REPORT #742

TAX SECTION

New York State Bar Association

REPORT ON SECTION 597 PROPOSED REGULATIONS

December 3, 1992

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TAX SECTION
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December 3, 1992

Honorable Shirley D. Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Peterson:

Please find enclosed a report on the proposed regulations under Section 597 of the Internal Revenue Code, relating to taxation of financial assistance to bank and savings and loan institutions.[1]/ The report commends the Internal Revenue Service and Treasury Department for improving substantially upon the approach taken to taxation of financial assistance in Notice 89-102, 1989-2 C.B. 436.

The principal comments made in the report relate to the treatment of so-called Continuing Equity under the Proposed Regulations. Technical comments are made with respect to the operation of the special deferral formula contained in the Proposed Regulations applicable to institutions with Continuing Equity. The report also questions whether the discretionary noncollection of tax should be

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[1]/ This report was prepared by the Committee on Corporations. The principal author of the Report was Dana L. Trier. Daniel C. Kolb and Kirk Van Brunt assisted in the preparation of the report. Helpful comments were received from William L. Burke, John A. Corry, Michael L. Schler, David Watts and Ralph O. Winger.

limited in the case of institutions with Continuing Equity, and suggests that, even if such a limitation is retained, the definition of Continuing Equity should be modified. The other significant comments made in the report relate to the toll charge payable in certain circumstance upon the formation of so-called “Bridge Banks,” and the treatment of instruments issued to agencies.

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

John A. Corry
Chair

Enclosure

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Tax Report #742

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON CORPORATIONS

REPORT ON SECTION 597 PROPOSED REGULATIONS

December 3, 1992

REPORT ON SECTION 597 PROPOSED REGULATIONS

by the New York State Bar Association
Tax Section/ Committee on Corporations[1]/

This Report addresses the proposed regulations (the "Proposed Regulations") published on April 23, 1992 under section 597 of the Code,[2]/ relating to the taxation of financial

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[1]/ The principal author of the Report was Dana L. Trier. Daniel C. Kolb and Kirk Van Brunt assisted in the preparation of the Report. Helpful comments were received from William L. Burke, John A. Corry, Michael L. Schler, David Watts and Ralph O. Winger.

[2]/ Citations to Code Sections are to the Internal Revenue Code of 1986. Citations to regulations and proposed regulations are to regulations and proposed regulations issued by the Treasury Department thereunder.

Section 597 is divided into three parts. Section 597(a) contains the general rule that "[t]he treatment for purposes of this chapter of any transaction in which Federal financial assistance is provided with respect to a bank or domestic building and loan association shall be determined under regulations prescribed by the secretary." Section 597(b) provides certain limited specific rules:

"(b) PRINCIPLES USED IN PRESCRIBING REGULATIONS --
(1) TREATMENT OF TAXABLE ASSET ACQUISITIONS -- In the case of any acquisition of assets to which section 381(a) does not apply, the regulations prescribed under subsection (a) shall --

(A) provide that Federal financial assistance shall be properly taken into account by the institution from which the assets were acquired, and

(B) provide the proper method of allocating bases among the assets so acquired (including rights to receive Federal financial assistance).

(2) OTHER TRANSACTIONS -- In the case of any transaction not described in paragraph (1), the regulations prescribed under subsection (a) shall provide for the proper treatment of Federal financial assistance and appropriate adjustments to bases or other tax attributes in connection with such assistance."

(3) DENIAL OF DOUBLE BENEFIT -- No regulations prescribed under this section shall permit the utilization of any deduction (or other tax benefit) if such amount was in effect reimbursed by non-taxable Federal financial assistance.

(Continued...)

assistance to banks or thrift institutions. The Proposed Regulations modify the interim guidance provided by the Internal Revenue Service (the "I.R.S.") with respect to such matters in Notice 89-102, 1989-2 C.B. 436 (the "Notice").

We make a number of substantive and technical comments in this Report. In general, we believe that the most problematic aspects of the Proposed Regulations relate to the treatment of so-called "Continuing Equity." Overall, however, we believe that the Proposed Regulations represent a major achievement of the Treasury Department and I.R.S. and improve substantially upon the workability of the approach taken in the Notice.

This Report will be divided into three parts:

(1) A description of the legislative and regulatory background to the Proposed Regulations;

(...Continued)
Section 597(c) defines Federal financial assistance for purposes of the statute:

"For purposes of this section, the term Federal financial assistance" means --

(1) any money or other property provided with respect to a domestic

continued)
building and loan association by the Federal Savings and Loan Insurance Corporation or the Resolution Trust Corporation pursuant to section 406(f) of the National Housing Act or section 21A of the Federal Home Loan Bank Act (or under any other similar provisions of law), and

(2) any money or other property provided with respect to a bank or domestic building and loan association by the Federal Deposit Insurance Corporation pursuant to section 11(f) or 13(c) of the Federal Deposit Insurance Act (or under any other provisions of law),

regardless of whether any note or other instrument is provided therefor."

(2) An overview of the Proposed Regulations; and

(3) A discussion of what we believe are the central substantive issues raised by the Proposed Regulations.

I. BACKGROUND

A. The Law Prior to FIRREA.

Prior to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, P.L. 101-73 ("FIRREA"), three special rules which originated in the Economic Recovery Tax Act of 1981 applied to financially troubled thrift, institutions:

(1) Under section 597 of the Code, financial assistance payments provided by the Federal Savings and Loan Insurance Corporation ("FSLIC") were excluded from gross income and no basis reduction was required in respect of such payments;

(2) Under section 368(a)(3)(D), FSLIC assisted acquisitions of financially troubled thrift institutions were permitted to qualify as tax-free reorganizations without regard to the continuity of interest requirement generally applicable to tax-free reorganizations; and

(3) Under section 382(1)(5)(F), special rules applied to the carryover of net operating losses and built-in losses of such institutions which prevented section 3 82 from limiting such losses in many

circumstances. Taken together, these provisions permitted what came

colloquially to be called the “double dip” -- i.e., the simultaneous exemption from the taxation of the receipt of federal financial assistance and the utilization of the net operating losses and built-in deductions relating to the economic losses in respect of which such assistance was, in effect, provided; this combination of advantages constituted what the authors of one article referred to as the “Savings and Loan Tax Shelter.”[3]/

B. FIRREA.

The shelter potential of these transactions was brought to an end by Congress in FIRREA by removing the exemption from tax for financial assistance and the special rules that facilitated the transfer of the benefit of net operating losses and built-in deductions. Faced with the spectacle of a number of widely publicized tax motivated financial acquisition transactions, the Treasury Department and I.R.S. came to the conclusion that it would be most appropriate for the federal government's subsidization of failing financial institutions not to be carried out through the tax code. Both the exemption for assistance and the rules facilitating transfer of losses were thus eliminated.

Two general policy problems were posed, however, by this change in the statutory framework applicable to assisted transactions. The first problem was one of normative tax policy -- to devise a regime that did not go to the opposite extreme and

[3]/ Kaden and Wolfe, “The Savings and Loan Tax Shelter,” Tax Notes, May 15, 1989.

cause overtaxation of the participants in assisted transactions. The second problem was an administrative one--to design a scheme for facilitating transactions within a framework in which no special tax incentives were to be granted to the participants in financial institution transactions.

1. Normative Tax Policy Concerns.

The tax policy problem was one of matching income and losses. In very general terms, it may be expected that assistance is provided in respect of losses that should previously have given, or which ultimately will give, rise to deductions to the institution receiving the assistance. Thus, even if assistance is subject to taxation and the “double-dip” of prior law thus averted, the taxpayer institution (or the acquiror of such institution) will be overtaxed if the income and the deduction are not matched.

A simple example will illustrate this point. Assume that institution T was originally capitalized with a capital contribution of 10x and incurred 90x of deposit liabilities so that it has gross assets of 100x. It lends 80x to real estate developers. Of the 80x, 40x of loans becomes worthless and the institution takes a loss. Aside from the loss, the institution has no net income or loss. Assume that the institution now has a negative net worth of 30x, i.e., 60x of gross asset value (100x - 40x), and 90x of liabilities, and that, accordingly, 30x of assistance is provided. The net operating loss of 40x- attributable to the worthless debt should more than offset the assistance. If, however, the 40x simply represented a built-in-loss and had not been written off yet for federal income tax purposes, immediate recognition of the income by the recipient of the financial assistance would lead to reporting of taxable income even though there are at least enough potential deductions (from the built-in losses) that may become available to the entity to offset such income.

