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Regulators Clarify Tax Allocation Agreements

On June 13, 2014, the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency (collectively, the "agencies") issued a final version of an addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure (the "policy statement") to address certain questions pertaining to an insured bank's entitlement to a tax refund owed to it when filing federal and state tax returns as a group with its parent holding company.

Importantly, the addendum requires that banks ensure that tax allocation agreements include certain language regarding the principal-agent relationship of a bank and its holding company by October 31, 2014, in order to avoid potential implications under Section 23A of the Federal Reserve Act.

The original policy statement was issued in 1998 and established regulatory expectations for tax allocation agreements. Specifically, the agencies required that such agreements be no less favorable to the bank than if it were a nonaffiliated, independent taxpayer such that the bank should receive any tax benefit it would have received had it filed as a stand-alone entity.

Recent controversy in this area centers on the nature of the relationship between a holding company and a bank when filing consolidated tax returns. Under the policy statement, the agencies indicated that this should be a principal-agent relationship, meaning that the holding company has no actual claim to the refund and simply holds the refund as an agent for its bank subsidiary. Further, tax refunds should not be described as property of the holding company in either the tax allocation agreement or in the holding company's corporate documents. Some recent court decisions, however, have instead classified this relationship as that of a debtor and its creditor. As a result, banks (and the FDIC, as receiver of many failed banks) have been treated as unsecured creditors for the refund, virtually eliminating their ability to recover the amount of the refund from the holding company during bankruptcy.

The addendum is an attempt by the agencies to address this issue. First, the addendum makes clear that tax allocation agreements must explicitly state that a principal-agent relationship exists between the bank and its holding company and that the agreements must not contain any language to the contrary. Further, the addendum requires that such agreements should expressly disclaim any right of the holding company to

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retain a tax refund. Second, the agencies have made it clear that the failure to include such language, or the inclusion of any language creating a debtor-creditor relationship, may cause the tax allocation agreement to constitute a loan to the holding company subject to Section 23A of the Federal Reserve Act.

The agencies have provided sample "safe harbor" language that reinforces the agency relationship, disclaims the holding company ownership interest in a tax refund and avoids the collateral and other requirements of Section 23A. Banks may use other language in place of the recommended "safe harbor" so long as it is substantially similar and reflects the intent of the addendum.

The agencies further emphasize the application of Section 23B of the Federal Reserve Act, which generally requires that transactions between a bank and its holding company be "arm's length." In this context, the agencies expect that tax allocation agreements between banks and their holding companies include terms requiring the prompt transfer of any refunds to the bank. Any agreements containing provisions entitling the holding company to hold on to the refund for any length of time will not be compliant with Section 23B.

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If you have any questions or would like additional information on the content in this advisory, please contact the authors Cliff Stanford and Elliot L. Franklin or any member of our Financial Services & Products Group.

Clifford S. Stanford
404.881.7833
cliff.stanford@alston.com

Elliot L. Franklin
404.881.7954
elliot.franklin@alston.com

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ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 12th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333