

Section 382 in the Face of the Financial Crises

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I. Recent Flood of Section 382 Notices

During the past few months, as dark clouds descended upon our financial systems, regulators used a number of tools to combat their perceived demons in the current financial crises. The tools used by the United States Treasury Department (Treasury) include the tax law. New guidance released by Treasury includes I.R.S. Notice 2008-83, which relieves banks of the obligation to treat deductions, losses, or bad debts attributable to periods before an ownership change data as built-in loss subject to the limitations of 26 U.S.C. 382(h), as well as several other pieces of guidance relating to Section 382.

Section 382 places limits on the amount of gains or losses that may be used by corporations after an ownership change.¹ It targets two types of losses in particular. The first type is net operating losses (NOLs) which occur when tax-deductible expenses exceed taxable revenues for a taxable year. The second kind is net unrealized built-in losses (NUBILs). Generally, a built-in loss is a loss or item of expense that accrues economically before an ownership change but is recognized after the ownership change.² The built-in losses are netted together to calculate NUBIL: the amount by which the “fair market value of assets of the corporation, immediately before an ownership change, is less than the aggregate adjusted basis of the assets.”³ In the case of troubled banks currently in the news, most of the

1 26 U.S.C. 382

2 LEWIS T. BARR ET AL., BNA TAX MANAGEMENT PORTFOLIOS, NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES – SECTIONS 381, 382, 383, 384, AND 269, 72 (2005) (hereinafter BNA TAX)

3 26 U.S.C. 382(h)(3)(A) states:

“the fair market value of assets of the corporation immediately before an ownership change is less than the aggregate adjusted basis of the asset.”

“(i) In general.--The terms “net unrealized built-in gain” and “net unrealized built-in loss” mean, with respect to any old loss corporation, the amount by which--

(I) the fair market value of the assets of such corporation immediately before an ownership change is more or less, respectively, than

(II) the aggregate adjusted basis of such assets at such time. ”

assets giving rise to NUBILs are loans for assets, such as home mortgages, that have lost value.⁴

Treasury's Section 382 initiatives started with the rescue of Fannie Mae and Freddie Mac, which remain publicly traded corporations, although the U.S. Government now owns a significant interest in the companies through stock and warrants.⁵ It issued I.R.S. Notice 2008-76 on September 7, 2008, the same day the U.S. Government took over Freddie Mac and Fannie Mae.⁶ Treasury issued this notice under power granted in Section 382(m).⁷ The notice effectively waived application of Section 382 to corporations that the United States gained control of as a result of a stock or options purchase pursuant to the Housing and Economic Recovery Act of 2008 (Housing Act).⁸

Treasury next released Notice 2008-84 under power granted in Section 382(m) on September 26, 2008, ten days after the United States accepted warrants for a 79.9% stake in American International Group (AIG) in return for an \$85 billion loan.⁹ It effectively waived application of Section 382 to corporations in which the United States acquires 50% of the value of the loss corporation.

Third, Treasury issued Notice 2008-78 on September 26, 2008 under Section 382(l)(1) in an apparent attempt at helping to recapitalize corporations.¹⁰ To that end, capital contributions will not trigger testing date/ownership change under Section 382(h) if it meets one of four prongs in a safe harbor.¹¹

4 It is unclear what percentage of those loans would be considered troubled. For example, a troubled mortgage occurs when a borrower can no longer make payments and faces foreclosure. *See* Calculated Risk blog, <http://calculatedrisk.blogspot.com/2008/09/homeowners-with-negative-equity.html> (“Not every homeowner with negative equity will default, in fact many of these homeowners will only be underwater by a few percent.”).

5 *See also* Yahoo! Finance – Fannie Mae, <http://finance.yahoo.com/q?s=FNM>; Yahoo! Finance – Freddie Mac, <http://finance.yahoo.com/q?s=FRE>.

6 Marie Leone, CFO.com, Fannie, Freddie Get Tax Pass, Too, Sept. 8, 2008, .

7 Section 382(m) gives “a broad delegation of regulatory authority for the Treasury to draft such regulations (retroactively) “ as is necessary to prevent the avoidance of the purposes of this section [382] ... including the avoidance ... through the use of related persons, pass through entities or other intermediaries.” BORIS I. BITTKER AND JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14-112 (7th ed. 2000). There are some questions about whether Treasury has the authority to waive application of 382(m) to any taxpayers. It is a proscriptive authority concerned with preventing avoidance and does not provide explicit authority to waive application of Section 382.

8 2008-39 IRB 768, <http://www.irs.gov/pub/irs-irbs/irb08-39.pdf>.

9 2008-41 IRB 855, <http://www.irs.gov/pub/irs-irbs/irb08-41.pdf>.

10 2008-41 IRB 851, <http://www.irs.gov/pub/irs-irbs/irb08-41.pdf>.

