FEDERAL RESERVE BANK
OF NEW YORK

Circular No. 8429
October 3, 1978

Intercorporate Tax Practices of Bank Holding Companies and State Member Banks

To All Banks and Bank Holding Companies in the Second Federal Reserve District:

The Board of Governors of the Federal Reserve System has issued a policy statement regarding intercorporate tax practices of bank holding companies and their State-chartered member bank subsidiaries. The policy statement is substantially the same as that published for comment earlier this year and sent to you with our Circular No. 8355, dated May 25, 1978.

Printed below is the text of the Board's policy statement. Questions regarding this policy may be directed to our Bank Examinations Department (Tel. No. 212-791-5240).

PAUL A. VOLCKER,
President.

Policy Statement Regarding Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State-Chartered Banks that are Members of the Federal Reserve System

It has come to the attention of the Board of Governors of the Federal Reserve System that a few bank holding companies and certain of their bank subsidiaries are engaging in intercorporate income tax accounting transactions that have the effect of transferring assets and income from the subsidiary banks to the parent company without offsetting benefits to the bank.

The practices include: (1) the bank paying taxes to the parent under an arrangement that may leave the bank less well off than if the bank filed a return on a separate entity basis;[1] (2) the bank paying taxes to the parent prior to the time that the parent's actual or estimated current tax liability is, or normally would be, due and payable; and (3) the bank transferring its deferred tax account to the parent, in most cases along with an equivalent amount of cash or earning assets. While these practices are not now widespread, the Board believes that they are inappropriate and should cease. Accordingly, the Board will apply appropriate supervisory remedies to these practices including, under certain circumstances, its cease and desist powers under the Financial Institutions Supervisory Act (12 U.S.C. § 1818).

One of the advantages of a bank holding company organization is to derive tax savings by offsetting the profits and losses of the various entities that participate in the filing of the consolidated tax return. Typically, bank subsidiaries having a profit pay current taxes to their parent either on a separate entity basis or on one

1/ As it is used in this statement, the term separate entity basis recognizes that certain adjustments, in particular tax elections in a consolidated return, may, in certain periods, result in higher payments by the affiliated bank than would have been made were the bank unaffiliated. The Board normally would regard such adjustments as acceptable.

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of a variety of allocation methods that often results in some lesser amount of taxes being remitted to the parent. In those cases where a bank incurs a loss, the bank may or may not receive an equitable refund from its parent.

The Board does not wish to prescribe the tax accounting methods to be used by bank holding companies. However, the Board does require that those methods employed give bank subsidiaries equitable treatment. Such equitable treatment would not result if: (1) the bank's tax payments to the parent during a profitable period exceed what the bank would pay if it filed on a separate entity basis; (2) the bank does not receive an appropriate refund from the parent when the bank incurs a loss; or (3) the bank's tax payments to the parent significantly precede the time that a consolidated actual or estimated current tax liability would be due and payable to the tax authorities.

Many bank holding companies now have written tax sharing agreements with their bank subsidiaries that specify intercorporate tax settlement policies. The Board believes that having such agreements is desirable and wishes to encourage all holding companies to have such agreements.

In the last several years, an increasing number of banks have been transferring their deferred tax account to their parent. Typically, these transfers have been accompanied by the bank transferring an equivalent dollar amount of cash or earning assets. The Board believes that a bank's deferred tax account does not constitute a current liability of the bank. Consequently, when a bank transfers its deferred tax account to its parent, usually along with an equivalent amount of cash or earning assets, the bank is engaging in a transaction that has an adverse effect on its financial condition. Such a transaction is tantamount to a prepayment or excessive payment of taxes. Moreover, the Board believes that the transfer of a bank's deferred tax account would result in the bank subsequently filing inaccurate reports for supervisory purposes.

In those few instances where deferred tax accounts of state member banks have already been transferred to the parent, the Board believes that such transfers should be reversed in the most expeditious way that is practical, given attendant circumstances and supervisory objectives. In most cases, this would involve an immediate reinstatement of the deferred tax on the books of the bank, along with the transfer by the parent of an equivalent amount of cash or appropriate earning assets. In those cases where the parent cannot immediately remit cash or appropriate earning assets, the holding company and the bank should work out an appropriate alternative arrangement with their Federal Reserve Bank.

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