Consolidated Group Tax Allocations: 
Navigating Consolidated Return Rules
Leveraging Allocation Agreements in Acquisitions, Spin-Offs, Issuances of Stock; Implementing New Interagency Guidance for Banks

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Consolidated Group Tax Allocations: Navigating Consolidated Return Rules

Consolidated Return Tax Allocation Methods

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Consolidated Federal Income Tax Returns

- A group comprised of a common parent corporation and its 80%-owned direct and indirect eligible corporate subsidiaries files a single federal income tax return and makes a single tax payment.

- Ineligible corporate subsidiaries such as foreign corporations, REITs and RICs are excluded. Tax consolidation does not match financial consolidation.

- The common parent corporation is the agent of all the members in signing the return, paying the tax and receiving notices and refunds (Reg. Sec. 1.1502-77).

- All consolidated corporations are jointly and severally liable to the IRS for the group’s tax.
Why Consolidated Groups Allocate Taxes

• Regulatory Reasons

• Creditor Concerns (with or without Bankruptcy)

• Minority Shareholders

• Tax Concerns
Tax Concerns: Intercompany Payments

- Federal Income Taxes Nondeductible (Code Sec. 275)
  - But are deductible in determining Earnings and Profits
- Possible Characterizations of Reimbursement of Tax
  - Dividend
  - Capital Contribution
  - Repayment of Loan
Tax Purposes

• Earnings and Profits (Reg. Sec. 1.1552-1)

• E & P - Tax Benefit Payments (Reg. Sec. 1.1502-33(d))

• Stock Basis Adjustments (Reg. Sec. 1.1502-32)
Affirmatively made in first consolidated tax return

If no affirmative election, deemed to elect Method 1

Automatic change of method under Rev. Proc. 90-39, 1990-2 C.B. 365, to Methods 1 to 3 if current method was not adopted in last five taxable years or if current method is initial method. Change is not retroactive

Does it matter if no initial election is made given the rare circumstances in which earnings and profits become relevant?
• Treas. Reg. Sec. 1.1552-1(b)(2) Effect of Allocation.
  - The amount of tax liability allocated to a corporation ... shall (i) result in a decrease in the earnings and profits of such corporation in such amount, and (ii) be treated as a liability of such corporation for such amount. If the full amount of such liability is not paid by such corporation, pursuant to an agreement among the members of the group or otherwise, the amount which is not paid will generally be treated as a distribution with respect to stock, a contribution to capital, or a combination thereof, as the case may be.

• Note that last sentence of above rule applies even if no Tax Allocation Agreement or Affirmative Tax Election
Earnings and Profits: Basic Method I

- Based on Contributions to Consolidated Taxable Income
- Actual Income Contribution may be less than Separate Taxable Income
- Members with Current Losses receive no Allocation
- But Members with Credits and Carryovers may receive Allocation even though they would not pay tax as unconsolidated corporations
Earnings and Profits: Basic Method II

• Based on ratio of Member “Separate Return Tax Liabilities”

• “Separate Return Tax Liability:” Actual Liability if Separate Return filed but with Timing Adjustments for Intercompany Transactions, ELAs, Stock Basis Adjustments, and Exclusions of Dividends

• Method Does Allow for Absorption of Credits and Carryovers Attributable to Member
Earnings and Profits: Basic Method III

• Hybrid of Basic Methods I and II
  - First, apply Basic Method I
  - Second, determine if Basic Method I produces excess tax for any Member in excess of Basic Method II
  - Third, reallocate excess Basic Method I tax from second step to Members for whom Basic Method II produces excess over Basic Method I, to extent of excess
  - Fourth, reallocate any remaining excess from second step among Members in accordance with Basic Method I

• More popular when there was a consolidated return surtax but may still be relevant for Members in lower tax brackets
• Any method approved by the Commissioner

• Rev. Rul. 57-392, 1957-2 C.B. 615, approved two-tier Method-I like allocation, first to operational groups and then among Members within operational groups