11 *Id.*

Fourth, Treasury issued Notice 2008-83 on September 30, 2008 under Section 382(h).¹² This notice is the topic of this paper. Under Notice 2008-83, banks do not need to treat deduction, losses, or bad debts attributable to periods before an ownership change date as built-in losses.¹³ Ordinarily, a company after an ownership change would be limited in its use of losses recognized as a result of net unrealized built in losses (NUBIL).¹⁴ New loss corporations that are banks will now be able to recognize built in losses immediately after the change date to offset income. This does not deal with recognized losses already on the books of an old loss corporation bank, but deals with losses recognized for tax purposes after the transaction that stem from a pre-transaction decline in the value of assets that come with the acquired old loss corporation bank and that have not been recognized for tax purposes. For example, Wells Fargo is in the process of acquiring Wachovia and expects to eventually write down \$74 billion in value from Wachovia's loan portfolio, most of which is likely to be considered NUBIL.¹⁵

Regulators and policy makers in Treasury moved so quickly to stave off contagion with this guidance that it appears little regard was paid to whether these are good tax policies. With regard to Notice 2008-83, I think it is not good tax policy because it is not economically efficient, not administrable, if perhaps not even within the purview of Treasury, and is a political lightning rod.

II. Section 382 in More Detail

A. NOL Limitations: Section 382(a) and (b)

A Net Operating Loss (NOL) occurs when tax-deductible expenses exceed taxable revenues for a taxable year.¹⁶ The tax code allows corporations to carry back NOLs to offset income during the

¹² 2008-42 IRB 905, <http://www.irs.gov/pub/irs-irbs/irb08-42.pdf>.

¹³ *Id.*

¹⁴BNA TAX, *supra* note 2, at 55-56

¹⁵This is discussed in more detail in section II(B).

¹⁶BNA TAX, *supra* note 2, at 1.

previous two tax years or carry over NOLs for a period of time (currently 20 years) before they expire.¹⁷

NOLs are considered deferred tax assets under Generally Accepted Accounting Principles (GAAP) accounting standard and appear as an asset on a corporation's balance sheet.¹⁸ Once a corporation expects not to use the NOL to offset income, it will then remove it from its balance sheet and count the NOL as a loss on its books. General Motors (GM) provides a good illustration of this. In September, 2007, GM realized losses on \$39 billion in tax assets that were expiring or it did not expect to redeem and updated its balance sheet to reflect that fact.¹⁹ That \$39 billion was included in losses it reported in that quarter's earnings results.²⁰ It currently lists \$3.58 Billion in “[o]ther current assets and deferred income taxes”.²¹

In the early 1950's, there were few rules that restricted a corporation from assuming the tax assets of another corporation it purchased.²² As a result, there was an open and thriving marketplace in which corporations were bought and sold only for the NOLs on their books.²³ Generally, in this case, NOLs were the only assets of the corporation.²⁴ Profitable corporations that purchased these shell companies were then able to use the NOLs from the acquired corporation to offset their actual gains.²⁵ In reaction, Congress stepped in and issued 26 U.S.C. 382 (Section 382) to stop trafficking in NOLs.²⁶

Section 382 limits how new loss corporations can use the losses from an old loss corporation.²⁷

¹⁷BNA TAX, *supra* note 2, at 1.

¹⁸ “A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and for carryforwards” <http://www.fasb.org/st/summary/stsum109.shtml> -

¹⁹ General Motors Corporation, Form-10Q, Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, 23-25 (August 2008) (Hereinafter GM 10Q).

²⁰ *Id.*

²¹ *Id.*

²² BORIS I. BITTKER AND JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14-41 (7th ed. 2000) (hereinafter BITTKER AND EUSTICE).

²³ *Id.*

²⁴ *Id.*

²⁵*Id.*

²⁶ *Id.*; BNA TAX, *supra* note 2, at 21.

²⁷ BNA TAX, *supra* note 2, at 21.

A loss corporation is a corporation entitled to use an NOL carryover or having NOL for the taxable year in which a change in ownership occurs.²⁸ To be more specific, an old loss corporation is the one that generated the loss before the change date and the new loss corporation is the one that can use the NOL after the change date.²⁹

Once an ownership change occurs, net operating losses are limited.³⁰ The phrase “change in ownership” is complex, fact-sensitive, and technical in nature. For example, the new and old loss corporations can be the same corporation.³¹ Also, a change of ownership can be triggered by many different things, including but not limited to the sale of the corporation, recapitalization, capital injections, stock transfers, IPOs,³² a change in actual ownership (shares exchanged) or through transactions that create an equity shift such as a reorganization.³³ A necessary assumption I make for this paper is that the corporation will be acquired all at once for purposes of discussion. When a target corporation is acquired all at once, a change in ownership has clearly occurred and, absent special rules like those discussed in this paper, NOL and related loss limitations clearly apply.

Section 382(b) limits the new loss corporation in how much in NOLs from the old loss corporation it may use annually.³⁴ To this end, Congress set a mechanical formula.³⁵ The annual limit is equal to, or less than, the value of the old loss corporation times the long-term federal tax-exempt bond rate, identified in Section 382(f).³⁶ The long term tax exempt bond rate is set by the IRS monthly. For December 2008, it is 5.4%.³⁷

2826 U.S.C. 832(k)(1); BNA TAX, *supra* note 2, at 52.

2926 U.S.C. 832(k)(1); BNA TAX, *supra* note 2, at 52.

30BNA TAX, *supra* note 2, at 21.

31*Id.* at 53.