As the elimination of the special benefits attributable to assisted transactions was being considered, a major difficulty faced by tax policymakers was that one could not be confident that generally applicable federal income tax case law would lead to the correct result from a tax policy point of view in even the most conventional form of assisted financial institution transaction. Consider, for example, the then common case of an acquiror who agreed to purchase a thrift institution if the government in turn offered, inter alia, to make certain assistance payments to the acquiror over time that were sufficient to assure that the assets of the institution would be equal to liabilities. Unless such payments were viewed as, in effect, paid to the target institution (even though received by the acquiror) and unless the target's built-in losses were recognized as part of the transaction (or at least before the assistance is taxable), over taxation might result.

In enacting FIRREA, Congress recognized quite clearly that this problem was best avoided by rules crafted by the I.R.s. and Treasury Department that would recognize the relationship between the assistance income and deductions from loss assets:

> Although most financial assistance received by, or paid with respect to, financially troubled financial institutions would be treated as taxable, such assistance will be deemed to be received by the financially troubled financial institution at the time the assets of such institution are sold or transferred. As a result, the financial assistance generally will be offset by the net operating losses and built-in losses of the financially troubled financial institution. Therefore, the committee, in general, expects that an

> acquired financially troubled institution will have no net tax liability resulting from the receipt of (or deemed receipt) of financial assistance.[4]/

The fundamental equation by which assistance equals losses or built-in losses might, however, not hold precisely true in all cases. As the fact situation described above itself indicates, for example, to the extent of capital contributions, the net operating losses and built-in deductions of a financial institution may exceed the amount of assistance. Losses can expire, or not be fully utilizable under the alternative minimum tax rules. Finally, as discussed further below, if acquisitions have occurred, other disparities between the bases of assets and the basis of stock could arise that have an impact on the relationship between income and deductions.

Congress specifically recognized in FIRREA that "the net operating losses and built-in losses of the financially troubled financial institution may not always be sufficient to offset the amount of financial assistance received . . ."[5]/In this respect, Congress focused, in particular, on cases involving institutions constituting members of consolidated groups:

> This may occur, for example, in cases in which the financially troubled financial institution was a member of an affiliated group of corporations filing a consolidated return and the net operating losses of such institution were used to offset the income of other members of the affiliated group.[6]/

2. Administrative Concerns.

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[4]/ H. R. Rep. No. 101-54, 101 Cong., 1st Sess., pt. 2, at 27 (1989).

[5]/ Id. at 27 n. 12.

[6]/ Id.

The second purpose underlying the tax provisions of the FIRREA legislation was to facilitate the financial institution disposition program of the government. At the core of the tax provisions of FIRREA was the notion that special tax subsidies were no longer to be granted to private parties as an incentive to thrift or other financial institution acquisitions. At the same time, however, it clearly was viewed as desirable not unnecessarily to impede assisted financial institution transactions when consistent with general tax principles. In this regard, for example, the legislative history specifically provides that "the conferees understand that the Treasury Department may exercise the regulatory authority provided to it by the bill to issue regulations or other guidance providing that, in certain circumstances, no net tax liability would be payable by financially troubled institutions as a result of the receipt of financial assistance.[7]/ Similarly, the legislative history indicates that the Treasury Department may provide that transferee liability will not be asserted against transferees that would otherwise be liable for the failed institutions" taxes.[8]/

Nonetheless, the precise intended scope of this grant of authority was left quite unclear. The legislative history of FIRREA states that "[i]t is expected that any such guidance be <u>consistent with the purposes of this provision and with the overall grant of regulatory authority</u> to the Treasury Department.[9]/ The narrowest reading of this legislative history is simply that the Treasury Department could provide that no net tax liability would be collected if none were expected to be due.

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[7]/ H. R. Conf. Rep. No. 209, 101 Cong., 1st Sess., at 464.

[8]/ <u>Id</u>.

[9]/ <u>Id</u>. (emphasis supplied)

In such a case, the sole role of noncollection of tax liability would be not to assert such liability so that the acquiror would not be dependent on NOL carryovers and built-in deductions, in fact, being enough to offset income from forgiveness: the exercise of authority to refrain from collecting tax would principally serve the objective of compensating for insufficient availability of information to the potential acquiror (and other interested parties, including perhaps the government). At the opposite extreme, noncollection could be granted in all cases in which the tax liability in question would otherwise be borne by the federal government: under this view, the grant of authority could be seen as to substitute for section 7507, a provision of uncertain scope historically.[10]/ As discussed extensively later in this Report, this question of the scope of the noncollection authority is one of the central issues raised by the Proposed Regulations.

3. Treasury and I.R.S. Discretion.

Both because of the inherent uncertainty of the tax treatment of financial institution acquisitions after the repeal of the special tax incentives, and because of the perceived necessity of providing immediate guidance to facilitate

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[10]/ Section 7507(a) provides that "[w]henever and after any bank or trust company, a substantial portion of the business of which consists of receiving deposits and making loans and discounts, has. ceased to do business by reason of insolvency or bankruptcy, no tax shall be assessed or collected, or paid into the Treasury of the United States, on an account of such bank or trust company, which shall diminish the assets thereof necessary for the full payment of its depositors; and such tax shall be abated from such national banks as are found by the by the Comptroller of the Currency to be insolvent." Proposed regulations under section 7507 published at the same time as the promulgation of the Proposed Regulations provide that "ceased to do business" does not include transfers to a Bridge Bank (as defined in the Proposed Regulations) or a transaction to which section 381(a) applies and that federal financial assistance should be taken into account as an asset of an institution to determine whether it is solvent or insolvent. See Prop. Reg. § 301.7507-1(b)(4) and - 1(b)(9).

disposition of ailing financial institutions, the Treasury Department and I.R.S. were granted enormous discretion in the FIRREA tax legislation to devise a regulatory framework that served the tax policy and administrative concerns described above. The principal questions that the Treasury and I.R.S. faced in this regard can perhaps be conveniently divided into two categories:

(1) To devise a workable scheme for matching income and deductions with respect to federal assistance; and

(2) To determine the scope of the exercise of authority to forgive taxation of the institution and transferees.

C. The Notice.

In the Notice, the I.R.S. provided preliminary guidance addressing these two basic problems, as well as a number of ancillary issues. As to both questions, the Notice concentrated on providing an appropriate result in taxable, “whole bank” acquisitions of financial institutions.[11]/

The problem of the receipt of assistance income, then, was addressed principally by crafting comprehensive rules governing the timing of assistance income and basis allocation for taxable acquisitions of the assets of an institution and providing special rules enabling the parties more easily to achieve taxable asset acquisition treatment. First, in accordance with the specific language of the statute itself, the Notice provided that in such a transaction, a so-called “Taxable Asset

[11]/ By its terms, the Notice refrained from addressing either insured deposit transfers or the voluntary supervisory conversion of solvent or marginally solvent mutual institutions into stock institutions. I.R.S. Notice 89-102, 1989-2 C.B. 436, 437.

Acquisition," assistance would be taxed as if the target institution had received such assistance immediately prior to the transaction, with the assistance in essence viewed as an asset of the target acquired in the transaction by the acquiror as to which basis would be allocated. To implement this overall scheme, the Notice provided a number of additional rules relating to, inter alia, the application of section 1060 of the Code, the treatment of loss guarantees and reimbursements, and other matters. Second, the Notice provided that section 338 elections would be facilitated by expanding the definition of purchase (for purposes of section 338(h)(3)(A)(ii)) to include transactions to which section 351 applies. Thus, irrespective of the form of the acquisition of an institution, the parties could, at their election, relatively easily cause the recognition of built-in losses in connection with the acquisition. The special rules regarding the timing of income and allocation of basis applicable to asset acquisitions served as the incentive for making the section 338 election.

The Notice also provided for the limited deferral of payment of tax on "pre-acquisition" assistance. Thus, the Notice provided that "[i]f Agency intends to cause the later acquisition of a Financially Troubled Institution..." and the target institution is not a member of an affiliated group filing consolidated returns, the institution "may elect to defer the payment of the net tax liability attributable to the assistance for a period not extending beyond the earlier of thirty-six months from the date such assistance is provided or the date on which the Target stock or assets and liabilities are acquired."[12]/

[12]/ I.R.S. Notice 89-102, 1989-2 C.B. 436, 442.

