Tax Opportunities and Issues for Acquirers of Banks Arising Under Section 1261 of the American Recovery and Reinvestment Act of 2009

Despite the furor sparked by Notice 2008-83, banks with grandfathered acquisitions have reason to be pleased with the American Recovery and Reinvestment Act of 2009.

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No IRS or Treasury administrative guidance in recent memory has generated a greater public and congressional furor[1] than last year's issuance of Notice 2008-83,[2] dealing with the application of the built-in loss rules of Section 382(h)[3] to banks experiencing a change of control during the financial crisis. Despite the furor, Section 1261 of The American Recovery and Reinvestment Act of 2009[4] ("ARRA Section 1261") grandfathers the provisions of Notice 2008-83 with the force of law for bank acquisitions occurring on or prior to January 16, 2009, or pursuant to binding contracts entered into on or before January 16, 2009. Accordingly, ARRA Section 1261 potentially has major implications for last year's mega financial institution rescues and for smaller, less publicized financial institution changes of ownership that occurred as well.[5]

While some critics have charged that Notice 2008-83 inappropriately gutted Section 382 as it applied to troubled bank acquisitions, a more balanced view is appropriate. The abuses that Section 382(h) is designed to restrict were not present in the rescue ownership changes that occurred in 2008. The banks being acquired were on the verge of failure, often because no one could determine the real value of the loans and other financial assets they held. The accounting rules, however, required that the acquiring bank determine a market value for all of the assets

[1] No sooner had the notice been issued than expressions of indignation emerged. Senators Grassley and Baucus called for an investigation by Treasury's inspector general for possible conflicts of interest; the inspector general announced his investigation; Congressman Doggett introduced H.R. 7300 to revoke the Notice; Senator Sanders wrote to all of his Senate colleagues expressing his indignation and introduced S.3692, calling for revocation; and Eric Solomon of Treasury wrote a somber and detailed justification of the guidance to these congressional figures on the meaning and purpose of the Notice.

[2] 2008-42 IRB 905.

[3] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the IRC).

[4] P.L. 111-5.

[5] Consider, for example, Countrywide and Wachovia, as well as National City, which potentially are covered by ARRA § 1261 if the transactions were structured as carryover basis transactions.

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and then determine if the acquiring bank could use the losses that would be created in the future.[6] Given the greatly unsettled nature of the banking industry last fall, the issuance of Notice 2008-83 allowed bidders to book both the loss and a potential future tax benefit for book purposes, even though the acquiring bank had no intention of trying to sell off the loans at a loss.

ARRA Section 1261 has the highly positive effect of confirming that Notice 2008-83 was properly issued and now has the force of statutory law for acquisitions prior to its grandfather date. However, acquirers of financial institutions in grandfathered transactions must carefully review and plan for ARRA Section 1261, because there are unsettled issues surrounding certain of its provisions and potential benefits. This article will explore the scope of ARRA Section 1261 in its application to grandfathered pre-January 16, 2009, transactions.

As a general matter, banks acquired prior to January 16, 2009, will benefit from future deductions related to taxable asset basis in excess of fair market value only if the acquisition is structured to permit carryover basis of assets. (A discussion of the types of such permissible acquisition structures is beyond the scope of this article.)

BASIC RULE OF THE NOTICE

The substantive provision of Notice 2008-83, only 63 words in length, is as follows:

> For purposes of section 382(h), any deduction properly allowed after an ownership change (as defined in section 382(g)) to a bank with respect to losses on loans or bad debts (including any deduction for a reasonable addition to a reserve for bad debts) shall not be treated as a built-in loss or a deduction that is attributable to periods before the change date.[7]

As a general rule, then, ARRA Section 1261 provides that deduction of losses recognized by a "bank" after a Section 382 change of control on loans or bad debts will not be built-in losses for purposes of the limits of Section 382. Notice 2008-83 defines a "bank" for purposes of the substantive rule to be a "bank (as defined in section 581) both immediately before and after the change date. . . ."[8] Section 581(a) explicitly defines the term "bank" to include a "domestic building and loan association." Thus, large 2008 thrift acquisitions such as the Countrywide acquisition by Bank of America, are potentially covered by the provision if such transactions were structured as carryover basis transactions. Banks and thrifts are often owned by holding companies that are not "banks" and customarily own non-bank subsidiaries such as property holding companies, insurance brokers, REITS, and any number of other types of entities. All of these entities are typically acquired when an Old Loss Bank is acquired. This article discusses issues that arise concerning the application of the built-in loss provisions of Section 382 to these non-bank entities.

