do what is in the best interest of the bank and do not disadvantage the bank or cause the bank to violate any banking statutes, particularly those related to affiliate transactions. Making sure that your income tax allocation policy and practices conform to the Policy Statement and Addendum is one way to meet this requirement.

In reviewing your tax allocation agreement, the agreement should clearly acknowledge that an agency relationship exists between the holding company and its banks with respect to tax refunds, and not contain other language to suggest a contrary intent. To further this goal, the Addendum states that you should amend your tax allocation agreement to include the paragraph or substantially similar as found in SR 14-6.

If you have questions as you address the Addendum, please feel free to contact the safety and soundness staff at the Federal Reserve Bank of Minneapolis. Leanne Kelly is senior examiner with the Federal Reserve Bank of Minneapolis.

Fed Notes is provided through a partnership the Bank Holding Company Association shares with the Federal Reserve Bank of Minneapolis.