The Notice also provided preliminary guidance as to the treatment of the parties responsible for tax liabilities in the assisted transaction context. Consistent with the legislative history described above, the Notice specifically provided that section 7507 of the Code will not apply "to prevent the assessment or collection of [f]ederal tax liabilities attributable to the receipt of [f]ederal financial assistance.[13]/ At the same time, however, the Notice provided broad rules for waiver of tax liability:

> If substantially all of [t]arget's assets are transferred in a Taxable Asset Acquisition and the Target was not includible in any consolidated return for the period that includes the acquisition date (or was the common parent of a group making a consolidated return), any net tax liability that results from a Taxable Asset Acquisition will not be assessed or collected if such net tax liability otherwise would be borne directly or indirectly by Agency . . .[14]/

In addition, the Notice provided that, if the target were acquired in a "Taxable Asset Acquisition," no uncollected liability would be assessed against the acquiror as transferee of the target institution.[15]/ Finally, the Notice made explicit that, if the target were acquired in an assisted transaction that is not a "Taxable Asset Transaction," the target institution and the acquiring corporation will have continuing liability for any

[13]/ Id. at 439

[14]/ Id. at 441 (emphasis supplied).

[15]/ Id. at 439. The term "Taxable Asset Acquisitions" was defined for purposes of the Notice as a "deemed or actual Agency assisted transfer of assets and liabilities of [t]arget in a transaction in which [t]arget recognizes gain or loss with respect to such assets." Id. at 438.

taxes of target, "whether attributable to the receipt of Federal financial assistance or otherwise."[16]/

The Notice also provided comprehensive rules relating to Interim Financial Institutions, so called "Bridge Banks.[17]/ The formation of such entities was viewed as a carryover basis transaction, and the new entity as the successor to the target institution. Moreover, if the original institution were a member of an affiliated group, it was required to continue to be a member of such group[18]/.

II. OVERVIEW OF THE PROPOSED REGULATIONS

According to the Preamble, the Proposed Regulations reflect four principles derived from the legislative history of FIRREA:

> First, FFA [federal financial assistance] is treated as ordinary income of the Institution that is being compensated for its loss through the provision of the assistance. Second, the timing of the inclusion of FFA should, where feasible, match the recognition of the Institution's losses. Third, where possible, the income tax consequences of an assisted acquisition should not depend on its form. Fourth, the Service generally will not collect tax on FFA if the Service determines a Federal insurer ("Agency") would bear the burden of the tax.[19]/

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[16]/ Id. at 439.

[17]/ The term "Bridge Bank" was technically defined in the Notice as "(i) a national bank organized by Agency and chartered by the Comptroller of the Currency pursuant to ... on the Federal Deposit Insurance Act ... or ... the Federal Home Loan Bank Act ... for the purpose of holding assets of the Target and continuing the operation of Target's business pending acquisition; or (ii) a Federal Savings Association organized ... for the purpose of holding assets and liabilities of a Target and continuing the operation of Target's business pending acquisition." Id- at 438. A virtually identical definition is employed in the Proposed Regulations. Hereinafter this defined term will be used in the text.

[18]/ Id. at 442.

[19]/ Treatment of Acquisition of Certain Financial Institutions; Certain Tax Consequences of Federal Financial Assistance to Financial Institutions, 57 Fed. Reg. 14804, 14805 (1992). Hereinafter, the defined term Agency will be used in the text.

The Treasury Department and I.R.S. apparently felt the need in particular to address three central problems that arose with respect to the Notice. First, the regime for matching assistance income and losses proved imperfect. As noted by the Preamble to the Proposed Regulations, "[t]he legislative history and the Notice both assumed that assistance typically would be provided in connection with the acquisition of an entire [i]nstitution and, thus, any remaining built-in losses of the [i]nstitution would be triggered at the time of the acquisition and would offset the receipt of taxable assistance."[20] Unless, however, at least eighty percent of the control of the stock of an institution was purchased (so that section 338 could be elected), asset sale treatment would not, under the Notice, be available in stock transactions. Moreover, although up to 36 months of deferral prior to an actual acquisition was provided in cases in which the target institution was not a member of an affiliated group, no other mechanism for deferral was provided, even though, as assumed by the legislation, built-in losses might be available that, if recognized, would offset such income.

Second, the mechanism contained in the Notice for dealing with "Bridge Banks" proved cumbersome. In particular, the requirement of continued affiliation with the former consolidated group proved impractical in many situations because of the old group's lack of control over and access to the failed institution.

Third, at least the I.R.S. came to be concerned that the availability of forbearance from collection of tax liability was too broad under the Notice. In particular, the I.R.S. apparently felt that such relief should not be provided in "open bank"

20/ Id at 14806.

transactions,[21]/ or other transactions in which former shareholders of the financial institution would continue to own equity in the institution.

A. The New Deferral Regime.

The most important step taken by the Proposed Regulations to further the objective of matching income and deductions is to set forth a comprehensive regime for deferral of income from assistance even in cases in which no actual or deemed asset transfer or liability assumption occurs. In this respect, the Proposed Regulations go well beyond the rules permitting deferral only for 36 months pending an acquisition.

As described in the Preamble, the underlying concept of the deferral mechanism contained in the Proposed Regulations is that income will be recognized “based on a formula designed to approximate the amount of tax benefits the Institution (or its consolidated group) either currently has available or has previously used.”[22]/ The formula provides generally that assistance is to be included in income for the taxable year only to the extent the institution's liabilities exceed the aggregate adjusted basis of its assets at the beginning of the taxable year, or the institution has a taxable loss for the year as determined without regard to assistance income or net operating or capital loss carryovers.[23]/ The deferred income then is generally recognized as losses are recognized in future years.[24]/

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[21]/ Open bank transactions generally are assistance transactions in which the institution is not put into formal receivership so that the holdings of existing shareholders are not eliminated.

[22]/ Treatment of Acquisition of Certain Financial Institutions, *supra* note 19, at 14806.

[23]/ Prop. Treas. Reg. § 1.597-2(c)(2).

[24]/ Prop. Treas. Reg. § 1.597-2(c)(4)(ii).

As discussed further below, a much less favorable rule is provided for transactions in which there is "Continuing Equity"[25]

B. Expansion of Deemed Asset Sales.

An additional measure taken in the Proposed Regulations to facilitate the matching of losses with assistance income is to broaden significantly the transactions to be characterized as asset sales for federal income tax purposes. The Preamble states generally that the purpose of these rules is ". . .to treat acquisitions of Institutions under Agency Control as taxable asset acquisitions] whether the acquisition is in the form of an asset purchase, a stock purchase or a carryover basis transaction . . ."[26] But the Proposed Regulations go considerably beyond merely eliminating the importance of form; for example, under the Proposed Regulations, a third party's mere assumption of deposit liabilities may be treated as a taxable asset acquisition under certain circumstances.[27]

The Proposed Regulations also expand the cases in which a stock sale will cause a transaction to be treated, for federal income tax purposes, as giving rise to a corporate level asset sale. During the legislative consideration of FIRREA, the possibility was considered of adopting a "mandatory section 338" election approach to assisted financial institution transactions, under which asset sale treatment would be required if eighty

[25] Prop. Treas. Reg. S 1.597-2(c) (3). See discussion at note 64 infra for the full definition of Continuing Equity. Hereinafter the defined term will be used in the text.

[26] Treatment of Acquisition of Certain Financial Institutions; supra note 19, at 14807. See note 29 infra for the definition of Institutions Under Agency Control.

[27] Prop. Treas. Reg. § 1.597-5(a).

percent or more control of such an institution was purchased. The Notice, in general, took a cautious approach and merely facilitated the section 338 election through relaxation of the "purchase" requirement under section 338 in technical respects, as discussed above.

The Proposed Regulations, by contrast, adopt a more far-reaching approach. A deemed sale of all corporate assets occurs when stock transfers cause an institution or its consolidated subsidiary that is under Agency Control either to enter or leave a consolidated group or to experience a fifty percent or more ownership change.[28]/ A financial institution is generally treated as under Agency Control if the RTC, FDIC or similar agency is conservator or receiver of the Institution or Agency and, in addition, will be deemed to be under Agency Control if it has a positive balance in its deferred assistance account, or the event results from an agreement while it was under Agency Control.[29]/

C. Treatment of Bridge Banks.

The Proposed Regulations also provide a substantial amount of additional guidance relating to Bridge Banks and other Institutions under Agency Control. First, the Proposed Regulations provide that such an institution will be viewed as a corporation for federal income tax purposes.[30]/ Second, it is provided that the imposition of Agency Control will not lead to an ownership change under section 382.[31]/ Third, the Bridge Bank

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[28]/ Prop. Treas. Reg. § 1.597-5(b)(1).

[29]/ Prop. Treas. Reg. § 1.597-l(b); Prop. Treas. Reg. § 1.597-5(b)[29/]. Hereinafter, the defined term "under Agency Control" will be used in the text.

[30]/ Prop. Treas. Reg. § 1.597-4(b).

[31]/ Prop. Treas. Reg. § 1.597-4(c).

