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The Federal Reserve, FDIC and OCC Release Proposal on Tax Allocation Agreements and Invite Comment

May 4, 2021

On April 22, 2021, the Federal Reserve Board (the "FRB"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC" and, collectively with the FRB and FDIC, "the agencies") jointly proposed a rule that would codify, and make additions to, existing guidance on income tax allocation agreements among banks[1] and their holding companies and affiliates.[2] The proposed rule would require any bank that files federal or state income tax returns as part of a consolidated group that includes members other than the bank and its subsidiaries to enter into a tax allocation agreement containing specified terms. The rule would be codified as part of the agencies' safety and soundness guidelines.

The comment period for the proposed rule will end 60 days following its publication in the Federal Register.

BACKGROUND

In 1998, the agencies and the Office of Thrift Supervision[3] adopted an interagency policy statement on income tax allocation ("the 1998 Policy Statement"),[4] which the agencies supplemented in 2014 ("the 2014 Addendum").[5] The 1998 Policy Statement and 2014 Addendum apply to insured banks and their holding companies and aim to ensure that, when filing as part of a consolidated tax group, a bank is treated no less favorably than it would be if it were filing as a separate taxpayer. The 2014 Addendum provides that tax allocation agreements should expressly state that an agency relationship exists between the bank and its holding company. The 2014 Addendum was issued to increase the chances that a subsidiary bank (or the FDIC, as its receiver) receives the full amount of tax refunds due to the bank from its parent in bankruptcy.[6]

The agencies did not adopt the 1998 Policy Statement and 2014 Addendum as binding requirements and, therefore, they are unenforceable. The agencies describe their primary rationale for the current proposal (which would be enforceable) as correcting noncompliance with the prior guidance. According to the agencies, such noncompliance has resulted in lawsuits and an increased risk of nonrecovery for the FDIC as it seeks in bankruptcy (as the receiver for failed banks) to recover tax refunds that should be due to the failed bank from its parent.[7]

SCOPE OF INSTITUTIONS SUBJECT TO THE PROPOSED RULE

The proposed rule would apply to national banks, state banks and savings associations that file a federal or state consolidated, combined or unitary income tax return as part of a group that includes members other than the bank and its subsidiaries (*i.e.*, a group

that includes a holding company or other affiliates).[8] The proposal would not apply to banks or holding companies that are not subject to income taxes at the federal or state level, such as entities electing S-corporation status.

GENERAL REQUIREMENTS

The rule would codify the 1998 Policy Statement and 2014 Addendum, and it would impose additional obligations aiming to ensure that a bank that files as part of a consolidated group is treated no less favorably than if it were to file as a separate entity. General requirements of the proposed rule include:

- When a bank in a consolidated group prepares separate regulatory reports, the bank must record current and deferred taxes as if it filed on a separate entity basis.[9]
- A bank must recognize all of its deferred tax items, including those based on or attributable to temporary differences or net operating loss or tax credit carryforwards on its separate entity regulatory reports, and these items cannot be presented separate from the entity that reports the asset or liability that gave rise to them. This provision expands the existing guidance.
- A bank that files tax returns as part of a consolidated group must enter into a tax allocation agreement that requires the bank to receive from its holding company no less than the tax refund amount it would receive if it had filed on a separate entity basis. If other affiliates' income offsets a bank's net operating losses in a consolidated return filing, the holding company must reimburse the bank for the use of those net operating losses on or before the date the bank would have filed on a separate entity basis for a refund.
- A bank cannot enter into a transaction in which its parent purports to forgive some or all of the bank's deferred tax liabilities (*e.g.*, through a capital contribution).

A tax allocation agreement may allow a subsidiary bank to pay its parent less than the full amount of the current income tax liability that the bank would have owed if calculated on a separate entity basis. Provided the parent will not later require the bank to pay the remainder of such stand-alone current tax liability, the bank must account for this unremitted liability as having been paid with a simultaneous capital contribution by the parent to the bank.

REQUIRED PROVISIONS FOR TAX ALLOCATION AGREEMENTS

The proposed rule would require banks to enter into tax allocation agreements with their holding companies and other members of their consolidated tax filing group. The agreement would be required to be approved by the board of directors, or a duly authorized committee thereof, of the bank and each holding company and to:

- Provide that an agency relationship exists between the bank and its holding company with respect to tax refunds; the bank owns tax assets that were created from its tax attributes; and the parent company does not obtain any ownership interest in any tax refund of the bank.
- Provide that any refund received from the taxing authority and due to the bank is held in trust by the holding company.
- Require that the bank promptly receives any tax refund attributable to the bank's tax attributes.
- Prohibit tax payments by the bank to its affiliates in excess of its current tax period obligations (calculated on a separate entity basis).
- Prohibit payments for the settlement of any deferred tax liabilities of the bank.
- Prohibit payment of tax expenses earlier than when the bank would have been obligated to pay had it filed as a separate entity.
- Provide that, if a bank makes payments during the year in excess of its annual tax liability at year end and would obtain a tax refund had it filed on a separate entity basis, the bank must receive from the holding company no less than the tax refund amount the bank would have received as a separate entity.