• PLR 8446013 (Aug. 8, 1984) approved two-tier Method II-like allocation, first to operational groups and then among Members within operational groups

• Possible approval of method that allocates based on operational groups that include SMLLCs
E & P Complementary Methods: The Problem

- Methods I through IV do not adjust E & P for absorption of another member’s losses and other tax benefits
- Without complementary method, absorption of loss would reduce E & P of member generating loss and not E & P of member that utilized loss
• Groups may affirmatively elect one of three Complementary Methods. No deemed election

• Election must be made in first consolidated tax return

• Automatic change of Complementary Method under Rev. Proc. 90-39, 1990-2 C.B. 365, if current method was not adopted in last five taxable years or if current method is initial method

• Automatic change is not retroactive

• Does choice of Complementary Method matter?

- The amounts allocated [under the Complementary Methods] are treated as allocations of tax liability.... For example, if P's taxable income is offset by S's loss, and tax liability is allocated under the percentage method ... P's earnings and profits are reduced as if its income were subject to tax, P is treated as liable to S for the amount of the tax, and corresponding adjustments are made to S's earnings and profits. If the liability of one member to another is not paid, the amount not paid generally is treated as a distribution, contribution, or both, depending on the relationship between the members.

Note that last sentence of above rule applies even if election is made by groups without a Tax Allocation Agreement.
• So-called “wait-and-see” method popular with regulated industries (derived from Public Utility Holding Company Act Rule 45(b)(6))

• Overall effect is to compensate benefit-generating member only when the benefit would notionally be used to reduce its separate return liability (“wait-and-see”) and not when the consolidated group obtains the benefit. If the benefit would have expired unused on a notional separate return, no amount is reallocated to the benefit-generating Member under Complementary Method I
• First, limit the Basic Method allocation to the excess notional cumulative calculation of each member’s liability as if it actually filed separate return for the current and all preceding years over the cumulative Basic Method consolidated tax allocations for all years through the preceding year

• Second, reallocate any excess to other members in proportion to their reductions in cumulative notional separate return liability for all years

• Third, allocate any remaining excess from the cap in the first step in accordance with Basic Method elected by the group
E & P Complementary Method II – Tax Benefits

- So-called “percentage method”- most commonly used
- First, decrease a member’s E & P by a fixed percentage (usually 100% is chosen) of the excess of its notional Basic Method II separate return tax liability for the current year over its Basic Method consolidated tax allocation
- Second, allocate the decreases in E & P to those members whose tax attributes were absorbed in the current year “in a manner that reasonably reflects the absorption of the tax benefits”
• Any other complementary method approved by the Commissioner

• Commissioner approved two-tier Method II-like allocation combined with Complementary Method I, first to operational groups and then among members of groups. LTR 9319012 (Feb. 4, 1993)

• Commissioner DISAPPROVED the use of a modified Complementary Method I that would turn off whenever regulated company did not have a loss. Rev. 75-80, 1975-1 C.B. 292
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Since 1995, stock basis adjustments have generally been based on members’ taxable incomes and not their respective E & P, but taxes and other nondeductible expenses must be taken into account.

Groups are required to use the same Basic Method as for E & P to allocate taxes in making stock basis adjustments.

Groups may only use Complementary Method II to allocate tax benefit payments.

What is effect of use of Complementary Method I?

Reg. Sec. 1.1502-36 and availability of Section 336(e) and 338(h)(10) elections may diminish importance of stock basis.
Stock Basis Adjustments – page 2

  The treatment of amounts allocated [for stock basis adjustment purposes] is analogous to the treatment of allocations under section 1.1551-1(b)(2). For example, if one member owes a payment to a second member, the first member is treated as indebted to the second member. The right to receive payment is treated as a positive [stock basis] adjustment ..., and the obligation to make payment is treated as a negative [stock basis] adjustment .... If the obligation is not paid, the amount not paid generally is treated as a distribution, contribution, or both, depending on the relationship between the member

- Note that last sentence of above rule applies even if no Tax Allocation Agreement
Stock Basis Adjustments – Special Post-1994 Election

- Groups that used Complementary Method I or III before 1995 for E & P determination could make a special transitional election with their first post-1994 tax return to use Complementary Method II for all taxable years (i.e., retroactively) or for all post-1994 taxable years.