(and certain other "Residual Entities") are treated as successors to the financial institution for federal income tax purposes.[32]/ And fourth, imposition of Agency Control generally does not terminate the institution's membership in a consolidated group, unless a special election is made.[33]/

This election is the most important aspect of the new rules relating to Bridge Banks. If the election is made by the relevant consolidated group, the amount of liabilities in excess of basis is paid as a toll charge.[34]/

D. Relaxation of Alternative Minimum Tax and Section 382 Rules.

To further assure that no net tax liability will result from the receipt of financial assistance in cases in which there are associated losses, the Treasury Department proposed other new rules. In this regard, one of the most important is that, in computing an institution's taxable income or alternative minimum taxable income for a taxable year, the limitations imposed by sections 56(d)(1) relating to the treatment of net operating losses for alternative minimum tax purposes and the limitations imposed by section 382 and the net operating loss provisions of the consolidated return rules do not apply.[35]/

32/ Prop. Treas. Reg. § 1.597-4(d)(1).

33/ Prop. Treas. Reg. § 1.597-4(f)-(g).

34/ Prop. Treas. Reg. § 1.597-4(g)(4).

35/ Prop. Treas. Reg. § 1.597-2(c)(5).

E. Limitation on Collection of Tax from Institutions.

The concern over the forgiveness of tax liability in open bank transactions is reflected in the provisions on collections of tax liability. The general rule is stated quite broadly:

> If an Institution without Continuing Equity (or any of its Consolidated Subsidiaries) is liable for income tax that is attributable to the inclusion in income of FFA or gain from a Taxable Transfer, the tax will not be collected if it would be borne by Agency.[36]/

This noncollection policy, however, does not extend to cases in which there is Continuing Equity.[37]/ Moreover, to ensure that there is no inappropriate benefit from noncollection, the Proposed Regulations, unlike the Notice, provide that income tax not subject to collection will continue to be assessed and used to offset any claim for refund made or on behalf of the Institution, the Consolidated Subsidiary or any other corporation with several liability for tax.[38]/

F. Transferee Liability.

In addition, the Proposed Regulations provide a broad rule with respect to collection of taxes from a successor corporation or acquiring entity. Similar to the general noncollection provision, the forgiveness of transferee liability is also limited in the event that there is a certain amount of common ownership with the target institution, although the test is not precisely the same as that applicable for determining Continuing Equity:

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[36]/ Prop. Treas. Reg. § 1.597-6(a) (emphasis supplied).

[37]/ Id.

[38]/ Prop. Treas. Reg. § 1.597-6(d).

> No income tax liability (including the several liability for taxes under § 1.1502-6) of a transferor in a Taxable Transfer will be collected from the New Entity or Acquiring unless one or more persons who owned, directly or indirectly, or through related persons within the meaning of section 267(b). five percent or more (by vote or value) of the transferor's stock at any time during the two-year period before the Institution was placed under Agency Control or first received FFA (whichever is earlier), own, directly or indirectly, or through related persons within the meaning of section 267(b), five percent or more (by vote or value) of the New Entity's or Acquiring's stock at any time after the Taxable Transfer.[39]/

By virtue of the deemed transfer provisions, this provision apparently may extend to buyers in an acquisition of stock of an institution or its "Consolidated Subsidiary."

G. Definition of Assistance.

A final important rule contained in the Proposed Regulations is that debt instruments, stock, warrants, or other rights to acquire stock of an institution are not treated as debt, stock or other interests of the issuer "while held by Agency or an entity under Agency control."[40]/ The effect of this rule, of course, is to cause consideration given by the Agency to be treated as assistance. This result also obtains under the definition of "Federal Financial Assistance", which provides, consistent with the express statutory language of section 597(c) of the Code, that money or property may constitute assistance "... regardless of whether the Institution or any of its affiliates issues Agency a [n]ote or other obligation, stock warrants, or other rights to acquire stock in connection with Agency's provision of money or property."[41]/

[39]/ Prop. Treas. Reg. § 1.597-6(e) (emphasis supplied).

[40]/ Prop. Treas. Reg. § 1.597-3(b).

[41]/ Prop. Treas. Reg. § 1.597-1(b)(2).

H. Other Rules.

In addition to these basic rules, the Proposed Regulations contain additional important rules implementing the overall scheme. For example, the Proposed Regulations provide that, for tax purposes, an institution is treated as the owner of all assets covered by a loss guarantee regardless of whether the Agency or an entity controlled by it would be treated as the owner under general income tax principles.[42]/ This rule removes a major source of uncertainty from assisted transactions.

III. PRINCIPAL ISSUES

In this Report, we will concentrate on seven principal areas with respect to which major substantive issues are raised by the Proposed Regulations:

(1) the deferral regime adopted by the Proposed Regulations in cases in which asset sale treatment is not applicable;

(2) the broadening of the cases in which there will be a deemed sale of assets;

(3) the treatment of Bridge Banks;

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[42]/ Prop. Treas. Reg. § 1.597-3(a).

(4) the exemption from application of the alternative minimum tax rules and the section 382 and consolidated return rules limiting net operating loss carryovers;

(5) the discretionary noncollection of tax liability, particularly as it pertains to transactions in which there is Continuing Equity;

(6) the elimination of transferee liability in certain cases; and

(7) the definition of assistance.

A. Deferral Regina.

The most significant new initiative reflected in the Proposed Regulations is the broad deferral mechanism that is utilized to match assistance income and available offsetting deductions. We believe that the approach of devising a broader deferral formula that does not depend on either an actual or deemed asset acquisition is a sensible one. A basic issue is raised, however, by the manner in which income from assistance is stacked against available or potentially available deductions under the Proposed Regulations.

As described above, under the Proposed Regulations, the amount of income that an institution without Continuing Equity must include in income in a taxable year is limited to the sum of:

(i) the excess at the beginning of the taxable year of the Institution's liabilities over the adjusted bases of the Institution's assets; plus

(ii) the excess for the taxable year of the Institution's deduction allowed by Chapter 1 of the Code (other than net operating and capital loss carryovers) over its gross income (determined without regard to financial assistance)[43]/

The Preamble to the Proposed Regulations states that the "formula [is] designed to approximate the amount of tax benefits the [institution (or its consolidated group) either currently has available or has previously used."[44]/

The intended operation of this formula may be illustrated by a simple example. Assume that institution T originally had assets of value and basis of 100x funded with deposit liabilities of 100x. Of these assets, assets with a basis of 50x have depreciated in value to 10x and the remaining assets have the same value and bases, i.e. there is a 40x built-in loss. Assume first that, prior to the taxable year in issue, assets with a 25x basis are actually disposed of for 5x, with a 20x loss recognized. The institution has no other income or deductions. At the beginning of the taxable year, 40x of assistance is provided. Immediately prior to the receipt of the assistance, the institution would have 100x liabilities, 20x of NOL carryovers and 80x basis of assets (75x of original assets plus 5x received on the sale) which are worth 60x, reflecting the remaining 20x built-in loss. On the theory that such loss is available to offset the income from assistance, 20x of income will be taxable at this point under the Proposed Regulations; the other 20x will be deferred until the remaining built-in loss of 20x is realized.

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[43]/ Prop. Treas. Reg. § 1.597-2(c)(2).

[44]/ Treatment of Acquisition of Certain Financial Institutions, supra note 19, at 14806.

The deferral formula assumes a relatively simple relationship between basis, liabilities, and deductions. That relationship, of course, may not always obtain. Relatively common, transactions -- for example, a stock purchase followed by a section 332 liquidation -- may destroy the relationship. Nonetheless, on balance, and viewing the tax system from an overall perspective, the simplifying assumptions made by the draftspersons of the Proposed Regulations in crafting the deferral formula seem reasonable.

The principal issue posed by this formula relates to the fact that it stacks taxable assistance first against the tax losses that the formula assumes an institution either has available or have been used and includes such amount in income rather than matching it against built-in losses that may be available in the relatively near term. Assume, for example, that T has 100x of liabilities and assets with a basis of 80x (not subject to liabilities) that are worth 60x, and that it has no NOL carryovers (for any of the reasons that we will discuss shortly). Assume further that 20x of interim assistance is provided in the taxable year, and there are no other income and deductions. In that case, the formula would cause 20x of income to be recognized because liabilities exceed basis by that amount, even though in the relatively near term 20x further of built-in-losses may be realized which would offset such income. In effect, the income is not permitted to be stacked against the built-in losses in the entity; rather the income from assistance is being arbitrarily viewed as not attributable to such losses.

