



The IRS Bailout of the Bailout

What tax practitioners need to know about the IRS' recent notices easing the application of the loss limitation rules of Code Section 382.

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To assist financial institutions during the economic crisis, the IRS has issued a number of notices easing the application of the loss limitation rules of Code Section 382. To fully understand the impact of these notices upon the application of the loss limitation rules, it is necessary to briefly review the basics of Section 382.

Overview of Section 382

Section 382, in its present form, was enacted to limit the loss carryovers of an acquired corporation — to stop the trafficking in “loss corporations.” Section 382 limits the amount of taxable income of a loss corporation that has undergone a change in ownership that may be offset by losses experienced before the change in ownership. A “loss corporation” is a corporation that has a net operating loss (NOL) carryover or net operating loss from the change in ownership year or has net unrealized built-in losses. A net unrealized built-in loss exists where immediately before the change in ownership the aggregate adjusted basis of a corporation’s assets exceeds the fair market value of those assets.

Section 382 applies only when as of a “testing date” there has been a change in ownership of the five-percent shareholders by more than 50 percent of value of the stock in a loss corporation. For these purposes, a “testing date” is any date on which there has been a change in ownership of any five percent shareholder. A change in ownership of a loss corporation must occur during a three-year testing period ending on the change date. The change date is the date on which there has been a change in ownership of the loss corporation’s stock owned by the five percent shareholders of more than 50 percent of the value of the stock over a three-year period. Under certain circumstances, there is a shorter testing period. Special constructive ownership rules apply in determining the stock ownership for calculating the change in ownership, which are beyond the scope of this article.

With respect to net unrealized built-in losses, any recognized built-in loss of the loss corporation during the five-year period after the date of the change in ownership is treated as a pre-ownership change loss, if such loss is greater than the lesser of 15 percent of the fair market value of the loss corporation assets or \$10,000,000. A realized built-in loss of a loss corporation is any loss recognized by the loss corporation on the disposition of any asset held by the loss corporation on the date of the ownership change, the loss does not exceed the loss inherent in the asset as of the date of the ownership change and any depreciation, amortization or depletion in the assets during the five-year period from the date of the ownership change.

Section 382 limits the extent to which loss corporation’s taxable income generated after a change date annually can be offset by losses incurred before the change date. This limitation equals the stock value of the loss corporation immediately before the ownership change multiplied by the prescribed long-term tax-exempt rate. In determining that value, any capital contribution received by a loss corporation as part of a plan a principal purpose of which is to avoid or increase the Section 382 limitation is not taken into consideration. It is presumed that any capital contribution made within two years ending on the date of the ownership change is made pursuant to such a plan. The fact that the loss corporation must satisfy the continuity of business enterprise requirement, throughout a two-year period beginning on the change date, further limits the use of pre-change carryovers. In any year ending after the change date, during which the continuity of business enterprise is not met, the limitation is reduced to zero. Generally, net operating losses incurred before the ownership change are subject to the Section 382 limitations; net operating losses incurred after the ownership change are not subject to these limitations.

IRS Guidance Regarding Application of Section 382 to the Bailout

In September and October 2008, the IRS issued guidance in the form of Notices 2008-76, 2008-78, 2008-83, 2008-84 and 2008-100 regarding the application of Section 382 on companies participating in the Capital Purchase Program under the Emergency Economic Stabilization Act of 2008. All of these Notices, except Notice 2008-83, were issued by IRS under the broad authority granted the IRS under Section 382(m) to issue regulations. Notice 2008-78, directed at the U.S. investment in Fannie Mae and Freddie Mac, provided that the “testing date” under Section 382 excluded any date on or after which the U.S. acquires stock or options. As a result, because there was no testing date, there could not be a change in ownership. Notice 2008-76 provided the same treatment for the acquisition of stock of a loss corporation by the U.S. in a Housing Act Acquisition. Notice 2008-84, directed to the Federal Reserve Bank of New York’s loan to AIG via the Credit Facility Trust provided that a testing date shall exclude any date as of the close of which the U.S. owns a more than 50 percent interest in a loss corporation. In all likelihood, the credit agreement would have been viewed as a contract or option to purchase the preferred stock held for the benefit of the U.S., resulting in a change in ownership. Since there was no testing date until the Trust disposed of the preferred stock, there could not have been a change in ownership in AIG.

Notice 2008-100 further provided that the loss limitation rules of Section 382 shall not apply as a result of the change in ownership by the acquisition of stock, options, or

warrants of a loss corporation by the Treasury Department or by a capital contribution by the Treasury Department to a loss corporation.

Notice 2008-83, provides that deductions for losses on loans or bad debts after an ownership change of a bank will not be subject to the loss limitation rules of Section 382. In other words, losses on loans or bad debts will not be treated as built-in losses attributable to periods prior to the ownership change. As a result of Notice 2008-83, Wells Fargo was able to outbid Citibank for Wachovia because Wells Fargo could use the \$75 Billion of losses in the loans of Wachovia.

Notice 2008-83 has been the subject of much criticism by members of Congress, and as a result, it is being reviewed by the Treasury Inspector General. Legislation has been introduced in both the Senate and the House to rescind it. However, until rescinded, Notice 2008-83 applies. Although there appears to be no authority for the issuance of Notice 2008-83, as it countermands the plain statutory language, the Secretary of Treasury suggests that Notice 2008-83 was issued pursuant to the general authority to issue regulations granted under the Economic Emergency Stabilization Act of 2008.

Whatever Will Be Will Be

In an October 30 letter to Treasury and the IRS, Senator Charles Schumer (D-NY) wrote: "I also fear that the notice could have the unintended consequence of motivating more financial firms wanting future tax deductions to shelter their earnings to buy competitors, leading to more consolidation in the financial industry than would be necessary to restore the stability in the financial sector." Only time will tell whether the trafficking in losses, by the expanding reach of Notice 2008-83, will become an essential ingredient of the Economic Emergency Stabilization Act of 2008.

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