32 BITTKER AND EUSTICE, *supra* note 23, at 14-73

33 *Id.* at 14-75. It is such an issue that some companies resort to enacting poison pills to prevent ownership changes that will cause it to lose its NOLs. Stephen Taub, Shareholder Rights Plans and Tax Benefits, CFO.com, February 17, 2005, <http://www.cfo.com/article.cfm/3666759>

34 BITTKER AND EUSTICE, *supra* note 23, at 14-92.

35BNA TAX, *supra* note 2, at 21.

36 *Id.*

37 2008-49 IRB 1232. *See also* 2008-40 IRB 811 (4.65% for October 2008); 2008-45 IRB 1099 (4.94% for November 2008).

$$\leq \left(\begin{array}{l} \text{value of} \\ \text{old loss corp.} \end{array} * \begin{array}{l} \text{Fed. tax-exempt} \\ \text{bond rate} \end{array} \right)$$

Two good examples that illustrate the application of the Section 382 limitations are Wachovia and General Motors.

Wachovia: Wells Fargo is currently in the process of acquiring Wachovia. The estimated purchase price is: \$24.5 Billion³⁸ This example assumes that is the closing value for Wachovia. The annual carry over allowance by the new loss corporation will be \$1.32 billion.

$$\$24.5 \text{ billion} * 5.4\% = \$1.32 \text{ billion.}$$

Note that the notices discussed in this paper do not change the limitations on NOLs for Wachovia, although they do change the limitations NUBILs for Wachovia, as discussed below.

General Motors: This example assumes General Motors is to undergo an ownership change, become subject to Section 382 limits, and have a value equal to \$2.67 billion.³⁹ If it were subject to Section 382 limits with those assumptions, its annual carryforward of NOLs would be limited to \$144 million.

$$\$2.67 \text{ billion} * 5.4\% = \$144 \text{ million}$$

38 Wells Fargo and Wachovia Unaudited Pro Forma Condensed Combined Financial Information (September 2008) (hereinafter Wells-Wachovia Pro Forma).

39 This value is based on the market capitalization at market close on 12/17/08 (in an earlier version of this paper, the value was \$3.64 billion based on market close for 10/17/08). Yahoo! Finance – General Motors Corporation, <http://finance.yahoo.com/q?s=gm>

The new loss corporation is generally not eligible to carry back any amount of the NOLs; however, it may carry forward any remaining amount.⁴⁰ So for example, if General Motors were to undergo an ownership change during November 2008, based on the example above, the new loss corporation could use \$144 million in NOLs this year and the remainder would carry over to the following year. It could not carry any back to offset income during previous tax years.

The annual limit on the deduction of NOLs will follow the lifetime of the carryovers.⁴¹ Currently, NOLs expire after 20 years.⁴² If the annual limit is \$5million due to Section 382, the maximum deductible amount is \$100 million dollars. $\$5 \text{ million} * 20 \text{ years} = \100 million . Anything beyond that maximum level is lost to the new loss corporation.⁴³

Returning to our examples, Wells Fargo will be able to utilize \$26.4 billion in Wachovia NOLs over the 20 year carry forward term.⁴⁴ Likewise, the theoretical new loss corporation that replaces GM (the old loss corporation) will be able to utilize \$2.88 billion in GM NOLs over the 20 year carry forward term.⁴⁵

B. NUBIL Rules

In addition to NOLs, new loss corporations are limited in their use of net unrealized built-in gains (NUBIG) or losses (NUBIL) through Section 382(h). This paper will only cover losses; that is, it will disregard the possibility that an acquired corporation has substantial NUBIGs to recognize and that their recognition would increase the ceiling that would otherwise apply to deducting NUBILs.

In 1986, when Congress updated the tax code, it specifically included provisions to limit new

40BNA TAX, *supra* note 2, at 17.

41*Id.* at 16.

42 *Id.* at 1.

43 BITTKER AND EUSTICE, *supra* note 23, at 14-92.

44 $\$1.32 \text{ billion} * 20 \text{ years} = \26.4 billion . According to its 10Q, Wachovia currently has \$1.65 Billion in tax assets.

45 $\$144 \text{ million} * 20 \text{ years} = \2.88 billion . In its 10-Q filing with the SEC for the quarter ending 6/30/08 GM reported \$3.5 billion in tax assets,

loss corporations from using net unrealized built-in gains (NUBIG) or losses (NUBIL) – in Section 382(h).⁴⁶ Before then, NUBIG and NUBIL were not specifically identified in the code.⁴⁷ To that end, Congress also put the burden on the new loss corporation to establish that a loss recognized during the recognition period is not attributable to the old loss corporation.⁴⁸

For NUBIL, limits are only placed on losses recognized during the five years after the change date.⁴⁹ There are three main elements to the rule. The built-in loss: 1) must be accrued at the time of the ownership changes;⁵⁰ the amount must be substantial (greater or equal to 15% fair market value of the assets or \$10 million) – de minimis rule;⁵¹ and it must be recognized within a limited period (currently five years). After the fifth year, the built-in losses are carried over without limitation.⁵²

Generally, a built-in loss is a loss or item of expense that accrues economically before an ownership change but is recognized after the ownership change.⁵³ When an unrealized built-in loss is recognized, it may have the effect of increasing the pre-change loss.⁵⁴ The recognized built in loss (RBIL) is added to the pre-change NOL carryovers and limited as such.⁵⁵

Without the special rules in Section 382(h), the loss corporation could circumvent the Section 382 rules by postponing or accelerating recognition transactions.⁵⁶ For example, take two identical corporations expected to undergo ownership changes in the near future. One lives in a world with Section 382(h) and the other does not. The one that lives in a world without Section 382(h) will likely slow down recognition of NUBIL until after the ownership change so the new loss corporation will have as much NUBIL to recognize as possible to offset income. Otherwise the built-in loss recognized

⁴⁶BNA TAX, *supra* note 2, at 72.