- By making this transition election, groups could conform stock basis and E & P calculations for all years in calculating gain or loss on future dispositions of subsidiary stock.

- It is possible that 9100 relief may still be available for late transitional elections – nearly 20 years later!
Summary

• The IRS regulations notionally allocate consolidated return group tax liability for the purposes of determining earnings and profits, tax benefit payments and stock basis adjustments.

• If actual intercompany payments do not match the regulatory allocations, the regulations deem distributions and contributions to have been made, in order to conform the tax and financial books. The regulations do not create intercompany liabilities requiring actual payments.

• Written tax sharing agreements require intercompany payments and thereby create liabilities under state law.
Consolidated Group Tax Allocations: Navigating Consolidated Return Rules

November 12, 2014

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Applicability of rules in various business situations

- Preliminary considerations
- Acquisitions
- Spin-offs
- Issuances of stock
- Audits and refund claims
- List of useful resources
Every member (and former member) is severally liable for the consolidated tax liability. Section 1.1502-6.

Accordingly, new shareholders should be careful when investing in a consolidated group member.

Section 1502 regulations do allocate tax liability among members, but only for purposes of determining investment basis adjustments (IBAs) and earnings and profits (E&P).

There is no need for the IRS to allocate responsibility for consolidated tax liability, because every member is severally liable under section 1.1502-6.

The group may utilize the consolidated tax allocation rules for purposes of allocating responsibility for consolidated tax liability among group members.
If payments in respect of tax liability differ from the allocation method used to determine IBAs and E&P, the amounts not paid are treated as distributions, capital contributions, or both, depending on the relationship between obligor and obligee.

When a member leaves the group, section 1502 regulations allocate certain tax attributes, e.g., losses and E&P, between the member and the group.

A member leaving the group could trigger deferred gains and excess loss accounts (ELAs).
Assume P group purchases all outstanding stock of T. Does T automatically join the P group?

* Yes. This is not an obvious point.
  * Sections 1504; 1502-1; 1502-75.
  * Regulations can be a bit misleading on this point, because of the requirement that every subsidiary must file Form 1122, consent to join consolidated group. Section 1.1502-75(a)(1), (b). However, that is just for the group’s initial year.

What if T was a member of the P group in the past?

* 60 months must elapse before reconsolidation. Section 1504(a)(3).
• What if a selling shareholder remains a minority shareholder of a target corporation that will join the purchaser’s consolidated?
  * The minority shareholder will have an interest in how the target’s share of the consolidated tax liability is determined, e.g., do loss members get compensated for their losses?
• When a corporation joins a consolidated group, its separate taxable year ends at the end of the day on which it joins the group (the “end of the day rule”); however, parties can reasonably determine whether a transaction that occurs after the member joins the group (but still on the same day) should be treated as occurring on the next day (the “next day rule”). Section 1.1502-76(b)(1). The IRS also has the power to apply the next day rule.
Example: P acquires T stock in the morning; T disposes of 50% of its assets in the evening, realizing a large amount of gain.

Is the seller doomed if the parties do not agree to apply the next day rule? Yes, unless the IRS applies the next day rule.

Would the allocation of items between separate and consolidated returns help the seller?

The target must allocate its items between separate and consolidated returns. The parties may close the books, or may generally elect ratable allocation. Section 1.1502-76(b)(2).

Consider the example above. Would ratable allocation be helpful?

Ratable allocation does not apply to “extraordinary items”.

Extraordinary items include, e.g., any item from the disposition of capital assets. Section 1.1502-76(b)(2)(C).

It looks like the seller could be doomed even with a ratable allocation.
• Election to waive T’s losses. Section 1.1502-32(b)(4).
  * Parent’s tax basis in T stock is reduced when T’s losses are absorbed or expire unused.
  * The election allows the P group to avoid the negative IBA adjustment that would otherwise occur when T’s losses expire.
Section 338(h)(10) election.