In the language of Section 382, its limitations apply to an "old loss corporation" that experiences an ownership change.[9] In this article, Old Loss Bank is used to refer to a "bank" as defined in the Notice that experiences a grandfathered ownership change as defined in Section 382 during periods prior to the "change date." New Loss Bank refers to the same entity during all periods after the change date. A NUBIL refers to a "net unrealized built-in loss" in the values and basis of the assets of Old Loss Bank determined under the rules of Section 382.[10] Finally, an RBIL refers to a recognized built-in loss in the hands of New Loss Bank after the change date under the rules of Section 382.[11]

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PRACTICAL EFFECT OF ARRA SECTION 1261

If one assumes that an Old Loss Bank will ordinarily have a NUBIL, the practical effect of ARRA Section 1261 will be quite positive in grandfathered acquisitions because, notwithstanding the existence of the NUBIL, all RBILs from loan losses and bad debt losses will be freely deductible outside the applicable Section 382 limit and in accordance with regular rules of Sections 166 and 165.

Lessened Potential for Disputes With the IRS. As a practical matter, this will enormously simplify bank examinations and avoid disputes with the IRS. In the

[6] FAS 141 and 109.

[7] Notice 2008-83, Section 2.

[8] Id., Section 2.

[9] See IRC §§ 382(g) and 382(k)(1), (2), and (3).

[10] See IRC § 382(h)(3).

[11] See IRC § 382(h)(2)(B).

absence of the provision, there is significant dispute potential because of the general Section 382(h)(2)(A) presumption that a post-change loss during the recognition period is automatically considered an RBIL unless the taxpayer demonstrates otherwise.

> *Example:* Old Loss Bank has Section 382 change of control on July 1, 2008. The job market in the community declines in the second half of 2008 and many borrowers lose jobs. Housing values in its geographic area decline drastically in the second half of 2008. In 2009, a mortgage that was current during 2008 falls into arrears and a loss is incurred. Was the loss "built-in" prior to the change, or did it result from adverse economic conditions after the change date, July 1, 2008. Absent application of the Notice, New Loss Bank and the IRS would be destined for endless tax disputes in such cases.

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The foregoing type of situation is precisely the fact pattern that motivated IRS to issue the Notice in the first instance.

What Are "Losses on Loans or Bad Debts" for Purposes of the Notice? A potential interpretative issue is whether application of the Notice is restricted to "loans" in any narrow qualitative sense. Is there any requirement that the principal of the loan have been advanced directly from the Old Loss Bank to the borrower/obligor in order to constitute a "loan" for purposes of the Notice? It appears that there is no such requirement because the alternative term "bad debt" used in the Notice carries no connotation of a direct lending relationship between the obligor under the "bad debt" and the Old Loss Bank. Thus, we would argue that the Notice applies broadly to any obligations held by the Old Loss Bank in the hands of the New Loss Bank that are "debt" for tax purposes and on which the New Loss Bank experiences a "loss" with respect to such debt. Thus, losses on loans that were purchased by Old Loss Bank from another lender, rather than extended directly to the borrower by Old Loss Bank, should be subject to the Notice.

A separate issue is whether the reference to "losses on . . . bad debts" includes an implicit connotation that only deductions under Section166 are considered covered by the Notice. If the Notice was intended to apply only to losses on bad debts under Section 166 this would have been a simple matter to specify in the Notice, but there is no reference to Section 166. There is not the slightest indication that the Notice is limited in this manner. Even where a bank loan to a borrower is classified as a security under Section 165(g), the consequences when it goes "bad" are the same to the bank as defaults on other types of bad debts, and the policy considerations are the same under Section 382(h). This is a critical point. The authors urge that guidance be issued making it clear that the Notice applies to any loss experienced by a New Loss Bank on an asset that is "debt" for tax purposes, regardless of its status as a security or an ordinary asset. Any contrary position will embroil the IRS and financial institutions in unnecessary litigation.

Because we would argue that the term "bad debt" for purposes of the Notice encompasses any loss arising from default on an instrument held by New Loss Bank that is classified as "debt" for tax purposes, we believe that it would apply to such commonly held bank assets as publicly traded debt securities; high-yield and other debt securities traded privately under Rule 144 and other exemptions; REMIC regular interests,[12] without regard to whether the bank originated the underlying mortgages held in the REMIC or purchased the regular interest from third parties; and credit card, auto loan, and student loan securitizations where the interests held by the New Loss Bank are considered debt for federal tax purposes.

There has been extensive litigation in the financial institutions industry concerning whether broad classes of lease investments are "true" leases for federal tax purposes. Some Old Loss Banks may have substantial portfolios of LILOs, SILOs and similar investments where the Old or New Loss Bank ultimately conceded the non-true lease status of the investment for tax purposes. Because such settlements ultimately included assessments of OID on the investment, it seems clear that the leases should be treated as debt in the hand of the New Loss Bank. Issues may also arise concerning property acquired in foreclosure. While a loss from the sale of property obtained in foreclosure or by deed in lieu of foreclosure should not itself be considered a "loss" from a "bad debt," the loss on the underlying loan should be.[13]

[12] See IRC §§ 165(g)(2)(C), 582(a) and (c), 860B(a), and 1271.