⁴⁷ *Id.*

⁴⁸*Id.*

⁴⁹BITTKER AND EUSTICE, *supra* note 23, at 14-99.

⁵⁰*Id.*

⁵¹*Id.*

⁵²*Id.*

⁵³BNA TAX, *supra* note 2, at 72

⁵⁴*Id.*

⁵⁵*Id.* at 75.

⁵⁶*Id.* at 72.

before the ownership change will be limited as NOLs under Section 382(b). The corporation that lives in a world with Section 382(h) will likely not go out of its way to time NUBIL it expects to recognize in the next five because losses will become NOLs attributed to the old loss corporation anyway.

Again, an example will help illustrate the rule. For example, if Wachovia holds a mortgage valued at \$100,000 but the fair market value of that mortgage is actually \$75,000. It will not recognize that \$25,000 loss until a recognition event occurs such as if it were to sell it or take a deduction under 26 U.S.C. 166 for partially or wholly worthless debt. Until Wachovia recognizes it, that loss is said to be built-in.

Section 382(h) considers all of the assets together to determine the NUBIL.⁵⁷ The NUBIL is the sum of all those built-in losses on the multitude of mortgages held by Wachovia.⁵⁸

One wrinkle is that the banks may write down the lost value for accounting purposes but not recognize it for income tax purposes. For example, under the fair value accounting method, banks must write down the value of their assets, such as loans and mortgage-backed or other asset-backed securities, for accounting purposes even though they have not recognized the losses inherent in these assets under the differing standards applicable for federal income tax purposes.⁵⁹ Banks that have taken those write-downs are likely to have a NUBIL.⁶⁰ For example, Wachovia wrote down almost \$19 billion in losses from its loan portfolio in October 2008.⁶¹ It is unclear whether this was recognized

⁵⁷ BNA TAX, *supra* note 2, at 73 “the fair market value of assets of the corporation immediately before an ownership change is less than the aggregate adjusted basis of the asset.”

⁵⁸ The number tossed around in the press is \$74 billion. It could be higher. *See also* Eric Dash & Ben White, Wells Fargo Swoops In, *New York Times*, October, 3, 2008, (“In the early hours of Friday morning, Wachovia executives learned that Sheila C. Bair, the head of the Federal Deposit Insurance Corporation, which had pressed for the Citigroup deal, would not stand in the way of the new agreement with Wells Fargo, as it would involve no risk to taxpayers.”) <http://www.nytimes.com/2008/10/04/business/04bank.html>

⁵⁹ Thomas R. May, IRS Addresses Loss Limitations Amid Financial Crisis, 2008 TNT 204-28 (“During the economic crisis, many banks have been forced to substantially write down the value of their assets, such as loans and mortgage-backed or other asset-backed securities, for book purposes under the fair value accounting method described in Statement of Financial Accounting Standards No. 157 of the Financial Accounting Standards Board”); *See* Statement of Financial Accounting Standards No. 157 of the Financial Accounting Standards Board, <http://www.fasb.org/st/summary/stsum157.shtml>.

⁶⁰*Id.*

⁶¹ Sara Lepro, *Associated Press*, October 22, 2008, <http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2008/10/22/financial/f042924D08.DTL>

under the tax code (in which case, it is considered a NOL for Wachovia) or for accounting purposes only (in which case, it would be included in the NUBIL calculation).

C. I.R.S. Notice 2008-83

Treasury, through the I.R.S., issued Notice 2008-83 on September 30, 2008. It is barely a page long and the operative section is only five lines:

“For purposes of section 382(h), any deduction properly allowed after an ownership change (as defined in section 382(g)) to a bank with respect to losses on loans or bad debts (including any deduction for a reasonable addition to a reserve for bad debts) shall not be treated as a built-in loss or a deduction that is attributable to periods before the change date.”⁶²

Most importantly, it effectively waives the application of Section 382(h) for banks and only banks,⁶³ has no termination date (i.e. is open ended), and does not have a date on which it becomes applicable.⁶⁴

III. The Wells Fargo & Wachovia Transaction, in Contrast with GM's position

On September 29, 2008, Wachovia agreed to a merger with Citigroup that was hastily arranged by federal regulators.⁶⁵ The following day, Treasury issued Notice 2008-83. Three days later, on October 3, the Wachovia board of directors accepted a merger agreement with Wells Fargo and canceled the earlier, government-brokered merger agreement with Citigroup.⁶⁶ Wells Fargo and Wachovia are expected to close the deal by the end of 2008.⁶⁷ Notice 2008-83 is credited for Wells

62 2008-42 IRB 905 <http://www.irs.ustreas.gov/pub/irs-irbs/irb08-42.pdf>

63 Banks, as defined in 26 U.S.C. 581.

64 Perhaps, because it does not say it applies from September 30, 2008 and beyond, it can be used by banks which merged in the last two years to take advantage of this rule.