While it is recognized that the Treasury Department and I.R.S. have made a yeoman effort to implement a comprehensive and workable deferral regime, it still must be asked whether this approach best accomplishes their objectives. In this regard, two lines of inquiry are particularly relevant. The first is whether the cases in which the mismatch occurs are necessarily appropriate ones for income to be recognized earlier, i.e. for assistance not to be stacked against built-in losses which might be recognized in the future. And the second is whether there is an administratively workable alternative system.

The first task in evaluating whether the approach of the Proposed Regulations makes sense is to pinpoint those cases in which assistance will be recognized and income actually reported because NOL carryovers are not available. The premise of the Proposed Regulations, as articulated in the Preamble, is that in such a case the losses will have been actually previously utilized. Assume, for example, the basic case of a financial institution that historically has been included and continues to be included in a consolidated return. Assume further that prior dispositions or write-offs of loss assets have occurred, and that the losses generated have been utilized against the income of other members of the group. For example, assume in the example above that the reason that liabilities exceed basis by 20x but there is no NOL carryover available is that the NOLs have previously been utilized elsewhere in the consolidated group.

This case may be relatively readily viewed as an appropriate one for early recognition of the income, irrespective of the fact that potential built-in losses are still available. Losses compensated by “insurance” that were previously deducted for the benefit of taxpayers currently related to the institution are, in effect, being recaptured.

The merits of other cases, however, would not appear to be as clear. If the losses were utilized in the consolidated return of another group, such losses may already have been recaptured, in effect, by operation of the investment adjustment rules because the prior group may have already recognized more gain on disposition of the institution as a result of the losses utilized. In that case, the formula operates simply to locate the income with the assets: it does not necessarily lead to the burden of taxation being placed on the parties who enjoyed the benefit of such losses. Moreover, it could be argued that the government's interest has been protected by operation of the investment adjustment rules.

Assume alternatively, for example, that the losses have simply expired. Does it make sense in that situation to cause the early recognition of income? Unless the carryover limits are eliminated for this purpose as proposed below, the Proposed Regulations can be viewed as arbitrarily allocating the assistance income away from built-in losses that will be recognized in the future.

Finally, it is possible that the losses may not be available simply because, under current tax rules, the efficient recognition of economic losses is not necessarily possible. Assume, for example, that T had bought the stock of another entity, which had assets with an aggregate basis less than the original stock basis T (i.e., purchase price of the stock). Assume further that the purchased entity declined in value, that T decided to dispose of it and that, because of the loss disallowance rules, it sold the assets to recognize some loss. That loss would still be less than the actual economic loss to the seller, and the equation assumed by the Proposed Regulations would become inoperative, i.e., liabilities of T could exceed basis by an amount in excess of the losses used or available.

The broader question is whether permanent deferral could be justified in such a case. To provide such deferral (or exemption) in such a case, however, would require a very refined mechanism. The point here is a narrower one -- simply that there also arguably could be good reason to continue the deferral in such a case when it is clear that built-in losses in a sufficient amount may be recognized in the relatively near term future to offset such income. As long as the income is recognized no later than the recognition of built-in losses, the "double dip" of pre-FIRREA law will not be available to acquirors.

Nonetheless, a strong conceptual case can be made for the deferral formula adopted by the Proposed Regulations. One way of understanding its operation is that it requires the recognition of assistance income in cases in which the institution would recognize income if all its assets were sold for the assumption of its liabilities. In this sense, then, the treatment of assistance income remains linked to the model assumed in the Notice -- the transfer of all the assets and liabilities of the institution in a single transaction. Thus, the fact that liabilities exceed basis indicates that, over the long run, the institution has an inherent potential for tax, irrespective of whether it has built-in loss assets that may be disposed of or written off in the near term which, in some sense, may be considered matched with the assistance income. Viewed in this manner, while there are some cases in which income recognition will be accelerated, the deferral formula nevertheless seems not to be unfair. Moreover, the potential carryback of losses will mitigate the long run effect of acceleration.[45]/

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[45]/ *See* Code sections 172(b)(1)(A) (general 3 year rule) and 172(b)(1)(C) (10 year rule for bad debt losses of banks before 1994).

The question also must be asked whether there is an administratively workable alternative formula that would permit continued deferral in the partial assistance case in which built-in losses remain available and that would otherwise serve the policy goals of the regulations. One possibility would be to adopt a mechanism like that historically contained in section 108 of the Code (relating to cancellation of indebtedness income) which simply requires attribute and basis reduction as assistance is received. Under this deferral mechanism, at least the “double dip” of prior law would be prevented, as NOL carryovers and built in deductions would not be available to the acquiror of the institution. The principal difficulty with this approach, however, is that assistance income would not be immediately taxable in the case in which related losses had already been utilized, i.e., the recapture of previously used losses would be delayed. We can, therefore, understand the reason that the Treasury Department and I.R.S. have not adopted this approach.

An alternative formula would continue deferral when and to the extent that there are actual built-in losses in the institution. Built-in losses are required to be computed in other contexts -- for example, under section 382 and the consolidated return regulations. The fact that an assistance transaction usually entails some type of valuation could, in fact, make such computations more reliable. Nonetheless, it appears reasonable for the I.R.S. to be reluctant to incorporate potential built-in losses in a deferral formula because of the required reliance on potentially subjective valuations and the attendant administrative problems.

On balance, then, we believe that the general deferral formula contained in the Proposed Regulations represents a very constructive approach to the problems that it is designed to address. The I.R.S. and Treasury Department are to be applauded for their ingenuity in this regard.

The operation of the special deferral formula applicable to institutions with Continuing Equity is more puzzling. Under the Proposed Regulations, the amount of assistance income that an institution with Continuing Equity is required to recognize is limited to the sum of the following:

> (i) the excess at the beginning of the taxable year of the Institution's liabilities over the adjusted bases of the Institution's assets; plus
>
> (ii) the greater of --
>
> (A) the excess for taxable year of the Institution's deductions allowed by Chapter 1 of the Code (other than net operating and capital loss carryovers) over its gross income)(determined without regard to FFA), or
>
> (B) the excess for the taxable year of the deductions allowed by Chapter 1 of the Code (other than net operating and capital loss carryovers) of the consolidated group of which the Institution is a member on the last . day of the Institution's taxable year over the group's gross income (determined without regard to FFA); plus
>
> (iii) the amount of any net operating loss carryover of the institution (or in the case of a carryover from a consolidated return year of the institution's current consolidated group, the net operating loss carryover of the group) to the taxable year.[46]/

In explanation of this complicated formula for recognition of assistance income by institutions with Continuing Equity, the Preamble states that "... [u]nder the less favorable deferral formula, such institutions are required to recapture

[46]/ Prop. Treas. Reg. § 1.597-2(c)(3). In addition, the Proposed Regulations provide that an institution with Continuing Equity must include in income the entire remaining balance of its deferred account in the taxable year in which it liquidates, ceases to do business, transfers (other than to a Bridge Bank) substantially all its assets and liabilities, or is deemed to transfer all of its assets pursuant to Proposed Regulation section 1. 597-5(b). Prop. Treas. Reg. § 1.597-2(c)(4)(iii).

deferred FFA even if their built-in losses remain unrealized."[47]/ The problem, however, is that the formula appears to discriminate against institutions with Continuing Equity that have already realized losses.

Assume the following simple case. Institution A has 100x of deposit liabilities and assets with a basis of 100x and a value of 50x at the beginning of the year. It receives 50x of assistance in that year and has no other income and deductions. It has Continuing Equity at the time of such assistance. Nonetheless, under the deferral formula, it would recognize no immediate income. For that institution with Continuing Equity, the formula operates precisely in the same manner as it does for institutions without Continuing Equity: in effect, the income will not be recognized until built-in losses are recognized.

Now consider the case of Institution B. Institution B also originally had 100x in deposit liabilities and assets with basis of 100x and value of 50x. Assume that it has, in the preceding year, disposed of assets with a basis of SOX' and value of 25x, incurring a net operating loss of 25x which it carries over. At the beginning of the taxable year in question, it now has assets with a value of 50x, but a basis of 75x (50x of original assets and 25x of cash from the disposition of the built-in loss assets); and it also has a 25x net operating loss carryover. Like Institution A, it receives 50x of assistance income in that year and has Continuing Equity at that time. Under the formula, it will recognize 50x of income (the sum of liabilities in excess of basis and NOL carryovers) under the formula, and because it has only 25x of NOL carryovers, have net taxable income of 25x; as suggested in the Preamble, it will not

[47]/ Treatment of Acquisition of Certain Financial Institutions, supra note 19, at 14806.

be able to use its remaining 25x of built-in losses to offset the income. It is not clear, however, that it makes sense for Institution A to be able, in effect, to continue to rely on such built-in losses to defer income, but not Institution B.[48] It also may be questioned whether it is appropriate generally to discriminate against financial institutions with Continuing Equity in the context of the deferral formula. We will discuss the treatment of Continuing Equity under the Proposed Regulations more broadly below. For now, it is worth noting only that the deferral mechanism is perhaps best understood as simply approaching the normatively correct tax treatment and not as a special preference. In that context, the discriminatory treatment of Continuing Equity seems unwarranted.