[13] See Rev. Rul. 74-159, 1974-1 CB 232.

Application to Successors to New Loss Bank. The syntax of Notice 2008-83 can be read to suggest a requirement that its application is limited to losses on loans and bad debts with respect to property owned by the Old Loss Bank and also by the New Loss Bank. Presumably all loans and debts owned by non-bank entities in the Old Loss Bank consolidated group such as the holding company, mortgage subsidiaries, investment subsidiaries, insurance subsidiaries, leasing subsidiaries, etc., are not exempt from RBIL status with respect to losses recognized on assets held by such entities after the change of control. IRS guidance in that regard would be helpful.

What if the New Loss Bank is merged into another *banking* subsidiary of the acquirer after the change? Do losses on the loans and debts now owned by the successor bank continue to qualify for the Notice? We would argue that such a merger should not alter the tax treatment and all loans and debts traceable to assets of Old Loss Bank should qualify for exemption from RBIL status. Again, guidance should clarify this point in favor of inclusion of such assets under the Notice.

Effect of the Notice on NUBILs and RBILs. IRS spokespersons have implied that NUBILs or NUBIGs must still be determined for an Old Loss Bank group that experiences a change on a group basis. Presumably most Old Loss Bank groups that are rescued will have a NUBIL absent special rules for determining built-in losses. While the technical rules are beyond the scope of this article, the general rule for determining the existence of a NUBIL is to determine any excess of the aggregate adjusted bases of all of the Old Loss Bank's assets over their fair market value determined immediately before the ownership change.[14] We believe that there is a statutory basis under the language of the Notice for the interpretative conclusion that built-in losses and bad debts in the hands of Old Loss Banks who are group members on the change date should be disregarded for purposes of determining the existence of NUBILs. If losses on loans and debts of the bank entities are not counted, many groups will not have a NUBIL or the NUBIL may fall under the de minimis threshold. The de minimis rule allows the New Loss Bank to treat the NUBIL as zero if it is below the lesser of 15% of the fair market value of Old Loss Bank's assets immediately before the ownership change or $10 million.[15] This would certainly be a desirable result and we urge an administrative interpretation adopting this rule.

Old Loss Bank Groups With REIT Subsidiaries. Many banks have subsidiaries that qualify as REITs and primarily hold mortgage loans. Such subsidiaries have never been included in the consolidated group of a bank or its holding company because their ownership must conform to the requirements of Section 856. Typically the REIT subsidiaries are included in the consolidated financial statements of the Old Loss Bank Group for GAAP purposes.

Typically, where the parent holding company of Old Loss Bank experienced a Section 382 change of control, the REIT subsidiary will also experiences a change of control. For the Old Loss Bank's consolidated group, NUBIL status and the Section 382 limits will be determined as though the group were a single corporation, excluding for this purpose REIT subsidiaries that are not members of the group.[16]

What if the New Loss Bank is merged into another *banking* subsidiary of the acquirer after the change? Do losses on the loans and debts now owned by the successor bank continue to qualify for the Notice?

Under general rules outside of Notice 2008-83, the Section 382 limitations must be apportioned between the Old Loss Bank consolidated group and non-consolidated REIT controlled group.[17] For such purposes, Old Loss Bank group presumably must determine the fair market value of the stock it owns in the REIT. This may require a significant appraisal of this closely held entity and has the potential to create tax disputes.

Because it is not a member of the bank's consolidated group, REIT subsidiaries of the Old Loss Bank will experience a separate Section 382 limitation. However, the applicable Section 382 regulation[18] imposes certain coordination and apportionment rules on 50% controlled groups to prevent "double counting" of the general value limit of Section 382 among of members of the consolidated group and other non-consolidated controlled groups. The general thrust of the rules is to exclude the value of the REIT subsidiaries from the Section 382 limit of the group. The typical complex bank holding company

[14] Treas. Reg. § 1.1502-93.

[15] IRC § 382(h)(3)(B)(i).

[16] Treas. Reg. § 1.1502-91(a).

[17] Treas. Reg. § 1.382-8.

[18] Id.

structure may include multiple brother-sister or parent sub-groups of 50% controlled groups and these rules seem destined to send loss banks groups into uncharted water.

Presumably the NUBIL must be separately determined for each REIT sub-group. Potential issues that may emerge include whether the existence of multiple limited entities will enable some to escape NUBIL status because of the de minimis rule. Another issue that may emerge is the question of what happens if a REIT is liquidated after the change date. Will subsequent loan losses be subject to the Notice? Where such REITS are subject to Section 382(h) limits, careful consideration will need to be given to the impact this will this have on satisfaction of minimum distribution requirements and other REIT requirements.

CONCLUSION

Notice 2008-83 deserved less criticism and more appreciation than it received. There remain significant technical issues to its implementation that will need to be carefully studied by banks with grandfathered acquisitions and addressed by the IRS.