65 Amit R. Paley, A Quiet Windfall for U.S. Banks, Washington Post, November 10, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/11/09/AR2008110902155.html>

66 *Id.*

67 *Id.*

Fargo making its late bid for Wachovia and is even dubbed the “Wells Fargo rule” by some in the main stream press.⁶⁸ Wells Fargo expects to eventually write down \$74 billion in value from Wachovia's loan portfolio, which is likely to be considered NUBIL.⁶⁹

As a result of Notice 2008-83, Section 382(h) limits on NUBIL will not apply to Wells Fargo after the change date. Immediately after the merger is complete, Wells Fargo can recognize NUBILs it owns through its acquisition of Wachovia by, for example, selling or foreclosing on nonperforming mortgages. Those recognized losses will not be treated as NUBIL, as they would be without the notice in place. Wells Fargo can then apply those losses through a carry back mechanism to offset income during the past two tax years and get a refund check from the Internal Revenue Service.⁷⁰ Any remaining amount of losses from those recognized built-in losses (RBIL) can then be used to offset income during the current tax year. Any excess remaining will carry over to the next tax year as NOL, up to 20 years, to offset future income.

Wells Fargo will still be limited in its use of Wachovia's NOLs. If Wachovia has already recognized those losses for income tax purposes, the losses will appear as NOLs and carry over as such.⁷¹

In contrast, consider GM. It is not a bank but does have a financial unit, GMAC. Assets that might contribute to built-in losses include inventory, securities as investments, factories, and other assets that may have a fair market value below basis. If GM were to undergo an ownership change and if it recognizes the NUBIL within five years of the acquisition, those recognized losses are attributed to GM of today, the old loss corporation, and are subject to Section 382 limitations. Using the values calculated above, if GM was valued at \$2.67 billion immediately before the ownership change, the

68 *Id.*

69 *Id.*

70 According to its 2007 Annual Report, Wells Fargo paid \$3.2 billion in Federal income tax in 2007 and \$3 billion in 2006. pg 123.

71 *See* discussion in Section II(A), *supra* 5. (“Section 382(b) limits the new loss corporation in how much in NOLs from the old loss corporation it may use annually”).

annual carryforward of NOLs and NUBILs would be limited to \$144 million. In which case, \$2.88 billion could be utilized by the new loss corporation over the 20 year carry forward term.

IV. Evaluating Notice 2008-83's Effectiveness as a Policy

This Part of my paper will measure the effectiveness of Notice 2008-83 as a tax policy by examining its economic efficiency. It will also briefly consider its administrability and whether it is politically acceptable. As discussed below, I think the economic efficiency analysis demonstrates that Notice 2008-83 is unwise tax policy.

A. Economic Efficiency

1. Misallocation of Resources

“If markets were perfect, efficiency would imply interfering as little as possible in market outcomes.”⁷² “The efficiency principle ... suggests that [tax] programs should never operate in a way that makes someone better off at the expense of making someone else worse off.” steuerle 13. Unequal treatment creates macroeconomic distortions through the misallocation of resources. These distortions in turn impede economic efficiency by directing resources to activities that are more lightly taxed, rather than to activities that would generate the most economic productivity. Generally, to limit distortions, similarly situated taxpayers should be treated similarly. For example, there are other non-bank corporations like GM with large NUBILs including, but not limited to, insurance companies, investment banks, manufacturers, real estate developers or holding companies, and hedge funds.⁷³ It seems here, that non-banks and other taxpayers, such as individuals, will end up paying for the shortfall in revenue that results from Notice 2008-83.

72 Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 *STAN. L. REV.* 42 (2006).

73 Not all will set up as corporations, although I am unsure which ones do not.

Notice 2008-83 causes macroeconomic distortion and misallocation of resources through a non-natural flow of capital to banks, changes to business behavior, and by overlooking other industries in peril. “Taxes by their very nature distort behavior” and will usually lead companies to avoid the taxed activity,⁷⁴ Or in this case, to favor the more lightly taxed activity. By giving tax breaks to one industry (banking) and not another, capital will flow to the industry with the tax breaks. Moreover, by giving tax breaks to one kind of bank (the kind with taxable income) and not other kinds, capital will flow to the tax-profitable entities.

In addition, this guidance changes the costs of doing business which will cause businesses to change their behavior to meet new expectations based on the new costs. That is precisely what Wells Fargo did. The week before Notice 2008-83 was issued, Wells Fargo had been among the three initial suitors discussing Wachovia with Federal banking regulators; however it walked away from that earlier, potential deal.⁷⁵ Three days after Notice 2008-83 was issued, Wells Fargo made its winning bid to Wachovia, despite the prior agreement between Wachovia and Citigroup.⁷⁶ Treasury issuing Notice 2008-83 is the most likely reason for Wells Fargo choosing to contact Wachovia and sweet talk it away from Citigroup.

