



# Deferred tax implications of final Basel III rules

On 2 July 2013, the Federal Reserve released the long-awaited final regulations implementing the Basel III standards for determining required levels of regulatory capital for banking organizations. These regulations amend, in several important respects, a notice of proposed rulemaking that was issued in June 2012 (the NPR). Included in these rules are numerous provisions limiting how and when deferred tax assets (DTAs) are required to be subtracted from GAAP equity in arriving at the various layers of regulatory capital. However, some of the rules in the final regulations differ significantly from those in the NPR. This alert covers three of those differences.

## Immediate reversal presumption

Without a doubt, the single most important issue addressed in the final regulations concerns the so-called hypothetical carryback. Since the 1985 release of Banking Circular 202, banking organizations were required to compute a limit on DTAs for regulatory capital purposes by looking to the quantum of tax paid in the relevant carryback period, which, back then, was 10 years. This same principle has been used ever since. In fact, under the current rules (e.g., 12 C.F.R. 225 Appendix A in the case of a bank holding company), banks are instructed to compute the amount of DTAs dependent on future income by assuming that all temporary differences reverse at the report date, and to the extent necessary, the resulting loss is assumed to be carried back (to offset current plus the two preceding years' tax liabilities) and then carried forward, along with any real tax carryforward items. In total, the amounts that would be carried forward are limited to the lesser of 10% of capital or 12 months of projected tax.

In the NPR, the Federal Reserve indicated that temporary difference DTAs that could be supported by a net operating loss (NOL) carryback would not be subject to limitation. However, it was not



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made clear whether, in measuring the ability to carryback, a bank would be required to chart out future reversals of DTAs and evaluate their maximum carryback capacity or whether the carryback capacity would be measured using the simpler method of adding up the taxes paid in the current and two preceding years on the basis of an immediate reversal presumption. In response to this uncertainty, several comment letters addressed this issue and asked for clarification. Although the Federal Reserve did not provide full clarification, it seems fairly certain that the existing treatment (i.e., the immediate reversal presumption followed by a hypothetical carryback as of the report date) will be left alone, based on the language in the preamble, which states:

The agencies confirm that under the final rule, DTAs that arise from temporary differences that the banking organization may realize through net operating loss carrybacks are not subject to the 10 percent and 15 percent common equity tier 1 capital deduction thresholds (deduction thresholds). This is consistent with the agencies' general risk-based capital rules, which do not limit DTAs that can potentially be realized from taxes paid in prior carryback years.

However, some questions still remain, such as whether the tax dollars recoverable in a hypothetical carryback should reflect other elements of tax law, such as Internal Revenue Code section 382 or the alternative minimum tax regime (which limits NOL utilization to 90% of alternative minimum taxable income, thereby insuring a minimum tax remains non-refundable).

## Deferred tax liability (DTL) netting and the hypothetical carryback

In the NPR and the final regulations, NOL DTAs and tax credit carryforward DTAs (collectively, tax attribute DTAs) are subject to a subtraction, rather than a threshold limitation. For purposes of determining the amount of these tax attribute DTAs that must be subtracted, section 22(e)(3) of the NPR provided rules for apportioning DTLs among gross temporary difference DTAs and tax attribute DTAs. Under those rules, it appeared DTLs would be apportioned based on the relative amount of tax attribute DTAs, net of any valuation allowance, versus temporary difference DTAs, net of any valuation allowance and net of the amount that could be hypothetically carried back. That is, DTLs were presumably apportioned post-hypothetical carryback. However, elsewhere in the NPR (in footnote 14) there was a reference to a net amount of DTA that could be supported by a hypothetical carryback. This prompted a comment from an industry group which postulated that footnote 14 and section 22(e)(3) were potentially incompatible because the former presumed a netting of DTLs against temporary difference DTAs would occur prior to performing the hypothetical carryback analysis, while the latter presumed the netting of DTLs would occur after the hypothetical carryback.

In response to this comment letter, the final regulation amends section 22(d)(1)(i) to clarify that the amount of temporary difference DTAs that are exempt from limitation are the "DTAs (net of any related valuation allowances and net of DTLs, in accordance with §\_\_.22(e)) arising from timing differences that the [BANK] could realize through net operating loss carrybacks." At first blush, this suggests that DTL netting occurs prior to reducing the temporary difference DTAs. However, section 22(e)(3) continues to provide that DTLs "must be allocated in proportion to the amount of DTAs that arise from NOL and tax credit carryforwards (net of any related valuation allowances, but before any offsetting of DTLs) and of DTAs arising from temporary differences that the [BANK] could not realize through NOL carrybacks (net of any related valuation allowances, but before any offsetting of DTLs), respectively." In other words, section 22(e)(3) supports the view that apportionment of DTLs occurs after the hypothetical carryback is evaluated.

