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Banking M&A

The US Internal Revenue Code (Code) has a number of provisions, including Section 382, designed to limit trafficking (the sale, for instance) of tax attributes (operating losses and unrealised built-in losses, for instance) from one economic group to another, unrelated economic group.

In general, Section 382 of the Code provides an objective bright line test that automatically limits the use of pre-change tax attributes of a loss corporation (a corporation having operating losses and built-in losses, for instance) after the loss corporation undergoes a substantial change in ownership (an ownership change). An ownership change generally occurs if the percentage of stock of the loss corporation owned by any one or more 5% shareholders has increased by more than 50% (by value) over a three-year period. The limitation, applied annually, generally equals the value of the stock immediately before the ownership change multiplied by a statutorily prescribed interest rate (4.94% at present). With respect to unrealised built-in losses, if a loss corporation undergoes an ownership change and recognises the built-in losses during a five-year period beginning on the date of the ownership change, such losses are treated as attributable to a pre-change period and, therefore, are subject to limitation under Section 382.

On September 30 2008, amid the financial tsunami that has hit the credit markets, the Internal Revenue Service (IRS) issued Notice 2008-83. In general, Notice 2008-83 provides that if a bank undergoes an ownership change, losses and deductions attributable to loans (including any deduction for a reasonable addition to a reserve for bad debts) that are otherwise allowable will not be treated as built-in losses or deductions attributable to a pre-change period. This means that if an acquirer acquires a target troubled bank in which an ownership change occurs, the target's use of its net unrealised built-in losses attributable to underwater loans (including, for instance, underwater mortgages) would not be limited by Section 382. The full amount of the loss attributable to the underwater loans, when recognised after the ownership change, could be used to offset the target's future taxable income.

It is important to note that the Notice only applies to losses and deductions attributable to loans of a ban. The Notice does not define loans. The term includes underwater mortgages and should include mortgage-backed securities. In addition, for the Notice to apply, it is important to note that the losses or deductions attributable to the loans must otherwise be allowed under the Code. For example, if the principal purpose of an acquisition of a loss corporation is to obtain a tax benefit, the benefit could be denied under Section 269 of the Code, another anti-abuse provision.

We expect the Notice to encourage acquisitions of troubled banks by stronger financial institutions. For example, on September 29 2008 Citigroup announced it would acquire Wachovia for $2 billion. The next day, the IRS issued Notice 2008-83 and, three days later, Wells Fargo announced that it would acquire Wachovia for $15 billion. It is widely speculated that Notice 2008-83 contributed to the change in the value and valuation of Wachovia as a target.

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