- Provide that, if a bank's loss or credit is used to reduce the consolidated group's overall tax liability, the bank must reflect the tax benefit of the loss or credit in the current portion of its applicable income taxes in the period the loss or credit is incurred.
- Require a bank to be compensated for the use of its tax assets by the holding company or other members of the consolidated group at the time the relevant tax asset is absorbed by the consolidated group.[10] This provision expands the existing guidance.
- Require bank affiliates to make available on demand to the bank or its successors (including the FDIC as receiver) all materials related to federal income tax returns. This provision expands the existing guidance.

The proposal includes an example paragraph describing the agency relationship between the bank and its holding company, which must be included in substantially similar form in tax allocation agreements.

ADDITIONAL OBSERVATIONS

The proposed rule largely codifies the existing guidance and, although implementing the expanded requirements likely will require some additional work, the agencies state that they do not expect the rule to materially increase the burden for most banking organizations. Although less impactful than other agency rulemakings, the proposed rule does help clarify the agencies' general priorities and current views on regulations, supervisory guidance and "guidelines".

- Specifically, given that the proposed rule largely codifies existing guidance with which many have banks already complied, the proposed rule underscores that the agencies place a high priority on protecting the Deposit Insurance Fund, including by helping to improve the FDIC's position in litigation as receiver of failed banks.
- The rule may also indicate that the agencies, consistent with their recent final rule on the role of supervisory guidance, are (i) willing to reissue guidance that they wish to enforce as a binding rule and (ii) more likely than in the past to formulate new agency statements as binding rules rather than as unenforceable guidance.
- Further, the proposed rule highlights that the agencies consider "guidelines" adopted under section 39 of the Federal Deposit Insurance Act to be legally binding requirements (despite the fact that section 39 provides that the agencies must prescribe standards thereunder by either "regulation or guideline").[11] Labeling a rule under section 39 as a "guideline", as opposed to a "regulation", provides the agencies with additional discretion in circumstances where a bank fails to comply with the rule.[12]

Also notable is that the proposed rule does not clarify an aspect of the earlier guidance that appears to yield an anomalous result in certain circumstances. Specifically, the proposed rule retains the requirement that a bank receive from its holding company no less than the tax refund amount it would have received on a separate entity basis. For example, suppose a bank is unable to carry back a current loss to its own prior taxable year because the consolidated return rules require the loss to first offset current year consolidated income. If different tax rates apply in the current year and the prior year (*e.g.*, 21% in the former and 35% in the latter), the proposed rule would seem to require the holding company to reimburse the bank based on the hypothetical value of the bank's 35% tax benefit rather than the 21% benefit the group actually realizes.

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[1] As noted in more detail below, the proposal would apply to national banks, state banks and savings associations. For simplicity, we use the term "banks" to refer to all such organizations.

[2] Joint Press Release, dated April 22, 2021, "Agencies invite comment on proposed rule for income tax allocation agreements", https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210422a.htm.

[3] The functions of the Office of Thrift Supervision have since been transferred to the OCC and FDIC.

[4] 63 Fed. Reg. 64757 (Nov. 23, 1998).

[5] 79 Fed. Reg. 35228 (June 19, 2014).

[6] *Id*.

[7] The preamble to the proposal states that the agencies "expect most covered institutions to already be in compliance with the proposal".

[8] The 1998 Policy Statement and 2014 Addendum only apply to insured banks; however, the proposed rule would also apply to OCC-chartered uninsured banks.

[9] Any adjustments for statutory tax considerations in a consolidated return must be made on a consistent and equitable basis among all members of the consolidated group.

[10] For example, a consolidated group could be required to use a bank's net operating loss to reduce the consolidated group's current tax liability under consolidated tax return rules.

[11] The agencies also suggested that this was their position earlier this year in a footnote to their final rule regarding the role of supervisory guidance. 86 Fed. Reg. 18173, 18174 n. 10 (Apr. 8, 2021) ("one source of law among many that can serve as a basis for a supervisory criticism is the Interagency Guidelines Establishing Standards for Safety and Soundness").

[12] 12 U.S.C. § 1831p-1(e)(1)(A).