It is possible that both rules could be correct. That is, perhaps the amount of DTA exempt from any limitation is a net DTA supported by a hypothetical carryback, where the amount of DTLs that should be netted for this purpose are measured under the rules of section 22(e)(3). Consider the example set out in the industry group's comment letter. In that example, a bank possesses temporary difference DTAs of \$800, foreign tax credit DTAs of \$400, DTLs of \$300 and \$700 of hypothetical carryback capacity (i.e., taxes paid in the relevant carryback period). Prior to the release of the final regulations, the industry group comment letter suggested the DTLs allocable to temporary difference DTAs might be \$60, based on a net temporary difference DTA of \$100 compared to \$400 of foreign tax credit DTA (where  $[\$100 / (\$100 + \$400)] \times \$300 = \$60$ ), or \$300, where 100% of the hypothetical carryback capacity would be applied to the \$800 temporary difference DTA prior to considering the allocation of DTL amongst the temporary difference DTA and the foreign tax credit DTA. As a result, the bank would be left with \$160 of tax attribute DTA (\$400 foreign tax credit DTA - \$240 of allocated DTL), which would be subtracted from capital under section 22(a)(3).

The final regulation suggests a different approach might be required. Section 22(d)(1)(i) states that DTLs must be netted against temporary difference DTAs under section 22(e)(3) before determining how much temporary difference DTA can be carried back. For netting purposes, the temporary difference DTAs might be computed as the difference between the gross temporary difference DTAs of \$800 and the maximum hypothetical carryback capacity of \$700. Consequently, \$60 of DTL would be allocated to temporary difference DTAs and \$240 of DTL would be allocated to tax attribute DTAs. However, for purposes of computing the amount of DTAs not subject to the threshold limitations (the 10% and 15% limitations under section 22(d)), the net temporary difference DTAs would seemingly be computed as the gross temporary difference DTA of \$800 minus the \$60 DTL allocated to temporary difference DTAs under section 22(e)(3), resulting in a net temporary difference DTA of \$740, which would then be compared to the hypothetical carryback capacity of \$700. Thus, the resulting \$40 excess (\$740 - \$700) would be subject to the 10% limitation (i.e., the remaining \$40 DTA would be subtracted to the extent \$40 exceeds 10% of common equity tier 1 capital).

	Given amounts	Carryback capacity	Net of C/B	DTL allocated under §22(e)	Net attribute DTA deducted from CET1	Gross temporary DTA, less DTL	Reduce DTA by c/b via §22(d)(1)(i)	Net temporary DTA subject to §22(d)
Temp DTA	800	(700)	100	(60)		740	(700)	40
Credit DTA	400		400	(240)	160			
DTL	(300)		(300)	300	-			
Net amounts	900	(700)	200	-	160	740	(700)	40

Of course, other interpretations may be equally as valid. One might argue that the new language added to section 22(d)(1)(i) reflects a view that DTLs should be apportioned to temporary difference DTAs prior to any consideration of hypothetical carryback capacity, notwithstanding the conflicting language to the contrary in section 22(e)(3). This would produce the following result:

	Given amounts	DTL allocated under §22(d)	Net attribute DTA deducted from CET1	Gross temporary DTA, less DTL	Reduce DTA by c/b via §22(d)(1)(i)	Net temporary DTA subject to §22(d)
Temp DTA	800	(200)		600	(600)	-
Credit DTA	400	(100)	300			
DTL	(300)	300				
Net amounts	900	-	300	600	(600)	-

The preamble does little to clarify which view is correct. The preamble states that “[t]he agencies have amended section 22(e) of the final rule text to clarify that the word ‘net’ in [footnote 14 of the NPR] was intended to refer to DTAs ‘net of any related valuation allowances and net of DTLs.’ (emphasis added).” However, section 22(e) was not amended; instead, the relevant amendment is found in section 22(d). Thus, it is difficult to ascertain what ultimate result was intended by these statements and the relevant changes in the rules.

## State-by-state Basel III computations

Many multi-state banks tend to account for state deferred taxes using a pooled approach, often treating all states as a single pooled jurisdiction with a blended tax rate and a single net DTA or DTL balance. Following the publication of the NPR in 2012, one bank submitted a comment letter asking whether the jurisdictional netting rules in section 22(e)(3) would permit a blended state rate or whether the new rules would require banks to untangle previously pooled deferred tax accounts for multiple state jurisdictions.

In the preamble to the final regulations, the Federal Reserve responds to this question, acknowledging that blended state tax rates can be used to determine deferred tax expense for GAAP purposes. However, the response further explains that a blended rate does not imply that cross-jurisdictional netting of DTAs and DTLs is permitted among states. As a result, the final regulations conclude that “banking organizations must calculate DTAs and DTLs on a state-by-state basis for financial reporting purposes under GAAP and for regulatory purposes.” Full compliance with these regulations will likely require a significant amount of effort.

As indicated in the introduction, there are numerous issues relating to the inclusion of DTAs in regulatory capital. The foregoing discussion covers just three of those issues. If you would like to discuss this topic in depth, please contact one of our regulatory tax accounting specialists listed below.

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