IRS Notice Allows Use of Built-in Losses of Banks Following an Ownership Change

New York
October 1, 2008

On September 30, 2008, the IRS issued Notice 2008-83 ("Notice"), which effectively suspends an Internal Revenue Code rule that limits the use of built-in losses of banks following a more than 50 percent change in ownership of the bank. The change will potentially allow acquirors of a bank through a stock purchase or tax-free asset acquisition to preserve unrealized tax losses in the bank's assets for use following the acquisition. Further, the Notice will allow a bank to preserve built-in losses following a change in ownership resulting from new issuances of stock. The Notice does not affect "NOLs" or net operating losses, which are realized losses.

Earlier in September, the IRS had taken action to preserve tax losses of AIG, Fannie Mae and Freddie Mac that otherwise would have been limited as a result of Government acquisitions of stock of those companies. The Notice is different in that it applies to any change in control of a bank even if the new owners are private investors.

Technically, the Notice relates to section 382 of the Internal Revenue Code ("Code"). This section limits the use of losses of a corporation following an "ownership change," which is generally a more than 50 percent change in ownership of its stock over a three-year period by 5 percent or greater shareholders. Section 382 applies to NOLs and also to certain "built-in losses." The most common example of a built-in loss is the potential loss that exists in an asset having a tax basis greater than its market value. Such a loss generally is recognized when the asset is sold or becomes worthless. Built-in losses also include certain deductions that have accrued but not yet been allowed for tax purposes.

The Notice states that unless and until there is additional guidance, a deduction properly allowed to a bank following an ownership change with respect to losses on loans or bad debts (including any deduction for a reasonable addition to a reserve for bad debts) will not be considered a built-in loss or deduction subject to section 382 limitations.

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

The Notice applies only to a "bank" as that term is defined for tax purposes in section 581 of the Code. The definition would include most commercial banks and thrifts. It does not include investment banks, securities dealers and unregulated bank affiliates. Also, it only applies to corporations that are "banks" both immediately before and after the change date, and thus would not apply to the built-in losses of a non-bank acquired by a bank.

The relief granted by the Notice is applicable only in cases in which there is an ownership change with respect to a bank and a bank continues to hold assets with built-in losses. Thus, it would apply if a bank undergoes an ownership change because a new owner acquires its stock (or stock of a holding company). It also would apply if a bank (or holding company) undergoes a change in ownership because of new issuances of stock or block trading. It should also apply if bank assets are acquired in a "reorganization" for stock of the acquiror. In a reorganization, the tax basis of acquired assets carries over to the acquiror, so that unrealized losses are preserved.

The Notice would not apply where a bank sells its assets to a buyer in a taxable transaction. In that case, the buyer would have a cost basis in the purchased assets and would not take over unrealized losses. The seller for its part would realize losses in the sale.

It is not clear if the reference to "losses on loans" was intended to include losses on loans that are held in the form of mortgage- or asset-backed securities. Hopefully, the IRS will clarify this point. Also, the Notice does not apply to real estate or to derivatives.

A bank that is a dealer in securities may mark to market for tax purposes some of the securities it holds. Often, loans acquired to be held are not marked to market. If an asset were marked to market for tax purposes immediately prior to an ownership change, any built-in loss would be converted to a realized loss and would fall outside of the Notice. Assets that are subject to a mark-to-market regime are marked to market at the end of the holder's taxable year. Accordingly, it may be important in applying the Notice to mark-to-market assets to determine whether an ownership change triggers the early termination of a taxable year. That would occur where a bank becomes a member of a new consolidated group.

The Notice states that banks may rely on the Notice unless and until there is additional guidance. The Notice does not state that it is effective only for ownership changes occurring on or after the date of the Notice, and it is possible that it was intended to have retroactive effect.

In the context of acquisitions, losses may be limited under certain Code provisions in addition to section 382. For example, in broad terms, section 269 may limit the use of losses following an acquisition of control of a corporation if the principal purpose of the acquisition is use of the losses. The Notice does not affect these other provisions. In the context of a bank acquisition that necessarily would involve significant ongoing risks and opportunities for the buyer, however, the main barrier to the use of built-in losses likely would be section 382.

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Questions regarding the Notice may be directed to James M. Peaslee, Jason R. Factor or any of our other partners or counsel in New York listed under Tax in the "Practices—Areas of Law" section of our website (http://www.clearygottlieb.com).

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