

relationships, and any disallowed deferred tax assets.

When the recorded amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, exceeds this limitation, the excess amount would be deducted from Tier 1 capital and from assets in regulatory capital calculations. Deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences generally would not be limited under the proposal.

### III. Public Comments on the Proposal

The comment period for the FDIC's proposal closed on June 4, 1993. The FDIC received comment letters from 23 entities, 18 of which were banks or bank holding companies, four of which were bank trade associations, and one of which was an accounting firm (which submitted two comment letters). Only two commenters expressed support for or nonobjection to the proposed regulatory capital limitation, although each raised an implementation question about the limit. Two others favored the concept of a regulatory capital limitation on deferred taxes, but recommended that the limit be set in a different manner than was proposed. Three commenters seemed to suggest that deferred tax assets should not be included in regulatory capital at all. The remaining 16 commenters, including all of the larger banking organizations that commented, expressed a preference for placing no limit on the amount of deferred tax assets that can be included in regulatory capital. These commenters generally indicated that a regulatory capital limitation on deferred tax assets is unnecessary because FASB 109 contains sufficient safeguards to ensure that the amount of deferred tax assets carried on an institution's balance sheet is realizable. Instead, they supported the full adoption of FASB 109 for both regulatory reporting and regulatory capital purposes, indicating that such an approach would limit regulatory burden. Nevertheless, while preferring no capital limit on deferred tax assets, two commenters considered the agencies' decision to include some deferred tax assets that are dependent upon future taxable income in regulatory capital as a positive step compared to prior regulatory policies and proposals permitting little or no inclusion of such deferred tax assets in regulatory reports and regulatory capital.

#### *Responses to the FDIC's Questions*

The proposed rule requested specific comment on a number of questions.

*Question (1):* The FDIC's first question asked about the appropriateness of the proposed capital limit, particularly the ten percent of Tier 1 capital limitation. Eight commenters specifically responded to this question, while the views expressed by most of the remaining commenters could also be regarded as responsive to this question. In other words, because more than two-thirds of the commenters favored relying on the proper application of GAAP to the reporting of deferred tax assets over establishing a separate regulatory capital limit on such assets, these commenters generally considered the proposed limits to be inappropriate and unnecessary. Some of those who commented on this issue noted that any percentage of capital limit would be inappropriate because realizability is a function of an institution's ability to generate future taxable income. Thus, several letters described the proposed ten percent limit as arbitrary and too conservative.

One commenter noted that healthy banks typically earn in excess of ten percent of Tier 1 capital each year, thereby ensuring that this percentage limit will be the operative limit for such banks. This commenter suggested setting the percentage limitation for institutions that are deemed to be "well-capitalized" for prompt corrective action purposes at 20 percent of Tier 1 capital.

Another commenter likened deferred tax assets to the two identifiable intangible assets, purchased mortgage servicing rights (PMSRs) and purchased credit card relationships (PCCRs), that are included in Tier 1 capital. This commenter's recommendation was to apply the existing percentage limits for these two intangibles to deferred tax assets, *i.e.*, a 50 percent of Tier 1 capital limit for the total of PMSRs, PCCRs, and deferred tax assets along with 25 percent of Tier 1 capital sublimits for both PCCRs and deferred tax assets.

*Question (2):* The second question dealt with whether certain identifiable assets acquired in a nontaxable business combination accounted for as a purchase should be adjusted for the tax effect of the difference between the market or appraised value of the asset and its tax basis. Under FASB 109, this tax effect is recorded separately in a deferred tax liability account, whereas under previous GAAP, this tax effect reduced the amount of the intangible asset. This change in treatment could cause a large increase, *i.e.*, a "gross-up,"

in the reported amount of certain identifiable intangible assets, such as core deposit intangibles, which are deducted for purposes of computing regulatory capital.

Six commenters indicated that institutions should be permitted to deduct the net after-tax amount of the intangible asset from capital, not the gross amount of the intangible asset. These commenters argued that FASB 109 will create artificially high carrying values for intangible assets and a related deferred tax liability when an institution acquires assets with a carryover basis for tax purposes but revalues the assets for financial reporting purposes. The commenters generally indicated that, under FASB 109, the balance sheet will not accurately reflect the value paid for the intangibles. Furthermore, commenters indicated that the increased carrying value of the intangible asset posed no risk to an institution, because a reduction in the value of the asset would effectively extinguish the related deferred tax liability.

On the other hand, one commenter indicated that deferred tax assets resulting from the gross-up effect in certain business combinations should not be treated differently from other deferred tax assets.

*Question (3):* The FDIC's third question inquired about (a) the potential burden associated with the proposal and whether a limitation based on projections of future taxable income would be difficult to implement and (b) the appropriateness of the separate entity method for determining the proposed limit on deferred tax assets and for tax sharing agreements in general.

*Question (3)(a):* The FDIC received seven comment letters specifically addressing the issue of potential burden and a limitation based on income projections.

Two commenters supported the use of income projections. The first one stated that capital limitations on deferred tax assets based on projected future taxable income should not be difficult to implement and should not impose an additional burden. This commenter noted that many institutions already forecast future taxable income in order to support the recognition of deferred tax assets on their balance sheets. The second commenter similarly observed that these taxable income projections must be evaluated by institutions' independent auditors and that the subjectivity and complexity involved in such projections are no greater than for the process of determining loan loss reserves. Another commenter added that