B. Deemed Asset Sale Treatment.

A related policy issue raised by the Proposed Regulations is whether the expansiveness of the deemed sale treatment contained in the Proposed Regulations is justified. As noted above, the Notice generally took a more cautious approach, reflecting perhaps a belief that a "deemed section 338" election would raise in some people's minds the possibility of expansion of such a rule to other areas. The deemed sale rules of the Proposed Regulations are, in fact, quite broad in their applicability. The tax treatment imposed by a section 338 election is no longer elective to the taxpayer. And the eighty percent stock purchase threshold of section 338 and the Notice has been lowered to fifty percent. It may be questioned whether

[48] Although the intended operation of the special deferral formula remains unclear, it appears that one problem is simply that there is a doubling up of the effect of the transactions creating NOL carryovers because such transactions will be reflected both in liabilities minus basis and NOL carryovers. Thus, as an alternative formulation, recognition could be required equal to the greater of liabilities minus basis or NOL carryovers, rather than in an amount equal to the sum of the two.

such broad rules are appropriate given the mechanism for matching provided by the deferral formula.

The policy issues generally associated with the expansive deemed sale rule (e.g. the treatment of the minority) are, however, substantially mitigated in this context by the fact that the rules in the Proposed Regulations only apply in the case of institutions “[U]nder Agency Control” or which have received assistance that has been deferred. There may, in fact, be no real “minority” other than the Agency itself. Moreover; it is generally unlikely that substantial net income will be recognized by the entity, although for the reasons discussed above such income recognition is possible in some cases. Thus, deemed sale treatment will principally serve the objectives of matching income and losses and of preventing the transfers of institutions whose losses have been utilized by separate taxpayers without additional tax being paid to reflect such loss utilization.

We believe, therefore, that in this limited context the approach of the Proposed Regulations is justified. It also seems clear that the broad regulatory authority granted under FIRREA provides ample legal basis for the approach taken by the Proposed Regulations.

We further believe that it was reasonable for the Proposed Regulations to expand the concept of “Taxable Transfer” to any transfer of deposit liability to a transferee other than a Bridge Bank, whether or not assets are transferred. In all cases, however, in which less than all the assets of the financial institution are transferred there is a potential mismatching of assistance income because there will frequently not be matching of losses on assets with the amount of assistance income.[49] This possible mismatch increases the need for a deferral mechanism of some kind, as is provided by the Proposed Regulations.

C. Bridge Banks.

The Rules relating to Bridge Banks contained in the Proposed Regulations pose some of the same conceptual issues as those relating to deferral discussed above. Like the Notice, the Proposed Regulations emphasize the proper location of the income from assistance. Thus, even though the reality of a Bridge Bank transaction may be that the Agency has assumed complete control, the Proposed Regulations treat the institution as remaining a member of its former consolidated group so that assistance income is treated as included in the group's income.

Because the required continuation of the Bridge Bank in the group can pose significant administrative problems for the group (which will likely no longer have a day-to-day operational role in the institution or access to its books and records), the Proposed Regulations provide a rule under which a consolidated group may disaffiliate the institution from the group by paying a “toll charge” equal to liabilities in excess of basis immediately before the deconsolidation or transfer of deposit liabilities.[50]

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[49] This mismatch may easily occur in this type of transaction because there is no particular reason to believe that the assets which accompany the liabilities in the transaction will have built in losses equal to the assistance income. Assume that acquiror is going to assume the deposit liabilities of 100X of Branch B of Institution T, together with assets worth 15x, and be provided assistance of 25x. For matching to occur, the assets taken must have a basis of 100x or there must be loss carryovers reflecting the past realization of such losses. However, since the deposit liabilities in Branch B may have funded assets in other parts of Institution T, there is no reason to believe that this will be necessarily be the case.

[50] Prop. Treas. Reg. § 1.597-4(g).

After the disaffiliation, the institution will be viewed as a new corporation with no NOL carryforwards, but with a noninterest bearing account receivable for assistance equal to the toll charge.[51]/

The toll charge also must be paid under certain other circumstances, e.g., when a Bridge Bank is formed with institutions from more than one group.[52]/ Moreover, a consistency requirement is made applicable with respect to this election to disaffiliate.[53]/

Because we believe that most (if not all) taxpayers will desire to make the election to disaffiliate, it is quite important to assess the operation of this mechanism. The first question that must be addressed in this regard is whether the amount of the toll charge is fair.

Several of the same issues described above with respect to the deferral formula are implicated here. In some cases, an amount equal to liabilities in excess of basis of the institution will exceed the prior utilization of losses or current availability of NOL carryovers relating to assistance. Nonetheless, in light of the fact that an amount equal to liabilities in excess of basis represents the minimum ultimate potential for taxation of the business comprising the institution and that a major corporate event has occurred, i.e. the placement of the institution in receivership, we believe that the relatively simple formula adopted by the Proposed Regulations is a reasonable one.

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[51]/ Prop. Treas. Reg. § 1.597-4(g)(7).

[52]/ Prop. Treas. Reg. § 1.597-4(g).(6)(ii)

[53]/ Prop. Treas. Reg. § 1.597-4(g)(2)(ii).

The second question is whether the location of the toll charge is appropriate. Under the Proposed Regulations, immediately before the subsidiary institution to which the election is applied is placed in Agency receivership, the members owning the common stock of the institution include the toll charge in income in proportion to their common stock ownership, the toll charge is included in the earnings and profits of the institution, and the members of the consolidated group are treated as having disposed of their stock in the institution.[54]/ The toll charge is treated as an “extraordinary gain disposition” under the loss disallowance regulations.[55]/

While it appears that the location of the toll charge recognition under the Proposed Regulations will lead to an appropriate result in cases in which the NOLs of the institution have previously been utilized, it will cause results in certain situations -- for example, cases in which the SRLY limitations on the use of NOL carryovers are implicated. Consider the following example. Institution T, owned by public shareholders, originally has 100x of both liabilities and tangible gross assets. The value of the assets falls to 80x. Despite the fact that T's liabilities exceed the value of its tangible assets, P now purchases all the stock of T for 5x reflecting in large part its perception of T's goodwill. P and T file a consolidated return. T now recognizes 20x of the built-in losses, all such losses being subject to SRLY.[56]/ Assume none of such losses are utilized by the group. Under those circumstances, there should be no net investment adjustment with respect to P's stock in T, which will continue to

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[54]/ Prop. Treas. Reg. § 1.597-4(g)(3).

[55]/ Prop. Treas. Reg. § 1.597-3(e).

[56]/ Treas. Reg. § 1.1502-15; Prop. Treas. Reg. § 1.1502-15.

have a basis of 5x (assuming there is no other net income or loss)[57]/ Agency takes over T, and P makes a disaffiliation election.

If we understand the operation of the Proposed Regulations correctly, there will be a toll charge of 20x (T's liabilities in excess of basis) which will be recognized by P. The 20x will be included in T's earnings and profits, thus (under current law) increasing P's basis in the T stock from 5x to 25x.[58]/ P will be treated as disposing of its stock, presumably for 0. But because the 20x is viewed as gain from an extraordinary disposition, only 5x of the loss can be recognized.[59]/ Thus, P will pay tax on 20x even though it had no use of the NOLs that caused T's liabilities to exceed basis, and the losses will never be utilizable (although there will be a 20x basis in an assistance receivable in the institution).[60]/ This result does not appear to be an appropriate one.

The correct result would be reached if the income from the toll charge were, in the first instance, taxable to the institution, thus permitting use of the SRLY losses. The situation illustrated in the above example may be relatively widespread, and we see no reason not to make this change.

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[57]/ Treas. Reg. § 1.1502-32(b)(1)(ii) and (2)(ii). The newly Proposed Regulations relating to investment adjustments would appear to have generally the same result.

[58]/ Treas. Reg. § 1.1502-32 (b)(1)(i)

[59]/ Treas. Reg. § 1.1502-20(c)(1)(i).

[60]/ One way that the losses would be utilizable would be if there was reattribution of the subsidiary institution's losses to common parent under Treas. Reg. § 1.1502-20(g). However, it would appear that the insolvency limitation of Treas. Reg. § 1.1502-20(g)(2) would usually be operative to prevent much, if not all, such reattribution.

