JONES DAY

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REVISITING NOTICE 2008-83

Much has been said and written about Notice 2008-83 (the "Notice") since the IRS issued it on September 30, 2008. Jones Day was among those who discussed this Notice, in an article published on our web site on October 6, 2008. Much of the commentary on the Notice has been consistent, with the exception of two possible points of contention. These are the authority of the Treasury and IRS to issue the Notice, and the potential "cost" of the Notice. For a number of reasons, including the availability of specific data filed with the SEC in the case of two prominent bank mergers, it is useful to revisit Notice 2008-83. Our observations are discussed at some length below, but they may be summarized as follows:

First, we do not believe Notice 2008-83 "changes" or "overrides" existing statutory law. It simply interprets it, which is the job of the Treasury and IRS.

Second, the Notice should be viewed as just one of a series of recent IRS announcements providing clarity critical to the consolidation and recapitalization of the financial industry. Absent this clarity, the Treasury and IRS would not have been doing their job, and financial consolidation and the restoration of the industry's capital and market stability could have been hindered.

Third, the potential "cost" of the Notice has been overstated. We earlier calculated a possible maximum "cost" from generic, industry-wide figures. Unfortunately, this "cost" has been frequently cited as authoritative, rather than extrapolative. Recent SEC filings with specific data show the likely cost of the Notice to be much smaller, and are instructive as to why this is so.

THE NOTICE DOES NOT "CHANGE" OR "OVERRIDE" STATUTORY LAW

The statute, section 382 of the Internal Revenue Code, imposes limits on a corporation's ability after it is acquired to use certain losses, including "net built-in losses," that existed before it was acquired. The statute provides no real guidance as to whether any particular loss should be considered "built in" at the time of an acquisition. The Treasury and the IRS have been working for years on a project to provide guidance

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identifying and quantifying "built-in losses," and in 2003 they published Notice 2003-65 providing initial guidance on this subject. Notice 2008-83 can be seen as a continuation of the regulatory authority exercised in Notice 2003-65. Moreover, Notice 2008-83's specificity as to the financial industry is understandable. Given illiquidity in the financial markets and the controversy over fair value reporting with respect to financial assets, valuing various financial assets is difficult. Thus, one could not readily determine whether a particular financial asset suffered from a built-in loss. Accordingly, in providing guidance here, Notice 2008-83 was an appropriate and timely exercise of executive authority.

THE NOTICE IS PART OF A PACKAGE OF RECENT GUIDANCE ADDRESSING TAX ISSUES RAISED BY THE FINANCIAL CRISIS

Financial institutions have been subject to obvious stress for many months. Through December 12, 25 banks having an aggregate of approximately $373 billion of assets have failed in the United States. The FDIC's Deposit Insurance Fund ("DIF") lost approximately $7.6 billion in the second quarter of 2008 and $10.6 billion in the third quarter of 2008, and the amount of the DIF on September 30 was 33 percent less than one year earlier. In the current quarter, the FDIC estimates additional losses from failed banks of approximately $4.5 billion to $4.8 billion. Bank failures generally are more disruptive and expensive to the government and the economy than mergers of troubled banks with healthier ones, or investor recapitalizations of undercapitalized banks. These less-costly alternatives were impeded by uncertain tax laws, however, which has caused the IRS to issue a series of notices (including Notice 2008-83) providing much-needed guidance. For example, Notice 2008-100 protects against a potential triggering of an "ownership change" for purposes of section 382 by reason of a bank's issuance of stock or warrants to the government under the TARP Capital Purchase Program ("CPP"). Notice 2008-76 similarly confirms that the government conservatorship of Fannie Mae and Freddie Mac will not cause a "change of ownership" of those institutions, which would have reduced their ability to use preexisting losses. Notice 2008-84 provides the same answer in the case of the acquisition by the government of a more-than-50-percent interest in any corporation, including upon the exercise of warrants or convertible securities.

Notice 2008-78 provides guidance regarding section 382's "anti-stuffing" rule and its effect on an investment in a company that subsequently undergoes an ownership change. The statutory "anti-stuffing" rule generally disregards any contributions to a loss company that are made to increase its ability to use losses, and imposes a presumption that any contribution within two years before a change is a "stuffing" transaction—except as provided in regulations. Notice 2008-78 announces that regulations will provide that a capital contribution will be treated as a "stuffing" transaction only if the facts and circumstances indicate an impermissible purpose.

Notice 2008-83 addresses the question of when losses or deductions recognized by a bank after an ownership change should be considered to have been "built in," and provides that bad debts and loan losses, which are typically recognized in conformity with charge-offs required by U.S. or state bank supervisory authorities, will not be treated as "built in" if they are taken into account after an ownership change. The Notice helps banks determine whether assets within a specific asset class suffer from a "built-in" loss. This guidance is consistent with the general guidance issued in 2003, which provided that losses or deductions should be considered "built in" only if they were properly accruable for book purposes before an ownership change.

REDUCED ESTIMATE OF COST

We earlier offered a possible maximum "cost" with respect to Notice 2008-83. This maximum was extrapolated from IMF estimates of $1 trillion of mortgage-related losses in the banking system, of which approximately $400 billion had not yet been taken into account. *If* those numbers were correct, *if* every bank with unrecognized losses had a change of ownership, *if* under applicable law all of those losses were in fact "net built-in losses," *if* there were no offsetting "built-in gains," and *if* the applicable 382 limitation would prevent, not just defer, the deduction of all such losses, then the total tax "cost" of deducting those $400 billion of losses would be approximately $140 billion. This latter number has been widely reported as authoritative, but without consideration of those very big "ifs."

Considering those very big ifs can dramatically reduce the $140 billion number. The losses of all banks not acquired can be removed from the calculation, for example, as can the losses of all banks that actually fail. So can the losses that banks may recognize for book and tax purposes before an acquisition. More technically, section 382 limits the post-acquisition deductibility of the amount of built-in loss that does not exceed an acquired bank's overall "net built-in loss," or NUBIL, recognized within the five-year recognition period. Those built-in losses, to the extent they exceed the bank's annual limitation amount, are carried forward, subject to future limitations. The calculation of "net" built-in losses is offset by any built-in gains under section 382 irrespective of Notice 2008-83. In any given bank, there may be assets with significant built-in gains, including core deposits and goodwill.

Perhaps the best caution on extrapolation from generic and hypothetical figures comes from reviewing the specific data filed with the SEC in the case of two pending bank acquisitions. In these two transactions, those with actual knowledge of the real figures (including the size of the built-in gains and the amount of losses deferred but not disallowed) have established that the "cost," or benefit, of Notice 2008-83 is quite modest. Thus, the benefit of Notice 2008-83 in those two cases was the clarity it brought to the tax calculations of the combined banks going forward. The benefit was not a significant tax subsidy.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Carl M. Jenks
1.216.586.7173 /
1.212.326.8321
cmjenks@jonesday.com

Chip MacDonald
1.404.581.8622
cmacdonald@jonesday.com

Candace A. Ridgway
1.202.879.3633
caridgway@jonesday.com

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