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IRS Provides New Tax Incentives for Banks in Change of Control Transactions

Expanded M&A Activity Is Expected

On October 1, 2008 the IRS issued Notice 2008-83, which changes the way banks can recognize losses on loans or bad debts in a change of control transaction.

Up until Notice 2008-83, Section 382 of the Internal Revenue Code provided limits on the utilization of net operating loss carry forwards against future taxable income of any new loss corporation following the ownership change. Section 382 provides that, after an ownership change, the amount of a loss corporation's taxable income for any post-change year available for offset by pre-change NOLs shall not exceed the Section 382 limitation for that year. The Section 382 limitation equals the fair market value of the corporation's stock as of the change date, multiplied by the long term tax exempt rate (currently about 4.65%). The section 382 limitation represents the hypothetical return on a loss corporation's value had it not undergone an ownership change. By limiting the absorption of NOLs to the hypothetical return of a loss corporation, Congress attempted to eliminate tax bias for or against the sale of loss corporations based on their NOLs.[1] Accordingly, the key here is relating post-change taxable income to losses that are recognized post-change, but may have been implicitly unrecognized pre-change. In other words, if the target bank has significant bad loans on its books, loans that were generated pre-change, the prior system of applying Section 382 would have limited the losses available to be recognized for deductions by the acquiring bank based on the application of the formula in Section 382.

APPLICATION OF SECTION 382(h) TO BANKS

Notice 2008-83
Section 1. Overview

The Internal Revenue Service and Treasury Department are studying the proper treatment under section 382(h) of the Internal Revenue Code (Code) of certain items of deduction or loss allowed after an ownership change to a corporation that is a bank (as defined in section 581) both immediately before and after the change date (as defined in section 382(j)). As described below under the heading Reliance on Notice, such banks may rely upon this guidance unless and until there is additional guidance.

Section 2. Treatment of Deductions Under Section 382(h)

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.

Section 3. Reliance on Notice

Corporations described in Section 1 of this notice may rely on the treatment set forth in this notice, unless and until there is additional guidance.[2]

IMPLICATIONS FOR THE FINANCIAL INSTITUTIONS MARKETPLACE

Notice 2008-83 is separate and distinct from the Emergency Economic Stabilization Act of 2008 ("EESA"), but was clearly coordinated through Treasury, and comes at a helpful time for the nation's troubled financial system. In addition to the bad mortgage loans that were the initial and precipitating consideration for the credit crunch, the investment assets such as mortgage-backed securities and collateralized debt obligations would appear to be included as bad debt instruments.

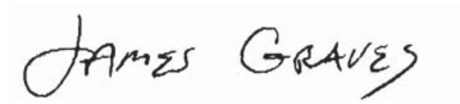
Moreover, the revised regulation applies to more than what we think of as a traditional bank. As defined in Section 581 of the Internal revenue Code, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. The term also means a domestic building and loan association.[3]

At this writing, the scope of the bad loans and debts held on the books of the nation's financial institutions is substantially unknown, but the size of the $700 billion EESA program implies a clear and present danger. For those banks and bank holding companies that have been relatively unscathed by the financial crisis, this additional incentive to acquire troubled banks with significant bad loans or debts on the books is compelling.

As reported in the *New York Times*, Wells Fargo's rejuvenated bid for Wachovia on Thursday, October 2, 2008, at a price greatly exceeding that of rival Citigroup, was clearly based on the "advantage of a lucrative tax loophole tied to deferred losses," and could be structured to avoid any direct government support.[4] While the deal was initially suspended by the court, the validity of the tax incentive was not at issue, and was obviously substantial. Citigroup had agreed to a $2.2 billion deal when Wells Fargo came in at $15.4 billion.

Additional consolidation in the U.S. banking system appears assured, given the severity of the financial crisis. For banks with reasonable profitability and growth prospects, this appears to be a propitious time to acquire market share and utilize the tax incentive of being able to deduct the expected losses from bad loans and debt obligations against future earnings.

At Mercer Capital, we provide bank consulting, valuation, and transaction assistance to banking entities on a national basis. Please contact Andy Gibbs, Senior Vice President and leader of our Financial Institutions Service Group, Ken Patton, or Jay Wilson at (901) 685-2120, or me at (502) 585-6340 if we may be of assistance to you as you consider your strategic options in this difficult market.



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ENDNOTES

1 Internal Revenue Service Technical Advice Memorandum, No. 200217009, Dec 4, 2001.

2 Application of Section 382(h) to Banks, Notice 2008-83, www.IRS.gov.

3 Internal Revenue Code, Section 581 Definition of a Bank.

4 Citigroup Says Judge Suspends Wachovia Deal, *The New York Times*, October 5, 2008.

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