It is not just banks that are having severe difficulty. The current economic crises are affecting other businesses in the financial services industry and other industries beyond finance. In addition, Non-banks perform financial services: GE Financial, GMAC, Ford Credit. The distortion caused by Notice 2008-83, in addition to other government assistance directed only to banks, is pushing such non-bank financial servicers to become banks or bank holding companies. The list of companies announcing intent to become banks or bank holding companies grows weekly. Investment banks Goldman Sachs and Morgan Stanley were the first, announcing in September, and have already

74 C. EUGENE STEUERLE, CONTEMPORARY U.S. TAX POLICY 13 (2004).

75 Amit R. Paley, A Quiet Windfall for U.S. Banks, Washington Post, November 10, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/11/09/AR2008110902155.html>

76 *Id.*

received regulatory approvals to become bank holding companies.⁷⁷ GMAC, the financing arm of GM, announced its intentions on Nov. 5.⁷⁸ American Express (AMEX) announced on November 10.⁷⁹ In the companion presentation to this paper, on November 12, I posited the question: “who would be next, insurance companies?” On November 14, four insurance companies announced intentions to buy thrifts to qualify to receive part of the \$700 billion bailout package.⁸⁰ It is not clear whether they will become banks or bank holding companies, under 26 U.S.C. 581, with the planned thrift acquisitions or if Notice 2008-83 affected their decisions. Stay tuned.

Taken together, the change in taxpayer behavior observed with Wells Fargo and the move by non-banks to become banks points to a potential over investment in banks.

Meanwhile, suitors are not lining up to purchase GM, despite its established brands, strong dealer network, existing product lines, or other assets. Any reorganization that GM undergoes may qualify as an ownership change will cap its use of NOLs and NUBILs. Unlike Wells Fargo, which can use some economic losses incurred by Wachovia to offset its own income, any potential new loss corporation that takes over control of GM may not have similar opportunities as Wells Fargo to utilize losses attributed to the old loss corporation.

2. Moral Hazard

Furthermore, in addition to issues of economic efficiency with regard to misallocation of resources, Treasury is creating moral hazard through its ad hoc regulations such as Notice 2008-83.

Moral hazard is a distortion that occurs when a taxpayer is insulated from certain risks and the taxpayer

77 Francesco Guerrero, AmexCo converts to bank holding company, November 11 2008, <http://www.ft.com/cms/s/0/2805855a-af91-11dd-a4bf-000077b07658.html>

78 *Id.*

79 *Id.*

80 Marcy Gordon, 4 Insurers Seek To Buy Thrifts For Part Of Bailout, Associated Press, November 19, 2008, http://biz.yahoo.com/ap/081114/treasury_bailout_insurers.html

then changes behavior to take risks they would not otherwise take.⁸¹ In this case, is Wells Fargo taking a greater risk purchasing Wachovia and its portfolio of toxic debt than it otherwise would have?

In addition, guidance like 2008-83 rewards bad actors who still retain equity in the companies that benefit from the new rules. Once the financial economy recovers, bankers will take bigger risks than they would otherwise have taken if they believe the U.S. Government will come to the rescue and create ad hoc regulations that protect the industry, in general. Congress and Treasury have come to the rescue of the financial industry in the past. What is to stop this from happening again?

3. There are Better Ways to Save Banks

Perhaps, we should ask what is this regulation intended to correct? Does it actually accomplish that goal or are there other intended or unintended consequences?

It appears this guidance, Notice 2008-83, is intended to help recapitalize banks in an effort to shore up the nation's financial system. If that is the case, this should be compared to other methods that could be used to recapitalize banks. Or, in other words, are there better ways to recapitalize a bank?

One method is direct capitalization.⁸² This is what Treasury is currently in the process of doing with much of the \$700 billion bailout money Congress authorized it to use.⁸³ Wells Fargo expects to write off \$74 billion from the Wachovia loan portfolio (NUBIL). Assuming a 35% corporate tax rate, we should expect up to \$25.9 billion in taxes lost.⁸⁴ Could that \$25.9 billion in lost tax revenue be

81 Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996) (“What moral hazard means is that, if you cushion the consequences of bad behavior, then you encourage that bad behavior.”)

82 Bankruptcy or receivership is a second option; however, I will not cover in this paper. Section 382 includes special rules for bankruptcy proceedings. Under some circumstances, some exceptions from Section 382 are provided for new loss corporations.

83 Edmund L. Andrews & Mark Landler, *U.S. Considers Cash Injections Into Banks*, NEW YORK TIMES, October 9, 2008, http://www.nytimes.com/2008/10/09/business/economy/10fed.html?_r=1

84 I calculated this amount by multiplying the expected value deducted from income (\$74 billion) by 35%. My calculation greatly simplifies matters but provides an idea of how much in savings Wells Fargo might expect. The true amount will vary with the effective tax rate that applies to Wells Fargo in a given year. For example, Wells Fargo's effective tax rate in 2007 was 30.7%, in which case it would save approximately \$22.2 billion (= \$74 billion * 30.7%). Wells Fargo Annual Report Pursuant to the Securities and Exchange Act of 1934 (2008).

better used recapitalizing Wachovia, or Wells Fargo, or Citigroup in return for an equity stake? I am not qualified to know but think that such a discussion should have happened before Notice 2008-83 was issued. We will find out more over the coming weeks and months as Treasury responds to Freedom of Information Act requests from Bloomberg and other news agencies and requests by Congress for investigations and reports into the guidance.

