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Federal Banking Agencies Proposed An Addendum to Policy Statement on Income Tax Allocation Agreements

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Corporate / Financial Institutions Alert

In 1998, the federal banking agencies (the "Agencies") issued the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure (the "Statement").

Under the Statement, members of a consolidated group, comprised of one or more insured depository institutions ("IDIs") and their holding company and affiliates (a "Group"), may prepare and file their federal and state income tax returns as a group so long as the act of filing as a group does not prejudice the interests of any one of the IDIs.

Since the issuance of the Statement, courts have reached varying conclusions regarding whether tax allocation agreements create a debtor-creditor relationship between a holding company and its IDI. Some courts have found that the tax refunds in question were the property of the holding company in bankruptcy (rather than property of the subsidiary IDI) based on the language on the agreement between the holding company and the IDI.

On December 19, 2013, the Agencies issued for comment an Addendum to the Statement indicating that Groups should review their tax allocation agreements to ensure the agreements achieve the objectives of the Statement. This Addendum clarifies and supplements but does not replace the Statement. It also provides guidance on how certain of the requirements of Sections 23A and 23B of the Federal Reserve Act ("FRA") apply to tax allocation agreements between IDIs and their affiliates.

Comments on the Addendum are due by January 21, 2014.

The Addendum provides that in reviewing a tax allocation agreement, a Group should ensure the agreement (1) clearly acknowledges that an agency relationship exists between the holding company and its subsidiary IDIs with respect to tax refunds, and (2) does not contain other language to suggest a contrary intent.

In addition, the Addendum directs that all Groups amend their tax allocation agreements to include the following paragraph or substantially similar language:

> "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

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> 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."

If a tax allocation agreement contains this or similar language, it will be deemed by the Agencies to acknowledge that an agency relationship exists for purposes of the Statement, the Addendum, and Sections 23A and 23B of the FRA.

The Addendum notes that tax allocation agreements are subject to the requirements of Section 23B of the FRA. Section 23B requires affiliate transactions to be made on terms and under circumstances that are substantially the same, or at least as favorable to the IDI, as comparable transactions involving nonaffiliated companies or, in the absence of comparable transactions, on terms and circumstances that would in good faith be offered to non-affiliated companies.

Furthermore, the Addendum indicates that tax allocation agreements that do not clearly acknowledge that an agency relationship exists may be subject to additional requirements under Section 23A of the FRA. Section 23A requires, among other things, that loans and extensions of credit from a bank to its affiliates be properly collateralized.

The Addendum states that the tax allocation agreement should direct the holding company to forward promptly any payment due the IDI under the tax allocation agreement, specifying the timing of such payment.

In the view of the Agencies, agreements that allow a holding company to hold and not promptly transmit tax refunds received from the taxing authority which are owed to an IDI are inconsistent with the requirements of Section 23B and subject to supervisory action. Whether a provision allowing the holding company to hold the refund or the tax allocation agreement in its entirety, is consistent with Section 23B will be based on the facts and circumstances of the particular tax allocation agreement and any associated refund.

For more information on this issue, please contact Tim Sullivan, Mike Morehead or your regular Hinshaw attorney.

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