

Does Your Bank or Thrift Holding Company Have a Tax Allocation Agreement with Its Depository Subsidiary?

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In carrying out their supervisory responsibilities of financial institutions, the regulatory agencies typically include a review of the allocation and payment of income taxes by financial institutions that are members of a group filing a consolidated income tax return. Although bank or thrift holding companies generally will file their federal income tax returns on a consolidated basis with their depository subsidiaries, each depository institution is viewed, and reports, as a separate legal and accounting entity for regulatory purposes. Consequently, the depository institution's applicable income taxes (reflected as either an expense or benefit) should be recorded as if the institution filed on a separate entity basis.

The regulatory agencies recommend that financial institutions that are members of a group filing a consolidated income tax return have a formal written, comprehensive *tax allocation agreement*—sometimes also referred to as a *tax sharing agreement*—to address intercorporate tax policies and procedures. The method of tax allocation should ensure that the depository subsidiary does not assume a larger tax burden than it would if it filed separately. If there is an overpayment of taxes by a depository subsidiary to its holding company, the payment may constitute an unsecured loan to an affiliate. Without such a written agreement in place, the tax allocation and payment practices of the financial institutions may be viewed as unsafe and unsound which could prompt informal or formal corrective action by the regulatory agencies.

Background:

In 1978, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Board of Governors of the Federal Reserve System (Board) each published a separate policy statement regarding the allocation and payment of income taxes by financial institutions which are members of a group filing a consolidated income tax return. At that time, the Office of Thrift Supervision (OTS) also provided supervisory guidance on this subject in its *Holding Company Handbook*.

Based on a later review by these agencies, it was determined that there were minor inconsistencies in the policy statements and supervisory guidance, although not substantive. The agencies determined that it would be beneficial to adopt a uniform interagency policy statement regarding intercorporate tax allocation in a bank or thrift holding company structure.

The Statement:

In 1998, an Interagency Policy Statement (the Statement) was developed by the OTS, FDIC, the Board, and the OCC.

The Statement provides uniform guidance to financial institutions regarding the allocation and payment/refund of income taxes between a holding company and its depository subsidiary. Many state banking departments have also adopted guidelines similar to those set forth in the Statement.

The Statement emphasizes that *intercorporate tax settlements between an institution and its parent company should be conducted in a manner that is no less favorable to the institution than if it were a separate taxpayer*. In addition, the Statement provided the following guidelines for financial institutions:

- Tax remittances from a depository subsidiary to its parent for its current tax expense should not exceed the amount the depository subsidiary would have paid had it filed separately.
- Payments by the depository subsidiary to its parent generally should not be made before the subsidiary would have been obligated to pay the taxing authority had it filed as a separate entity.
- Depository subsidiaries incurring a tax loss should receive a refund from their parent which refund should be in an amount no less than the amount the subsidiary would have received as a separate entity, regardless of whether the consolidated group is receiving a refund.
- Adjustments for statutory tax considerations which may arise in a consolidated return are permitted as long as the adjustments are made on a basis that is equitable and applied consistently among the holding company affiliates.
- Regardless of the method used to settle intercorporate income tax obligations, when depository institution members prepare regulatory reports, they must provide for current and deferred income taxes in amounts that would be reflected as if the institution had filed on a separate entity basis.
- A depository subsidiary should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to its parent since these are not liabilities required to be paid in the current reporting period.
- Transactions in which a parent “forgives” any portion of a depository subsidiary’s deferred tax liability should not be reflected in the subsidiary’s regulatory reports since the parent cannot relieve its subsidiary of this potential future obligation to the taxing authorities. This is because the taxing authorities can collect some or all of a group liability from any of the

group members if tax payments are not made when due.

- Financial institution members of a consolidated group should have a written, comprehensive tax allocation agreement to address intercorporate tax policies and procedures.

Tax Allocation Agreement:

The Statement encourages holding companies and their subsidiaries to enter into a formal written tax allocation agreement. Tax allocation agreements come in various forms and will vary in terms of comprehensiveness and payment methodology. With respect to financial institutions, the tax allocation agreement should address, at a minimum, the following items:

- The computation of the subsidiary depository institution's income taxes, both current and deferred, on a separate entity basis.
 - The amount and timing of the institution's payments for current taxes, including estimated tax payments.
 - The procedure for reimbursements to an institution when it has a loss for tax purposes.
 - The prohibition of the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.
 - The method elected under the Internal Revenue Code for allocating consolidated tax liability for purposes of determining the earnings and profits of members of the group and, if applicable, the complementary method elected to compensate members of the group for use of their tax attributes.
 - The procedure and approval required for preparation and filing of tax returns and refund claims.
 - The procedures for tax adjustments resulting from an amended tax return, audit, carryover or carryback of losses or credits, or otherwise, and the recomputation and allocation of liability and required remittance.
 - A provision providing for a comparable methodology and procedure for allocation of state income tax liability and state tax payments. There are instances where the members of the federal consolidated group and the members of the group for state tax purposes (which may file on a consolidated, combined or unitary basis) will not be coexistent, and a separate tax allocation agreement for state tax purposes may be necessary.
 - The provision for any alternative minimum tax liability and payment thereof.
 - The procedures for the tax liability of incoming and departing subsidiary members of the holding company's affiliated group.
- Other provisions in the tax allocation agreement may be advisable to address additional items specific to the holding company and its subsidiary group members and tailored to their specific structure and circumstances.

If a bank or thrift holding company and its depository subsidiary do not currently have a written tax allocation agreement, it is strongly recommended that such an agreement be prepared, adopted, and implemented to govern the relationship between the subsidiary and its holding company.

It is recommended that the financial institution's tax advisor and legal counsel assist in the preparation of the tax allocation agreement.

The board of directors of each entity should approve the written tax allocation agreement and such approval should be recorded in the minutes of the board of directors.

Once adopted, the directors, officers, and employees of the institutions must follow the procedures outlined in the written tax allocation agreement. Complete documentation of any calculation utilized by the depository subsidiary or the holding company with respect to the flow of funds for the payment of any tax liability should be made.

Once the tax allocation agreement is in place between the bank or thrift holding company and its depository subsidiaries, it is recommended that it be periodically reviewed for compliance with the regulatory guidance and the IRS's consolidated tax return regulations. An annual review of the tax allocation agreement and the intercompany tax reconciliation should be included in the minutes of each company's board of directors. ■

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