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CLIENT ALERT

October 2008

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New Guidance Allows Greater Use of Built-In Losses in Bank M & A Deals

The Treasury Department and the IRS have issued favorable guidance under Internal Revenue Code Section 382 for banks engaging in merger and acquisition activities, as well as certain capital raising efforts. Given the current state of the economy, banks engaging in such transactions are likely to hold financial assets that have decreased in value. Traditionally, bank investors' and acquirers' use of these unrealized losses after an acquisition would be significantly limited. Under the new guidance, no such limitation would be imposed. This shift is no doubt part of a larger policy initiative to encourage the capitalization and acquisition of troubled banks in the wake of the current financial crisis.

Code Section 382 generally imposes limitations on the use of existing unrealized losses and net operating loss carryforwards against income earned after a corporation has had a change in ownership of 50 percent or more. The policy behind this rule is to prevent the development of a market where taxpayers could buy and sell tax losses. This loss limitation rule effectively prevents one corporation from buying another corporation with significant losses for the primary purpose of using those losses to offset the acquiring corporation's future taxable income.

Generally, unrealized losses and net operating loss carryforwards can be used after an ownership change only up to the amount of the "Section 382 limitation." The Section 382 limitation is equal to the fair market value of the corporation on the date of the ownership change multiplied by the long-term tax-exempt rate, which is published each month by the IRS. (4.65 percent in October 2008.) Notice 2008-83, however, provides that for a bank, losses on loans or bad debts that are recognized after an ownership change will not be treated as built-in losses or deductions that are attributable to periods before the change date. Practically speaking, the impact of this new rule is that acquiring banks may be able to fully utilize any unrealized losses held by target banks if the acquisitions are otherwise properly structured.

In addition, the Treasury Department and the IRS have relaxed the presumption of a tax avoidance motive for contributions made within two years of an ownership change. These "anti-stuffing" provisions attempt to disallow the arbitrary inflation of a corporation's value when capital contributions are made in anticipation of a change in ownership, as increases in value would result in a higher limitation amount under Section 382. Currently, any contribution made within two years of a change in ownership is presumed to be part of a plan for the avoidance of tax and is subtracted from the value of the corporation for purposes of calculating the Section 382 limitation, thus reducing the amount of losses that can be utilized after the change date. Notice 2008-78 removes this presumption altogether and provides four safe harbors under which contributions will not be deemed to be part of a plan for the avoidance of tax. This notice also makes it clear that failure to fall within one of the safe harbors is not evidence of a plan for tax avoidance. This change in the anti-stuffing rules is not limited to banks.