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IRS and Treasury Take Some of the Bite Out of Section 382

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With the economic crisis now in full swing, the government is doing everything it can to save our banks. This includes limiting the application of Section 382 with respect to banks, in the hopes that stronger competitors will come to the rescue and acquire them. Section 382 provides that the taxable income of a loss corporation for a year following an ownership change that may be offset by prechange losses (including net unrealized built-in loss) cannot exceed the Section 382 limitation for such year. For this section to apply, there need to be certain ownership changes (which relate to 5 percent owners) or equity structure shifts. The government has just released Notices 2008-83 and 2008-100, which change the impact of Section 382 with respect to certain banks.

As a result of the economic crisis, we are now bearing witness to bank sales at fire-sale prices. The fact that these banks are selling for such depressed prices is important because the limitation imposed under Section 382 is based on the value of the old corporation multiplied by the long-term tax-exempt rate, published by the IRS. If Section 382 applies, the cap on deductions would be very low, since the value of banking stocks has been plunging and the long-term tax-exempt rate is low. To encourage and aid the impending banking industry consolidation, the IRS and the Treasury have released guidance that either prevents the Section 382 limitation from being triggered, or if triggered, increases the limitation so as to allow for increased deductions.

Notice 2008-83 applies only to unrealized built-in losses and not to net operating losses. For Section 382 purposes, any deduction attributable to net unrealized built-in loss of the acquired corporation properly allowed after an ownership

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change shall not be subjected to the Section 382 deduction limitations. This is a powerful tool, since it can allow a bank to take tax deductions on the losses of the loan portfolio of the bank it has acquired. This reduces the overall cost of the acquisition while allowing the acquirer to increase its market share and customer deposits. For example, this makes the overall costs for Wells Fargo to acquire Wachovia much lower.

Notice 2008-83 may only be relied upon unless and until there is additional guidance. In addition, the legal support for this notice is unclear. Therefore, it is best to take advantage of it while it is available.

Notice 2008-100 takes a slightly different approach than its predecessor by preventing the occurrence of a "change in ownership" with respect to Section 382. This Notice says, for purposes of testing for an ownership change, that stock acquired by the Treasury, pursuant to the Capital Purchase Program ("CPP"), will not count with respect to testing whether the Treasury has increased its ownership percentage. This is important because in most instances the Treasury will have previously had no ownership interest in the company and it will continue to be treated as having no ownership interest, for purposes of testing for an ownership change, no matter how much stock it acquires. Therefore, the purchase of an ownership interest in the company by the Treasury will not, in and of itself, cause an ownership change to have occurred with respect to Section 382.

On the flip side, the stock will still count with respect to other shareholders unless the stock owned by the Treasury, pursuant to the CPP, is redeemed by the corporation. This will help prevent a change in ownership from occurring, because the additional outstanding shares will serve to dilute the other 5 percent shareholders' interest. Also, the preferred stock purchased by the Treasury under the CPP will be treated as "pure" preferred stock so that it will not count as stock for purposes of determining whether or not consolidated returns can be filed. This allows the Treasury to buy bank preferred stock while simultaneously permitting the bank and its holding company to file consolidated tax returns. To be able to file consolidated returns, the holding company must own 80 percent of the vote and value of the stock of the bank. Since the "pure" preferred stock purchased by the Treasury does not count as stock when calculating whether or not the holding company owns 80 percent of the vote and value of the bank it is easier to meet the threshold required.

In addition, Notice 2008-100 also prevents certain warrants and stock options from being deemed exercised for purposes

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of testing for an ownership change under Section 382. As a final protection, any capital infusions made by the Treasury, under the CPP, will not be considered to have been made as part of a plan a principal purpose of which was to avoid or increase any Section 382 limitation. This is significant because if Section 382 does apply, the amount of the deduction allowed will be higher due to the increase in the value of the corporation that results from the Treasury's capital infusion.

By providing the right tax incentives, the Government is encouraging consolidation of the banking industry. Manatt, Phelps & Phillips, LLP, stands ready to assist banks on the complex application of all of the tax issues arising out of the current economic crisis.

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