* If the acquisition qualifies for election under section 338(h)(10), the P group is treated as if its subsidiary, new T, acquired old T’s assets.

* New T remains liable for old T’s taxes, including under section 1.1502-6. Section 1.338(h)(10)-1(d)(2). Accordingly, it is important for the P group to get an indemnity from the selling group.
Section 355 distributions of Controlled stock to Distributing shareholders – a preliminary point about nomenclature.

* A pro-rata distribution is a “spin-off.”
* An exchange of Controlled stock for Distributing stock is a “split-off.”
* A part exchange and part pro-rata distribution is a “splint-off.”
* A division of Distributing into multiple Controlleds, and a distribution of all of them to Distributing shareholders is a “split-up.” (A split-up does not have to be pro-rata.)

Section 355 requires a distribution of at least section 368(c) control of Controlled.

* Thus, a section 355 distribution deconsolidates Controlled.
* It may be possible for Distributing to retain up to 20% of Controlled. Section 355(a)(1)(D).
Section 355 protects against two levels of tax.

- Distributing is protected against section 311(b) gain on distribution of Controlled stock.
  - Whether Controlled is newly formed or historic, Distributing’s tax basis in Controlled stock is likely to be less than FMV.
  - There are two likely culprits, debt and appreciation.
  - Though uncommon, Distributing’s basis in Controlled could be negative. Section 1.1502-19.

- Distributing shareholders are protected against shareholder-level tax on receipt of Controlled stock.
In the context of a consolidated group, there is a third type of gain to watch out for: deferred intercompany gain. Section 1.1502-13.

Example: Controlled and RemainCo are existing subsidiaries of Distributing. RemainCo sells land to Controlled and realizes a (deferred) $100 section 1001 gain. Two years later, Distributing distributes Controlled stock in a section 355 distribution. RemainCo’s section 1001 gain is triggered.

Same as above, except RemainCo distributes the widget to Distributing, and Distributing contributes the widget to Controlled. RemainCo’s section 311(b) gain is triggered.
Assume instead that RemainCo contributes the widget to NewCo and distributes NewCo stock to Distributing. Distributing then contributes NewCo stock to Controlled and distributes Controlled. RemainCo avoids recognizing gain if section 355 applies to RemainCo’s distribution of NewCo stock to Distributing.

Assume instead that in a section 351 transaction RemainCo contributes the widget to NewCo, and Distributing contributes Controlled stock to NewCo. Can RemainCo transfer its Newco stock to Distributing without realizing gain? Probably not.
Assume instead that Distributing checks the box on RemainCo (or converts RemainCo from a corporation to a single-member limited liability company). Is it better for RemainCo to sell the widget to Controlled, or distribute the widget to Distributing (a disregarded step for tax purposes), followed by Distributing’s contribution of the widget to Controlled? If Distributing sells the widget, that will create deferred gain.
Even if Controlled is newly formed, it will be a member of the consolidated group for at least a brief period.

Controlled’s taxable year generally ends at the end of the day on which it leaves the group, unless the next day rule applies. These rules operate the same way as when a corporation joins the group (discussed above).

Recall that if the next day rule applies, a transaction that occurs after closing on the day of the closing will be treated as occurring the next day.
* Tax sharing agreements in the spin-off context.
  * Corporate-level tax on the distribution is imposed on Distributing. Thus, if the parties intend for Controlled to bear that tax, Controlled must indemnify Distributing.
  * Controlled, as a member of the consolidated group, has exposure under section 1.1502-6. Thus, if the parties intend for Distributing to bear the corporate-level tax, Distributing must agree to indemnify Controlled.
* Expenditures related to Controlled’s business could become deductible after the spin-off. If Distributing pays, e.g., pursuant to an indemnity, it may want Controlled to pay over the benefits arising from the deduction.
  * Generally, post-spin-off payments are treated as pre-spin-off capital contributions or distributions.
  * In some cases, a post-spin-off payment could be treated as occurring after the spin-off. EEC 2013-10-039.
* If Controlled is historic, it will take its share of NOLs with it. If Controlled is newly formed, it will not have any NOLs.
  * Section 381 does not provide for inheritance of NOLs in a section 351 transaction or in a divisive D reorganization.
* If spin-off is taxable, the parties could agree to make a protective section 336(e) election.
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If a member of a consolidated group issues stock to an outsider, there are two potential scenarios. Either the member leaves the group, or it does not.