One argument for providing the banks a loophole that bypasses Section 382(h) is that saving the financial system should trump arguments for economic efficiency. This is true; however Citigroup did bid for Wachovia without this provision.⁸⁵ Granted, Citigroup did require the United States government assume certain risks;⁸⁶ however, Wells Fargo was previously interested in Wachovia without Notice 2008-83. According to filings with the SEC, it only backed out because Federal regulators wanted a firm commitment before Wells Fargo had a chance to complete its due diligence. Such facts support the argument that we should let banks compete based on reasons other than tax incentives granted. In addition, large parts of the economy are not covered by Notice 2008-83, including other non-bank corporations that are part of the financial system not covered.

B. Administrability

Good tax policies should “minimize administrative and compliance costs.”⁸⁷ Notice 2008-83 is a one-off, ad hoc item of guidance intended to apply to one specific company or industry and it will add to both administrative and compliance costs. Each new piece of ad hoc guidance or regulation adds an additional layer of complexity to the system. Instead of needing to know one uniform rule, a taxpayer

⁸⁵ Amit R. Paley, A Quiet Windfall for U.S. Banks, Washington Post, November 10, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/11/09/AR2008110902155.html>

⁸⁶ “Citigroup would acquire the stock of Wachovia’s banking subsidiaries and other mutually agreed assets for \$2.16 billion in cash and/or stock at Citigroup’s election and the assumption of approximately \$53.2 billion of Wachovia’s senior and subordinated debt. ... The FDIC would provide Citigroup with loss protection on a \$312 billion loan portfolio to be identified by Citigroup, on which Citigroup would absorb the first \$30 billion of losses and additionally absorb up to \$4 billion a year of losses for the first three years.” Wells-Wachovia Pro Forma, supra note 39.

⁸⁷ Lily L. Batchelder et al., Efficiency and Tax Incentives: The Case for Refundable Tax Credits, 59 STAN. L. REV. 42 (2006).

and the regulatory staff expected to monitor compliance need to know the original, uniform rule and the new exception to that rule. If additional ad hoc rules and exceptions are added, the complexity of the system is compounded and it becomes more difficult to manage over time.

Notice 2008-83 raises the possibility that other corporations thought to be too big to fail in other industries will get similar preferential treatment to correct a market ill? For example, the auto industry has been to Washington D.C. twice in the past month with hat in hand and been denied both times.⁸⁸ What if it were General Electric instead?

There is also another administrative issue: Is Treasury stepping beyond its powers? It is essentially waiving enforcement of the law to a subset of corporations. But Congress writes the laws. This issue is beyond the scope of this paper, although it is also mentioned in the next section in regard to politics.

C. Politics

Although some in the federal government encouraged the Wells Fargo – Wachovia merger because it holds “no risk to taxpayers,”⁸⁹ it became clear that the notice that enabled the deal certainly did involve substantial cost to taxpayers – between \$120 billion and \$140 billion.⁹⁰ In light of this, Notice 2008-83 was not politically well received. Within days after it was issued, Senators Charles Schumer (Democrat) and Charles Grassley (Republican), both on the Senate Finance Committee, publicly denounced the guidance it provides.⁹¹ In reaction, they called for hearings into Notice 2008-83 when the Senate convenes after the election.⁹²

88 Associated Press, Administration says it's still working on rescue, December 16, 2008, <http://www.freep.com/article/20081216/BUSINESS01/81216045/1014/BUSINESS01>

89 Eric Dash & Ben White, Wells Fargo Swoops In, New York Times, October, 3, 2008, (“In the early hours of Friday morning, Wachovia executives learned that Sheila C. Bair, the head of the Federal Deposit Insurance Corporation, which had pressed for the Citigroup deal, would not stand in the way of the new agreement with Wells Fargo, as it would involve no risk to taxpayers.”) <http://www.nytimes.com/2008/10/04/business/04bank.html>

90 Carl M. Jenks et al., Jones Day Commentaries: Major Tax Incentive For Bank Purchases: IRS Eliminates the Limitation on Banks' Built-In Losses Post-Purchase, October 2008; Amit R. Paley, A Quiet Windfall for U.S. Banks, Washington Post, November 10, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/11/09/AR2008110902155.html>

91 Ryan J. Donmoyer, Grassley Seeks Probe of Tax Ruling Before Wachovia Takeover, Bloomberg News, Nov. 15, 2008.

92 Jesse Drucker, Obscure Tax Breaks Increase Cost of Financial Rescue, Wall Street Journal, October 18, 2008.

They are upset because Congress was not notified or consulted before the notice was issued, yet it is expected to cost taxpayers over \$100 billion dollars in lost revenue.⁹³ It is not clear that Treasury had the authority to issue the Notice under Section 382(m), which provides “a broad delegation of regulatory authority for the Treasury to draft such regulations (retroactively) “ as is necessary to prevent the avoidance of the purposes of this section [382] ... including the avoidance ... through the use of related persons, pass through entities or other intermediaries.”⁹⁴ It is a proscriptive authority concerned with preventing avoidance and does not provide explicit authority to waive application of Section 382 to taxpayers. In addition, the Congressional Review Act (C.R.A.) requires agencies to consult Congress before rules may take effect.⁹⁵ In this case, Treasury did not comply with the law first.⁹⁶ An open question is whether Notice 2008-83 is valid because Treasury did not meet the requirements of C.R.A. before issuing the notice and whether Wells Fargo or any other bank that relied on Notice 2008-83 knew or should have known the notice did not comply with the C.R.A.⁹⁷

