

Client Alert

December 21, 2016

IRS Provides Guidance on TLAC

By Thomas A. Humphreys, Remmelt A. Reigersman and David J. Goett

On December 16, 2016, the Internal Revenue Service (“IRS”) issued Revenue Procedure 2017-12 (the “Revenue Procedure”), which provides that certain instruments issued by global systemically important banking organizations (“GSIBs”) that provide total loss-absorbing capacity (“TLAC”) will be treated by the IRS as indebtedness for federal income tax purposes.

The IRS guidance comes one day after the Board of Governors of the Federal Reserve System (the “Board”) issued final regulations (the “Federal Reserve Regulations”) that prescribe the amount and form of TLAC required for domestic GSIBs and the U.S. operations of foreign GSIBs.¹

Under the Federal Reserve Regulations, GSIBs are required to issue both “external TLAC,” which is TLAC issued to third-party investors, and “internal TLAC,” which is issued to related parties. One example of internal TLAC is in the context of a foreign GSIB with a significant U.S. presence that holds securities issued by its domestic intermediate holding company (“IHC”). In that case, the Federal Reserve Regulations require such internal TLAC to:

- not be secured, not be guaranteed by the IHC or a subsidiary of the IHC, and not be subject to any other arrangement that legally or economically enhances the seniority of the instrument;
- have a maturity of greater than or equal to one year from the date of issuance;
- be governed by the laws of the United States or any State thereof;
- not provide the holder of the TLAC a contractual right to accelerate payment of items denominated as principal or interest on the instrument, except a right that is exercisable on one or more dates that are specified in the instrument or in the event of (A) a receivership, insolvency, liquidation, or similar proceeding of the IHC or (B) a failure of the IHC to pay principal or interest on the instrument when due and payable that continues for 30 days or more;
- be issued to and held by a company that is incorporated or organized outside of the United States, and directly or indirectly controls the IHC or is a wholly owned subsidiary of such company; and
- have a contractual provision approved by the Board that provides for the immediate conversion or exchange of the instrument into common equity tier 1 of the IHC upon the Board’s issuance of an internal debt conversion order for the TLAC (the “Debt Conversion Feature”).²

¹ For a discussion of the Federal Reserve Regulations, please see our client alert available at <https://media2.mofo.com/documents/161215-federal-reserve-final-tlac-rule.pdf>.

² 12 C.F.R. § 252.161.

Client Alert

Although TLAC is issued in the form of debt for state law purposes, tax commentators have questioned whether debt issued with certain features, such as a Debt Conversion Feature, would qualify as indebtedness for federal income tax purposes.³ Whether TLAC is treated as indebtedness or equity of the issuer for tax purposes has a major impact on the cost of capital due to the fact that interest on indebtedness is generally deductible for tax purposes while distributions on equity are generally not deductible.

The Revenue Procedure acknowledges the issue involving internal TLAC: “Despite being debt in form, internal TLAC issued under the Board regulations lacks several of the elements that generally are required for an instrument to be treated as indebtedness for federal income tax purposes.” According to the Revenue Procedure, however, “the Treasury Department and the IRS believe that it is in the interest of sound tax administration to apply federal tax principles in a manner that will support the rules promulgated by the Board for recapitalizing the issuer of internal TLAC on a going-concern basis.”

Accordingly, the Revenue Procedure provides that internal TLAC that is issued by an IHC of a foreign GSIB pursuant to the Federal Reserve Regulations will be treated by the IRS as indebtedness for federal tax purposes, to the extent the instruments have not been converted into equity.

Earlier this year, the IRS issued final regulations under Section⁴ 385 that recharacterize certain debt instruments as equity debt instruments for federal tax purposes if the parties do not comply with documentation requirements or if the instruments are issued in transactions that the IRS deems abusive.⁵ The preamble to those regulations indicated that the IRS was considering guidance to address debt-equity characterization in the case of debt issuances required by regulators.

The Revenue Procedure applies to internal TLAC instruments issued on or after December 15, 2016, and specifically states that no inference should be drawn about the federal tax characterization of an instrument that is outside the scope of the Revenue Procedure. Importantly, the Revenue Procedure is not a statement of the IRS’s legal opinion on whether internal TLAC is debt or equity for federal income tax purposes. Instead it simply announces that the IRS will treat internal TLAC as debt for federal income tax purposes. By not extending the Revenue Procedure to external TLAC the IRS may be indicating that it does not see a need for a similar statement there or, possibly, that it intends to address external TLAC in the future. In any event, taxpayers will view the Revenue Procedure as demonstrating the IRS’s willingness to accommodate the Federal Reserve’s efforts to regulate financial institutions.

³ See Lee A. Sheppard, “Bank Capital Requirements and Tax Treatment, Part 2,” 81 Tax Notes Int’l 810 (Mar. 7, 2016).

⁴ All section references are to the Internal Revenue Code of 1986, as amended.

⁵ For a discussion of the final regulations under Section 385, see our client alert available at <https://media2.mofo.com/documents/161020-irs-debt-equity-regulations.pdf>.

Client Alert

Contacts:

Thomas A. Humphreys

(212) 468-8006

thumphreys@mofo.com

Remmelt A. Reigersman

(415) 268-6259

rreigersman@mofo.com

David J. Goett

(212) 336-4337

dgoett@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.