The third question raised by the toll charge mechanism is whether it would be appropriate to defer the recognition of the toll charge amount until assistance income is actually received by the institution placed under receivership. It is possible (but perhaps not likely) that partial interim assistance rather that full assistance will be provided to the institution so that recognition of the full toll charge seems unfair; in any case, full assistance may not be provided immediately. Moreover, in cases like those described above in which the liability in excess of basis formula is not fairly reflective of the prior use of losses, such a deferral mechanism seems even more appropriate. Nonetheless, because of the advantages of a “clean break”, we believe that, on balance, it is reasonable not to provide for such deferral in the general elective disaffiliation case.

The case in which the toll charge is required to be paid because institutions are combined presents a more sympathetic case for such a mechanism, however. In that case, the actions of a federal agency over which an old group has no control, in effect, force the deemed election because the agency may decide to combine institutions without any participation of the former groups owning the institutions. Thus, the disadvantages associated with a mechanism for deferral of the toll charge may be viewed as outweighed by considerations of fairness in such a case.

D. Exemption from Alternative Minimum Tax and Restrictions on Loss Carryovers.

Additional policy issues are raised by the exemptions provided in the Proposed Regulations from the alternative minimum tax and the section 382 and consolidated return restrictions on net operating loss carryovers. Such exemptions clearly facilitate the matching of income and losses. But it could be argued that these rules impede the matching of income and deductions in other cases, and it may be questioned why a more favorable rule is provided in this context.

Nonetheless, we believe that, on balance, the position taken in the Proposed Regulations is a justifiable one. By providing these exemptions, the Treasury Department and I.R.S. are, in effect, serving the twin objectives of achieving a normatively correct tax treatment while facilitating the financial institution bail out program of the federal government. Given the authority delegated by Congress to exempt transactions from tax altogether in this context, these rules seem to be within the contemplated scope of the regulatory guidance.

In addition, we believe it would be appropriate for the Proposed Regulations to provide that the time limits applicable to the use of net operating loss carryovers are not applicable.

We are aware of cases in practice under the Notice in which matching was not possible solely because of the expiration of loss carryovers.

E. Forgiveness of Tax Liability.

One answer to the potential imperfection of the various mechanisms to achieve matching of income and losses is to provide broad authority for the I.R.S. to exercise its discretion not to collect the tax in certain situations. While the Proposed Regulations do contemplate relatively wide scale noncollection of tax liability, however, the purported rationale for this forgiveness of tax liability is not specifically linked to the matching of income and deductions.

The treatment of discretionary noncollection of tax liability is, in our view, the most difficult aspect of the Proposed Regulations to evaluate, in part because the issues raised go well beyond tax policy. This difficulty is increased significantly because a comprehensive overall rationale for noncollection is not stated in either the legislative history of FIRREA or the Preamble or Proposed Regulations.

As described above, the basic rule is that, if an institution without Continuing Equity is liable for income tax that is attributable to the inclusion in income of financial assistance or gain from a “Taxable Transfer,” the tax will not be collected “if it would be borne by Agency.” The final determination of whether it would be “borne by Agency” is within “the sole discretion of the Commissioner.[61]/ The Proposed Regulations also provide that “... [c]ollection of the several income tax liability from members of an Institution's consolidated group other than the [institution or its [consolidated [subsidiaries is not affected by this section.”[62]/

Three questions are raised by these rules:

(1) Whether the basic decision to permit noncollection of tax liability in the Commissioner's discretion is appropriate;
(2) Whether the discriminatory treatment of Continuing Equity is justified as a policy matter; and
(3) Whether the particular definition of Continuing Equity utilized in the Proposed Regulations

[61]/ Prop. Treas. Reg. § 1.597-6(a).

[62]/ Id.

adequately serves the policy objectives of discriminatory treatment.

1. Whether Granting of Noncollection Generally Is Appropriate.

In many ways, the most significant issue raised by the Proposed Regulations is whether the potential grant of noncollection is too broad. As noted above, one of the core concepts underlying FIRREA was that federally assisted financial institution transactions should no longer benefit from a tax subsidy.[63]/ Thus, the policy decision was made by Congress that such a subsidy on the revenue side was no longer justified even if the cost to the federal government on the spending side was increased.

In that context, the question is raised as to the proper scope of the exercise of authority granted by Congress. Most of the Proposed Regulations reflect an attempt to achieve a proper matching of income and losses. Full exercise of the broad noncollection authority contained in the Proposed Regulations, by contrast, theoretically would lead to a forgiveness of tax liability attributable to overall net income; indeed, the Preamble states that noncollection is “to benefit [the] Agency.”[64]/ It is somewhat difficult, then, to square the legislatives history of FIRREA with the broad, discretionary noncollection of tax “to benefit [the] Agency” provided in the Proposed Regulations.

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[63]/ Treatment of Acquisition of Certain Financial Institutions, supra note 19.

[64]/ Treatment of Acquisition of Certain Financial Institutions, supra note 19, at 14808

One rationale for the noncollection authority is essentially premised in creditors rights considerations: in the context of an insolvent institution with two government creditors with claims to a limited estate, the I.R.S. will subordinate its claim to the Agency. Given the history of section 7507, and the evident relationship between section 7507 and section 597, this rationale is a plausible and, indeed, reasonable one. However, it can have extremely broad implications if viewed in isolation: in effect, the I.R.S., to the extent of the noncollected tax, becomes the insurer of deposits.

An alternative approach to rationalizing noncollection of tax in this context would be simply to view the authority as properly exercised in the discretion of the Commissioner consistently with the matching of assistance income with the losses to which the assistance pertains. Exercised within that framework, noncollection of tax liability could perform an integral role in the government's financial assistance program by alleviating the transaction costs associated with imperfect information. Thus, it would clearly be appropriate to agree in advance to refrain from collecting tax liabilities in a broad range of cases in which it is objectively likely that losses should be available to offset assistance income, but the facts concerning net operating losses could only be ascertained with difficulty by a prospective acquiror (or the government). Moreover, exercise of the noncollection authority might be viewed as appropriate when the deferral formula does not lead to a proper result for the reasons described above.[65]

We believe that these two alternative rationales should, in essence, be viewed together. Thus, we believe that exercise of the Commissioner's authority with the purpose to "benefit Agency" in this regard is inappropriate unless it is likely that substantially all the proper amount of tax is being collected, from either the institution in question or other taxpayers, in the largest proportion of cases in which the I.R.S. refrains from collecting tax and that the Agency would likely bear the tax imposed in the particular case because of actual or imminent insolvency of the institution. It is a significantly greater decision to defer the tax liability of an ongoing institution that is likely to have built-in losses relating to the income than permanently to forgive the ultimate collection of it for the benefit of Agency when it is possible, viewing the tax system as a whole, that the proper amount of tax may never be collected; the decision to do so should not be taken lightly.

The most troublesome case in this regard is that in which the institution in question has previously been a member of a consolidated group. Under the Proposed Regulations, in the case in which the institution continues to be a member of a group, liability will be asserted against other members of the group. It

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[65] Noncollection, would appear to be more appropriate in such a case when combined with continued assessment of the tax liability because under the Proposed Regulations noncollection is not limited to cases in which all the assets are transferred to a new entity or the entity goes out of existence; unless assessment continues, the "double dip" of simultaneous exemption of assistance income and use of deductions from built in losses could, in effect, continue. In this regard, the limitation of the role of continued assessment in the Proposed Regulations to the offset of refunds could be questioned. The very expansive Taxable Transfer rules will, however, mitigate the potential for abuse substantially. If, as suggested by the Report, the role of the "Continuing Equity" rules is limited significantly, it may be desirable either to trigger a Taxable Transfer whenever there is noncollection or to broaden the role of continued assessment.

is also possible, however, that the institution will no longer be a member of the group that took the losses in question when the assistance is provided. In general, the consolidated return investment adjustment rules (including the excess loss account rules) will operate to recapture such losses upon the taxable disposition of the institution by the prior group. However, in cases in which there is no excess loss account, the investment adjustment rules will only serve to preserve the potential for “recapture” in the case of a tax free reorganization. Thus, in at least the tax free reorganization case, unless the disaffiliating transaction was a “Taxable Transfer” under the Proposed Regulations (which generally will be true only if Agency has taken control or assistance was previously granted), the tax liability relating to use of the losses may never, in fact, be recaptured; in any event it will not necessarily be recaptured prior to or at at the time the losses are, in effect, compensated for by the receipt of assistance by the institution if, at that time, the institution is no longer a member of the group that benefitted from the losses in question.

