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Notice 2008-83: The IRS Offers Reassurance to Troubled Banks

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The Internal Revenue Service ("IRS") reacted in a surprisingly swift manner to the current volatile environment for U.S. banks, the existence and ownership of which has been changing on a daily basis. On September 30, the IRS issued Notice 2008-83, 2008-42 I.R.B. 1 (the "Notice"), in which it announced that losses and deductions attributable to loans or bad debts of a bank[1] (including any deduction for a reasonable addition to a reserve for bad debts) that are otherwise allowable after the date of an ownership change under Section 382 of the Internal Revenue Code (the "Code"), will not be treated as built-in losses or deductions attributable to a pre-change period. The Notice effectively removes a potential barrier to bringing in new equity ownership of a struggling bank by assuring taxpayer banks that the IRS does not intend to challenge otherwise allowable deductions as being attributable to pre-ownership change periods.

Code Section 382 was enacted to prevent tax-motivated acquisitions of loss corporations. Ordinarily, the provisions of Section 382 operate to limit the use of a corporation's existing net operating losses and net unrealized built-in losses against future income where the corporation experiences an ownership change, which generally occurs where 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 testing period. Where a loss corporation experiences an ownership change, the future use of its pre-change net operating loss is generally limited to the fair market value of its stock immediately before the ownership change, multiplied by the applicable long-term tax-exempt rate. Additionally, if the loss corporation has a net unrealized built-in loss[2], the deduction of that loss when recognized will be limited as if it was a pre-change loss for a five-year period beginning on the date of the ownership change (the "recognition period"). Deductions during the recognition period that are attributable to periods before the change date are treated as recognized built-in losses under Section 382(h)(6)(B), and therefore limited.

In order to qualify for the treatment described in the Notice, the taxpayer must be a bank as defined in Code Section 581 immediately before and immediately after the ownership change. The Notice does not give a formal effective date, but says that banks may rely on the treatment set forth in the Notice unless and until additional guidance is issued. It cautions that it does not address the application of any other provision of the Code other than Section 382 (i.e., the losses must otherwise be deductible.)

Footnotes:

[1] The term "bank" is defined in Code Section 581 and includes a bank or trust company incorporated and doing business under the laws of the U.S. or any state, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising certain fiduciary powers, and which is subject by law to supervision and examination by State or Federal banking authorities. The term also includes a domestic building and loan association.

[2] Generally, the amount by which the fair market value of the corporation's assets immediately before the ownership change is less than the aggregate adjusted basis of such assets at such time.