The member leaves the group if the group loses ownership that satisfies the 80% vote and value test in section 1504(a)(2).

  - The notice is a response to section 1504(a)(5), which authorizes issuance of regulations addressing value measurements.

- Alumax v. Comm’r, 109 T.C. 133, aff’d, 165 F.3d 822 (11th Cir. 1999).
  - Alumax addresses the vote requirement where the minority shareholder could elect directors that had blocking power over several major corporate governance items.
Assume the member leaves the group.

- The member’s taxable year ends at the end of the day on which it leaves the group; however, parties can reasonably agree to treat a transaction that occurs after the member leaves the group as occurring on the next day. Section 1.1502-76(b)(1).
  - These rules operate the same way as when a corporation joins the group (discussed above).
  - For example, consider a deconsolidating stock issuance followed by an asset sale. The asset sale is pre-wired to occur immediately after the stock issuance. That is just one of the multitude of ways in which the next day rule could be implicated.
The parties should address the following items regardless of whether the member leaves the group.

- Both the group and the new shareholders will want to address how the member’s tax liability is allocated.
  - If the target stays with the group, the relevant allocation methods are the ones for allocating consolidated tax liability.
  - If the target deconsolidates, the relevant allocation methods are the ones in section 1.1502-76(b)(2).
* Both the group and the new shareholders may want to prepare (or review) the target’s tax returns, and to control (or participate in) the target’s tax audits and contests.

* The group may resist sharing sensitive information with the target’s outside shareholders, especially if the target remains a member of the group.
Audits and refund claims

- Two alternatives
  - A member of the group has outside interests
  - A member leaves the group
Group member with outside interests

What might these interests be?
- Regulators
- Creditors
- Outside shareholders
- Officers and employees

What items should you watch out for?
- Preparation and review of tax returns, and refund claims
- Control of contests, and consent to settlements
* Ownership of refunds.
  * The parent corporation generally transacts with the IRS on behalf of the group. Section 1.1502-77.
  * This includes filing consolidated tax returns, and receiving refunds.
  * If a refund ultimately belongs to a specific subsidiary, it may be important whether the parent receives the refund as an agent or a creditor of the subsidiary.
    * For example, assume that both the parent and the subsidiary have outside creditors, and both file for bankruptcy.
    * If the parent receives the refund as an agent of the subsidiary, the parent will be structurally subordinated to the subsidiary’s creditors, and so may not benefit from the refund. If the parent is determined to be a debtor of the subsidiary with respect to the refund, the subsidiary’s creditors may share the refund with the parent.
A member leaves the group – what should you watch out for?

Same audit and refund issues that arise anytime a target is acquired.

- Review of amended tax returns (it may be necessary to include “black box” audit rights, to prevent new shareholders from having access to former group’s tax returns).

- Control of audits and contests – a party may not let an outsider control its audits unless the outsider acknowledges its indemnity and, possibly, posts a security.
Useful Resources

Special Issues Affecting Depository Institutions

Case Law and Regulatory Guidance on Tax Allocation Agreements

Keith R. Fisher
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What Entity is Entitled to Refunds?

