

## Client Alert

# Financial Markets Developments

### Proposed Legislation Would Reverse Benefit To Bank Acquirers and Restrict Deductions On Losses

Proposed legislation would reverse the recent concession by the United States Department of the Treasury ("Treasury") that waived the limitation on the deduction of losses of a bank that undergoes an ownership change.

#### Introduction

In September 2008 the Treasury released IRS Notice 2008-83, which waived the limitation on the deduction of losses on loans and bad debts for a bank that undergoes an ownership change. Recently proposed legislation threatens to eliminate the benefit created by the Notice. There is a limited grandfathering clause for transactions or acquisitions either closed on or before January 16, 2009 or for which there was a binding, written contract entered into on or before January 16, 2009.

#### Background

When a corporation undergoes an ownership change, as defined below, Section 382 of the Internal Revenue Code of 1986, as amended, limits the use of net operating losses, net unrealized built-in losses ("NUBIL") existing at the time of the ownership change and deductions that are properly attributable to a period prior to the ownership change. If there is an ownership change, the amount of losses (including NUBILs recognized within five years after the ownership change) that may be used each year after the ownership change will be limited to an amount generally equal to the value of the loss corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate in effect at the time of the ownership change (the "Loss Limitation").

An ownership change is deemed to occur if the percentage of stock owned by one or more 5 percent shareholders increases by 50 percentage points over the lowest percentage of stock held by those shareholder(s) over the past three-years. The three-year testing period can be altered if there are successive ownership changes or if the corporation's losses began after the beginning of the three-year period.

In general, a corporation is considered to have a NUBIL at the time of an ownership change if the aggregate value of its assets immediately before the ownership change is less (by more than a specified material amount) than the aggregate adjusted basis of those assets at the time of the ownership change.

On September 30, 2008, the Treasury released IRS Notice 2008-83. Such Notice created an exception to the Loss Limitation for banks that have an ownership change and that have losses on loans or bad debts (including a reasonable addition to a reserve for bad debts). While use of those losses on loans and bad debts would normally be subject to the Loss Limitation, IRS Notice



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2008-83 provides an exception to the Loss Limitation and allows such losses to be fully deducted by the loss corporation. The Notice also stated that taxpayers could rely on that treatment unless or until additional guidance was issued.

### Developments

IRS Notice 2008-83 has met with significant disapproval from various members of both houses of Congress. For example, Sen. Charles Grassley, ranking member of the Senate Finance Committee, Sen. Charles Schumer, a member of the Senate Finance Committee, and Rep. Lloyd Doggett, a senior member of the House Ways and Means Committee, have publicly challenged the Notice. Critics of the Notice expressed concern that the Treasury exceeded its authority in issuing the Notice and that the exemption could cause long lasting and unnecessary revenue losses.

Title I of H.R. 598, the “American Recovery and Reinvestment Tax Act of 2009,” would revoke IRS Notice 2008-83 with respect to acquisitions taking place after Jan. 16, 2009, the date the House bill was introduced. If this legislation is signed into law, it would reinstate the Section 382 limitation on losses on loans and bad debt for banks that undergo an ownership change. The bill declares

that the Treasury lacked the authority to issue the Notice, but states that taxpayers should generally be able to rely on guidance from the Treasury. To that end, the bill would allow deductions in accordance with the Notice if the ownership change took place on or before January 16, 2009, or is pursuant to a binding, written contract entered into on or before January 16, 2009. The bill was passed by the House on January 28, 2009 with the expectation of presenting a final bill to the President before February 16, 2009. The Senate’s version of the bill echoes the provisions in the House bill, including the January 16, 2009 effective date.

### Conclusion

The “American Recovery and Reinvestment Tax Act of 2009,” would, if passed, revoke IRS Notice 2008-83 and thereby reinstate the Section 382 limitation on losses on loans or bad debt unless the bank acquisition was either closed on or before January 16, 2009, or is pursuant to a binding, written contract entered into on or before January 16, 2009. Given the significant possibility, if not probability, of the enactment of this legislation, one should be wary of relying on Notice 2008-83 in current and future transactions.

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