

26 CFR § 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

Rev. Proc. 2017-12

## SECTION 1. PURPOSE

This revenue procedure provides that the Internal Revenue Service (IRS) will treat an instrument described in section 3 of this revenue procedure as indebtedness for federal tax purposes.

## SECTION 2. BACKGROUND

.01 In addition to special provisions of the Internal Revenue Code and Treasury regulations relating to the federal income taxation of banks, banks are generally subject to comprehensive non-tax regulation that governs their capital structure and their transactions with affiliates. To promote consistency between the rules of different countries, and to enhance global financial stability by improving the quality of banking supervision worldwide, an international body known as the Basel Committee on Banking Supervision (Basel) sets internationally agreed minimum standards for the regulation and supervision of banks. Another international body, the Financial Stability Board (FSB) also develops regulatory and supervisory policies for financial entities, including banks. The FSB focuses on the risk that the failure of one financial institution or the

collapse of one financial system could trigger a chain reaction throughout the broader financial system, commonly referred to as systemic risk. Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 (124 Stat. 1376 (2010)) (Dodd-Frank), includes rules prescribing the “orderly liquidation authority,” which permits the Federal Deposit Insurance Corporation to take over and resolve certain bank holding companies in a process similar to that which it uses to resolve a failing bank. Dodd-Frank also requires each large bank to prepare a “living will,” which sets out a plan for unwinding the bank group so that the critical services provided to the U.S. financial system by core members – notably the bank – can continue even if other services are terminated or other members are liquidated or sold off. The living will process has required banks to restructure to facilitate the implementation of these plans.

.02 The current framework for bank capital is commonly known as Basel III.<sup>1</sup> Basel III responds to events of the past decade by strengthening both capital and liquidity requirements for banks, especially global systemically important banking organizations (GSIBs). In addition to the enhanced capital required by Basel III, regulators have sought to minimize the risk of insolvency by requiring GSIBs to issue instruments that provide total loss-absorbing capacity (TLAC). Standards issued by the FSB describe the requirements for an instrument to qualify as a TLAC and require GSIBs to issue an amount of TLAC determined by reference to the bank group’s risk-weighted assets and Basel III leverage ratio. The FSB standard distinguishes between “external” and

---

<sup>1</sup> See Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (December 2010; revised June 2011), available online at <http://www.bis.org/publ/bcbs189.pdf> (Basel III Bank Capital Rules).

“internal” TLAC. External TLAC are securities issued to third-party investors by an entity subject to resolution powers (generally, the top-most parent bank or bank holding company). Internal TLAC are securities issued by a subsidiary of a resolution entity to the resolution entity. Thus, for example, a foreign GSIB with a significant U.S. presence would be required under the FSB standard to establish a domestic intermediate holding company (IHC) to hold its U.S. subsidiaries, and the IHC would be required to issue internal TLAC to the foreign GSIB.

.03 Both external and internal TLAC are issued in the form of debt. The FSB standard requires TLAC to have a maturity of at least one year, to be callable prior to maturity only with regulatory approval, to be unsecured, and generally to be subordinated to insured deposits, other short-term deposits, derivatives, structured notes, non-contractual liabilities like tax liabilities, and secured liabilities. TLAC may rank senior to certain securities that can qualify for equity credit under Basel III,<sup>2</sup> but generally must be subordinate to a bank’s depositors and general creditors. The FSB standard also calls for TLAC to contain a contractual trigger or be subject to a statutory mechanism that permits the relevant resolution authority to effectively write the TLAC down or convert TLAC to equity in resolution.

.04 Separately, the Board of Governors of the Federal Reserve Bank (Board) has issued regulations (Board regulations)<sup>3</sup> that prescribe the amount and form of both external and internal TLAC required for domestic GSIBs and the U.S. operations of foreign GSIBs. In the case of internal TLAC, the Board regulations require the IHC of a

---

<sup>2</sup> Basel III 2011 Bank Capital Rules, Part I.B.3, at 17-19.

<sup>3</sup> The final regulations were approved by the Board of Governors of the Federal Reserve System on December 15, 2016.

foreign GSIB to issue a specified minimum amount of TLAC to its foreign parent (and not to third parties). Under 12 CFR §252.161, the Board regulations generally require that internal TLAC:

- 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.

An internal debt conversion order means an order by the Board to immediately convert or exchange to common equity tier 1 capital an amount of TLAC specified by

the Board in its discretion. The Board may issue an internal debt conversion order only if the Board has determined that the IHC is in default or danger of default and any of three enumerated circumstances apply. 12 CFR §252.163(a). One of those circumstances is that the home country supervisor of the top-tier foreign banking organization has consented or not promptly objected after notification by the Board to the conversion or exchange of the TLAC issued by the IHC. 12 CFR §252.163(a)(2)(ii). The Board regulations also prescribe the circumstances in which an IHC will be considered to be in default or danger of default. 12 CFR §252.163(b). An objection by the home country supervisor to the conversion or exchange of TLAC issued by the IHC is considered to be prompt if the Board receives the objection no later than 24 hours after the Board requests the consent or non-objection from the home country supervisor. 12 CFR §252.163(b)(2). Finally, the preamble to the Board regulations acknowledges that the regulations do not restrict the ability of an IHC to include certain traditional debt terms in TLAC, provided that such terms are consistent with applicable law. Examples of such terms noted in the preamble are terms providing that existing equity would be transferred to the IHC and canceled upon transfer if the TLAC converts to equity, or debt covenants on the same terms permissible for covered bank holding companies.

.05 TLAC is issued in the form of debt. An instrument issued in the form of debt, however, may have one or more features, or lack one or more features, that cause the instrument not to be respected as indebtedness for federal tax purposes. In particular, an instrument that does not unconditionally obligate the issuer to pay a sum certain on demand or at one or more fixed dates, or that does not provide the holder with the rights

of a creditor to enforce the obligation, generally will not be treated as indebtedness for federal tax purposes. The rights of a creditor typically include the right to force an issuer into insolvency, and a right superior to that of a shareholder to share in the assets of the issuer in case of dissolution. 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 tax purposes.

.06 GSIBs play a unique role in the global economy, and are consequently subject to extensive oversight of their transactions and capital structure. As part of this oversight the Board has prescribed unique and highly specific rules to minimize the risks that GSIBs present, including the use of TLAC to enable the Board to resolve an IHC owned by a GSIB. 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.

### SECTION 3. SCOPE

This revenue procedure applies to internal TLAC that is issued by an IHC of a foreign GSIB pursuant to the Board regulations described in section 2.04 of this revenue procedure.

### SECTION 4. APPLICATION

The IRS will treat an instrument described in section 3 of this revenue procedure as indebtedness for federal tax purposes to the extent that the internal TLAC has not been subject to a debt conversion order.

## SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for an instrument described in section 3 of this revenue procedure issued on or after December 15, 2016.

## SECTION 6. NO INFERENCE

This revenue procedure provides guidance with respect to the federal tax characterization of an instrument described in section 3 of this revenue procedure. No inference should be drawn about the federal tax characterization of an instrument that is outside the scope of this revenue procedure.

## SECTION 7. CONTACT INFORMATION

For further information regarding this revenue procedure, contact William E. Blanchard or Diana Imholtz of the Office of Associate Chief Counsel (Financial Institutions & Products) at (202) 317-3900 (not a toll-free call).