- IRS consolidated return regulations do not determine who is the “owner” of a tax refund
- Issue always comes to a head in insolvency settings, failed insured depository institution (“IDI”) and its holding company in bankruptcy
- Case law relies on a number of factors, including
  - Whether there is a tax allocation agreement and, if so, how the operative language is couched
  - Whether there is evidence of a fiduciary relationship
  - Whether there has been any unjust enrichment
- Fundamental Bank Regulatory Principles
  - Holding Company is a Source of Strength for its IDIs
  - Maximizing Recoveries for Deposit Insurance Fund
Typical Insolvency Dynamics

• Bank holding company is a general business corporation and goes into bankruptcy when insolvent

• Insured depository institution is placed into FDIC receivership or conservatorship or possibly sold to a solvent institution in a purchase & assumption transaction

• Different creditors of each entity lead to disputes over which estate owns tax refunds

• Federal Deposit Insurance Act: Complex insolvency provisions -- different legal regime from Bankruptcy Code

• **N.B.** Several themes in insolvent bank cases are also found in insolvent insurance company cases.
• The court decisions on tax allocation agreements (TAAs) turn largely on questions of contract interpretation.
  - Does the language create an agency relationship between holding company and its IDI subsidiary where the IDI is the principal and the holding company is the agent?
  - Does the language create a fiduciary relationship between them?
  - Can the language be interpreted to create a constructive trust?
  - Does the language create a debtor/creditor relationship whereby the holding company owns the refund and has only a contractual obligation to remit to the IDI the percentage of the refund attributable to its contribution?
The Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure (the “Policy Statement”) was originally promulgated by the prudential bank regulators in 1998.

- Supervisory authority may be exercised by whichever agency is the IDI’s appropriate Federal banking agency (“AFBA”)

The Policy Statement provides that intracorporate tax settlements involving IDIs that are members of a group filing a consolidated return should result in no less favorable treatment to the IDI than if it had filed its tax return as a separate entity.

- Encourages HCs and their subsidiary IDIs to enter into comprehensive, written TAAs
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• Require each IDI to compute its income taxes (both current and deferred) on a separate entity basis

• Discuss the amount and timing of the IDI’s payments for current tax expense, including estimated tax payments

• Discuss reimbursements to an IDI when it has a loss

• Prohibit payment or transfer of deferred taxes by the IDI to another member of the consolidated group

• When the HC’s consolidated obligation arising from AMT exceeds regular tax on a consolidated basis, the excess should be consistently and equitably allocated amongst the group
Contents of TAAs Under Policy Statement (2)

- Payment of deferred taxes to HC is a dividend for regulatory purposes and subject to any applicable dividend restrictions (e.g., Prompt Corrective Action provisions)
- Payments (including estimated payments) made to the parent HC before the IDI would have been obligated to pay the IRS (or other taxing authority) may be deemed –
  - extensions of credit to the parent
  - Subject to the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act
- Properly allocable refunds should be paid to the IDI within a reasonable period following the date it would have filed
  - regardless of whether the group is receiving a refund
  - or else the AFBA may consider the receivable as either a dividend or an extension of credit
If the HC uses an IDI’s tax loss even though the IDI would not separately be entitled to a tax refund, the HC may reimburse the IDI for use of the tax loss.

- If reimbursement is timely, the IDI should reflect the benefit of the tax loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, it should be treated as a loss carryforward.

Regardless of the treatment of an IDI’s tax loss for regulatory reporting or supervisory purposes, a parent HC that receives a refund obtains those funds as agent for the benefit of the consolidated group.

- Accordingly, the TAA should not purport to characterize refunds attributable to an IDI as property of the parent.
• IDIs and their HCs should review their existing TAAs and, if necessary, amend them expressly to acknowledge that the HC receives any tax refunds solely in an agency capacity and to delete any language that suggests a contrary intent.

- A model clause to that effect is included in the guidance for clarification of that purely agency relationship.

• TAAs should now require HCs promptly to forward any tax refund payments due to their IDIs and should specify the timing of such payments.
The regulators also considered how Sections 23A and 23B of the Federal Reserve Act apply to tax allocation agreements. According to the new guidance:

- Any TAA that does not clearly acknowledge that an agency relationship exists may be subject to additional requirements under Section 23A; and

- Any TAA that permits a HC to retain and not promptly transmit tax refund payments received from a taxing authority and owed to an IDI is incompatible with the requirements of Section 23B.
If you have questions about any of the bank regulatory material covered today, please contact:

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