On November 14, 2008, Senator Grassley followed up his earlier complaint with a letter to the Inspector General of Treasury, asking him to investigate the reasons behind Notice 2008-83.⁹⁸ In it, he asked the Inspector General to investigate possible conflicts of interests of officials in Treasury, questioned the authority of Treasury to change the law and referred to the loophole to Section 382(h) provided by Treasury to banks as a “shelter.”⁹⁹

93 Jones Day estimates this will cost taxpayers \$140 billion. Others say less, closer to \$120 billion; *See* Amit R. Paley, A Quiet Windfall for U.S. Banks, *Washington Post*, November 10, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/11/09/AR2008110902155.html>

94 BITTKER AND EUSTICE, *supra* note 23, at 14-112.

955 U.S.C.A. § 801 states:

(a)(1)(A) Before a rule can take effect, the Federal agency promulgating such rule shall submit to each House of the Congress and to the Comptroller General a report containing--

(i) a copy of the rule;

(ii) a concise general statement relating to the rule, including whether it is a major rule; and

(iii) the proposed effective date of the rule.

96 Binyamin Appelbaum, Tax Change for Banks Challenged, *Washington Post*, October 10, 2008.

97 That analysis is left for another paper.

98 Sen. Chuck Grassley, *Letter to Inspector General Eric M. Thompson, United States Treasury*, November 14, 2008, <http://finance.senate.gov/press/Gpress/2008/prg111408c.pdf>

99 *Id.*

While section 382 provides Treasury the authority to issue regulations to implement section 382, Treasury's action raises significant questions about whether it exceeded implementing authority by attempting to change the law. Prior to the Notice, the amount of income that an acquiring bank could shelter in order to be able to absorb the losses of a bank it acquired was limited. Now, the Notice allows an acquiring bank to use an acquired bank's losses to shelter its income without limitation.¹⁰⁰

Since then, Senator Bernie Sanders submitted a bill to the Senate to rescind Notice 2008-83.¹⁰¹

The notice "is considered null and void and of no effect" and the "Internal Revenue Code of 1986 shall be applied and administered as if Treasury Notice 2008-83 had never been issued."¹⁰²

Moreover, the political fallout is likely to be compounded because Notice 2008-83 affects the revenue of states in which the new loss corporation banks operate. There are a dozen or more states in which Wells Fargo operates that expect to lose billions of dollars as a result of Notice 2008-83. For example, California is expected to lose two billion dollars as a result of just the Wells Fargo purchase of Wachovia.¹⁰³

There is more to the political backstory such as allegations of an "ideological battle over how the tax code deals with a company's losses,"¹⁰⁴ Congressional fears that protesting too loudly will hurt already fragile financial markets¹⁰⁵, and alas, as fun as it would be to delve into political theater, those are all for another paper.

¹⁰⁰*Id.*

¹⁰¹Senator Bernie Sanders, A Bill to Rescind Treasury Notice 2008-83. http://sanders.senate.gov/files/MAT08487_xml.pdf;
See also Senator Bernie Sanders Official Web Site, Closing Corporate Loopholes news release, November 18 2008
<http://www.sanders.senate.gov/news/record.cfm?id=305065>

¹⁰²*Id.*

¹⁰³This seems to be the case due to state laws; *see* "Officials at the state Franchise Tax Board, California's tax collection agency, say state law requires them to conform with the new rule." Evan Halper, Bush's tax breaks for banks could cost California \$2 billion, Los Angeles Times, November 11, 2008, <http://www.latimes.com/news/local/la-me-budget11-2008nov11,0,5914265.story>; Not within the purview of this paper is whether the States may sue the United States to recoup those lost revenues for whatever reason.

¹⁰⁴Amit R. Paley, A Quiet Windfall for U.S. Banks, Washington Post, November 10, 2008,
<http://www.washingtonpost.com/wp-dyn/content/article/2008/11/09/AR2008110902155.html>

¹⁰⁵*Id.*

V. Conclusion

I think that Notice 2008-83 is not good tax policy because it is not economically efficient, not administrable, if perhaps not even within the purview of Treasury, and is political lightning rod.

I feel this way mostly because it is not economically efficient. It supports over investment in banks through a misallocation of resources by providing tax incentives only to banks while other industries also have problems. This is already demonstrated by the tax savings Wells Fargo will see in its acquisition of Wachovia as well as the number of non-bank financial institutions declaring their intentions to become banks. In addition, it creates moral hazard by inducing banks to take bigger risks than they would otherwise have taken had Notice 2008-83 not been released as guidance by Treasury. Furthermore, I think there are likely other ways to save banks such as direct recapitalization.

In addition, it is likely not politically acceptable because it will limit Federal revenues and increase an already large tab for the bailout of the financial system.