TREASURY ISSUES SERIES OF NOTICES LIBERALIZING TREATMENT OF NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES OF FINANCIAL INSTITUTIONS

In General

Section 382 of the Internal Revenue Code of 1986 (the "Code") restricts the use of net operating loss carryforwards and other tax attributes such as recognized built-in losses if a loss corporation undergoes an ownership change. In broad terms, an ownership change is a 50 percentage point or greater change in the ownership of the value of the equity of a company, measured by comparing the percentage of stock (by value) owned by each "5-percent shareholder" to the lowest percentage owned by such shareholder during the preceding three-year period. The determination of whether an ownership change has occurred is made at various times referred to as "testing dates."

In a series of Notices issued beginning in early September, the Internal Revenue Service (the "IRS") announced that it will amend applicable Treasury Regulations to ameliorate the effect of certain equity investments in financial institutions by the United States Department of the Treasury (the "Treasury") and others. These changes either prevent or postpone an ownership change (the trigger for application of Section 382) or, in cases in which a change has occurred, liberalize the restrictions on use of net operating losses or items such as bad debt deductions that might otherwise have been limited by Section 382. Also, the IRS most recently clarified in Notice 2008-101 that amounts furnished to a financial institution pursuant to the Troubled Asset Relief Program ("TARP") will not be treated as the provision of "Federal financial assistance" within the meaning of section 597 of the Code (which assistance is generally taxable). In each case, the regulations to be promulgated will be retroactive to the date of the Notice, or in the case of the Notice addressing section 597, the rule set forth will be applicable until contrary guidance is adopted.

Notices 2008-76 and 2008-84

In Notices 2008-76 and 2008-84, the IRS stated that a "testing date" does not occur when the United States acquires a controlling interest in the loss corporation. The absence of a "testing date" prevents an ownership change from occurring. The earlier Notice was apparently directed at the takeovers of Fannie Mae and Freddie Mac, in which the Treasury was issued preferred stock and warrants with a nominal exercise price to acquire approximately 80% of the outstanding stock, but the later Notice expands the concept to apply to any acquisition of a controlling interest by the United States government. However, the latter ruling adds that "the loss corporation will be required to determine whether there is a testing date and, if so, whether there has been an ownership change for purposes of section 382, on any date as of the close of which the United States does not directly or indirectly own a more-than-50-percent interest in the loss corporation." Accordingly, the United States (and any minority shareholders that may exist) will not be able to transfer the benefit of this exemption from Section 382 to a third-party purchaser.

Notice 2008-100

In Notice 2008-100, the IRS addressed the implications of the Treasury's acquisition of minority interests in financial institutions under the Capital Purchase Program (the "CPP") pursuant to the Emergency Economic Stabilization Act of 2008. Under this program, the Treasury intends to purchase $125 billion of equity in nine large banks, including Goldman Sachs, Citigroup, Morgan Stanley and JPMorgan Chase, among others, and will also invest a like sum in smaller banks. Under this Notice, the preferred stock to be purchased by the Treasury is treated as preferred stock satisfying the requirements of Section 1504(a)(4) of the Code, and therefore is not treated as outstanding stock for purposes of determining whether a Section 382 ownership change has occurred. In addition, any warrants granted to the Treasury are not deemed exercised, and common stock issued to the Treasury is not treated as increasing ownership of the Treasury for any ownership change computation. However, such common stock is treated as outstanding for purposes of diluting the ownership of other shareholders, thereby permitting more stock to be issued to a new investor without causing an ownership change. In addition, if and when such common stock held by the Treasury is redeemed, all ownership change computations will be made as if such stock had never been issued, providing a possible incentive to the loss corporation not to redeem the stock (because the redemption would reverse the dilutive effect of the Treasury stock on other stock issuances). Lastly, stock issued to the Treasury will not be treated as having been issued as part of a tax avoidance plan. Absent this last holding, any such contribution would be excluded when computing the equity value of the loss corporation, thereby reducing the loss corporation's annual limit on tax attribute use if an ownership change does occur.

Notice 2008-78

This treatment of equity contributions as increasing equity values was made applicable in more general circumstances in Notice 2008-78. Under Section 382(l)(1) of the Code, all capital contributions made within two years of an ownership change are presumed to have a principal tax avoidance purpose and are not taken into account in determining the equity value of the loss corporation, except to the extent provided in Treasury Regulations -- and prior to this Notice no such Regulations were issued or proposed since the 1986 enactment of Section 382. Under the Notice, whether a capital contribution is part of a tax avoidance plan is "determined based on all the facts and circumstances, unless the contribution is described in one of the [specified] safe harbors" or the bankruptcy exception in 382(l)(6) applies. This new general rule and safe harbors apply to all types of corporations, not only financial institutions.

Safe harbors.

A capital contribution will not be considered part of a plan if -

(a) the contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party; no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution; there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and the ownership change occurs more than six months after the contribution.

(b) the contribution is made by a related party but no more than 10% of the total value of the loss corporation's stock is issued in connection with the contribution, or the contribution is made by a person other than a related party, and in either case there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and the ownership change occurs more than one year after the contribution.

(c) subject to certain restrictions, the contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan.

(d) the contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built in loss) or it is received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit or excess foreign taxes (or in which a net unrealized built-in loss arose).

Notice 2008-83

Even if an ownership change does occur, under Notice 2008-83, bad debt deductions and additions to bad debt reserves will not be treated as built-in losses or deductions attributable to periods prior to the ownership change, and the loss corporation will be able to use such deductions free of the restrictions of Section 382. Under Section 382(h), the limits of Section 382 apply not only to net operating loss carryforwards but also to "recognized built-in losses." Notwithstanding the fairly compelling argument that bad debt deductions with respect to loans that have already declined in value should be treated as "built-in losses," the Notice provides that they shall not be treated as such.

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If you have any questions concerning the foregoing or would like additional information, please contact Henry M. Cohn (212-728-8209, hcohn@willkie.com), Richard L. Reinhold (212-728-8292, rreinhold@willkie.com), Amanda L. Granacher (212-728-8860, agranacher@willkie.com), or the attorney with whom you regularly work.

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