Nonetheless, while it is clear that some leakage will occur and that net tax will potentially go uncollected by exercise of the authority to refrain from tax collection, we believe that, viewed from an overall perspective, the impact will not be substantial, particularly after the Taxable Transfer rules in the Proposed Regulations are fully operative.[66]/ Thus, in light of the fact that the other public benefits from exercise of the discretionary noncollection authority may be significant, a broad noncollection authority is justified. While we believe that the rationale for noncollection properly should be premised on

[66]/ Even the tax free reorganization case should be viewed as a minor case because, if the excess loss account rules are not operative, the losses can be viewed as financed by equity, not depositor liabilities.

more than the benefit of Agency, the noncollection authority should be available to the I.R.S. to exercise in appropriate cases.

2. Discrimination Against Institutions With Continuing Equity.

The second question is whether the discriminatory treatment of institutions with Continuing Equity is appropriate. This question should be considered against the backdrop of the rationales for noncollection discussed above.

As discussed above, in addition to other rules that are less favorable for institutions with Continuing Equity, the Proposed Regulations provide that discretionary noncollection of tax will never be available in cases in which there is Continuing Equity. An institution has Continuing Equity for any taxable year if one or more persons who owned directly or indirectly, or through related persons within the meaning of section 267(b), five percent or more (by vote or value) of an institution's stock at any time during the two-year period before the institution was first placed under Agency Control or first received assistance, whichever is earlier, owns such amount on the last day of the taxable year.[67]/

The Preamble explains the discriminatory treatment of institutions with Continuing Equity rather cryptically:

> [N]oncollection does not extend to an [institution with Continuing Equity because, in such cases, noncollection benefits those who owned the [i]nstitution during the period it incurred the losses.[68]/

[67]/ Prop. Reg. 1.597-1(b).

[68]/ Treatment of Acquisition of Certain Financial Institutions, supra note 19, at 14808.

Two more elaborate rationales have been proffered for this concern with a benefit to Continuing Equity. The first is that the persons with Continuing Equity can justifiably be viewed as the cause of the institution's demise, and that, therefore, such persons should not be rewarded by permitting tax liabilities otherwise due to go unpaid. The second possible rationale articulated is that it is inappropriate for a favorable treatment intended to prevent the government's loss to go further and benefit private parties, i.e., those parties that would otherwise lose their money. We also understand that some I.R.S. personnel have expressed concern for arrangements under which a failed institution is “flipped” back to the original owners.

At the outset, it is necessary to clarify the precise benefit to Continuing Equity if the noncollection of tax in the Commissioner's discretion is exercised only to the extent the tax would be “borne by Agency.” Assume, for example, an institution with tangible assets of 50x, liabilities of 100x, and goodwill of 5x. If the Agency provided 50x of assistance in that case, and some portion was subject to tax, the Agency would be required to pay more assistance and, to that extent, it would “bear” the tax; in such a case, if the Agency closed the institution and exercised its subrogation rights against its assets, it would bear the loss because there are no assets beyond goodwill. However, if the tax liability from 50x of assistance is relieved, and the institution is not closed, the effect is to preserve the equity of 5x. Thus, it must be acknowledged that current stockholders will often benefit from noncollection of tax that also “benefits” the Agency.

For three reasons, however, it can be argued that this benefit to Continuing Equity does not necessarily justify a rule that provides that noncollection is precluded in such a case. First, as we have discussed, the matching of income and losses should be viewed as one of the major considerations underlying the exercise of the Commissioner's authority to forgive taxation. Because the deferral formula will not always operate perfectly and because adequate information will not always be available to the parties, there will be ample tax policy justification for the discretionary noncollection of tax in many cases in which there is Continuing Equity, irrespective of the benefit to particular private parties.

Second, viewed from a purely tax perspective, in at least some cases in which net tax liability would, in fact, be due, the parties who are the best candidates for bearing the burden of the liability -- those who owned the institution when it generated losses that are no longer available -- may very well not be involved either as owners of the institution or otherwise. Thus, for example, in the case described above of the institution formerly a member of a consolidated group, the best candidates for bearing the burden are arguably the shareholders of the group of which the institution was formerly a member, not the current shareholders.

Third, although we do not purport to be experts in financial institution matters, we would expect that unavailability of noncollection in all cases in which there is Continuing Equity could materially increase the burden on Agency (and the taxpayers) without good tax policy necessarily being served. Thus, for example, in one type of case in which there would be Continuing Equity -- the open bank transaction -- the Agency may have concluded that the overall value of the institution would be maximized by keeping the institution “open.” If it were otherwise concluded that the correct amount of tax were likely to be collected by forgiveness, such a transaction might appear to be a particularly appropriate one for exercise of the Commissioner's discretion.

3. Definition of Continuing Equity.

Even assuming that there should be a special treatment of institutions with Continuing Equity, we must question whether the definition of Continuing Equity contained in the Proposed Regulations properly performs the role for which it was intended. To begin with, we would note that the concept does not necessarily distinguish between cases in which Continuing Equity benefits from the forgiveness and other cases: the persons in question could have completely lost their investment in the institution and made a new investment and still cause the institution to come within the rule.

This problem is exacerbated by the second difficulty with the rule -- the extreme breadth of the definition of Continuing Equity. The current form of the rule will likely sweep in some passive institutional investors, and it may be very difficult in many cases to assess whether there is, in fact, Continuing Equity.

4. Proposed Modifications.

There are generally two possible ways that the concept of Continuing Equity could be limited. One would be to increase the threshold to a much larger percentage -- for example, twenty or twenty-five percent. We can understand, however, the reason that the I.R.S. and Treasury would not be amenable to that approach, particularly in light of the creditors rights rationale described above: a continued significant equity participation belies the fact that the institution is dead, with losses being borne by an agency of the government.

The second possible approach is to limit significantly the breadth of the definition. The operation of the attribution rules of section 267(c) as applicable under the definition of Continuing Equity should be cut back significantly. Moreover, a minimum threshold of ownership should be required to be taken into account (at least two percent), or the number of owners taken into account otherwise limited. Any particular concern with the planned “flipping” of an institution can be adequately addressed with a general anti-abuse rule. We believe that these steps should be seriously considered if the Treasury Department and I.R.S. decide to retain the concept of a limitation or noncollection in cases in which there is Continuing Equity.

F. Transferee Liability.

Broad rules are also provided under the Proposed Regulations under which income tax liability (including the several tax liability for taxes under the consolidated return regulations) will not be collected from a new institution or acquiror unless there is overlapping ownership. The breadth of this rule is particularly great because it appears that this exemption could apply, for example, to a transfer of a large amount of diversified assets in a “Consolidated Subsidiary” in connection with a Taxable Transfer. Given the position of the I. R.S. and Treasury Department on joint and several liability in section 338(h)(10) transactions, this exemption is a striking one.

Nonetheless, we believe less serious policy considerations are implicated by this broad rule than those relating to noncollection. First, only transferee liability is at issue so that there is less likelihood of an outright forgiveness of tax liability in this case. Second; the case for exemption is particularly compelling from an overall policy point of view to encourage acquirors of thrift institution assets.

The treatment of cross-ownership, however, is also problematic in this context. One rationale again for such a rule here would be to assure that the transferee institution is, in substance, a different entity. On that basis some limitation on common ownership appears reasonable.

Nevertheless, we believe that the I.R.S. and Treasury Department should consider at least two changes here as well. First, it would be helpful from the perspective of simplicity to have precisely the same standard as for Continuing Equity if that concept continues to be applicable in other settings. Second, we believe that it would again be advisable to limit substantially the scope of the applicable definition to facilitate compliance.

G. Definition of Assistance.

As noted earlier in this Report, the Proposed Regulations treat all funds provided by Agency as taxable assistance irrespective of whether the Agency received a note, preferred stock or another instrument in exchange. Given the potential for abuse and the difficulties of valuation, we are sympathetic to the administrative concerns of the I.R.S. reflected in this position. Moreover, this position is consistent with the express statutory language defining assistance. We believe, however, that significant refinements may be required to the adjustments contained in the Proposed Regulations governing actual payments on those instruments. The only available adjustment mechanism is apparently that contained in Proposed Regulation § 1.597-2(d), relating to “Transfers to Agency.

At a minimum several points should be clarified. Any transfer to Agency in respect of an instrument owned by Agency should reverse assistance income as provided in the Proposed Regulations, not simply to the extent in excess of fair market value received (if, for example, the instrument is redeemed). Second, reversal should occur even if made by a party other than the institution that received the assistance, in the case that the institution was acquired and the acquiror in effect has basis in this taxable assistance. Finally, in the case of debt instruments, rules are necessary to assure that the deductions £or interest are not, in effect, lost, at least in cases in which the debt instruments become held by parties other than Agency after interest has accrued.