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IRS Issues Tax Relief Notices Affecting Financial Institutions that Participate in the Treasury Senior Preferred Stock Purchase Program

On October 14, 2008, the Internal Revenue Service ("IRS") issued Notice 2008-100 to provide tax relief for financial institutions that sell stock to the Department of the Treasury ("Treasury") under the Capital Purchase Program ("CPP"). As we noted in our October 14, 2008, Alert, *TARP Takes a New Turn; FDIC Takes on a New Role*, Treasury will purchase up to $250 billion of preferred stock and warrants from financial institutions under the CPP. Notice 2008-100 provides relief from adverse tax consequences that might otherwise arise under Section 382 of the Internal Revenue Code of 1986, as amended ("Code"), as a result of such purchases by Treasury.

In general, following an ownership change of a loss corporation, Section 382 of the Code imposes an annual limit on the amount of post-change taxable income that may be offset by the loss corporation's pre-change NOL carryovers. An ownership change generally occurs if the percentage of stock owned by one or more 5% shareholders has increased by more than 50% over the lowest percentage that these shareholders owned at any time during the relevant testing period.

Notice 2008-100 is intended to neutralize the adverse tax impact that might otherwise arise under Section 382 as a result of Treasury's purchase of stock and warrants in a financial institution under the CPP. In particular, the notice provides that regulations will be issued to provide the following:

- For purposes of testing whether an ownership change has occurred, the percentage ownership represented by shares purchased by Treasury under the CPP generally will not be treated as an increase in ownership by Treasury in the loss corporation (and thus should not contribute toward an ownership change). However, the shares purchased by Treasury generally will be considered as outstanding for purposes of determining the percentage of loss corporation stock owned by *other* 5% shareholders on a testing date.
- In addition, when shares purchased by Treasury under the CPP are redeemed, such shares will be treated as if they had never been outstanding. Thus, shifts in percentage ownership triggered by the redemption should be ignored.

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- Any preferred stock of a loss corporation that Treasury acquires as part of the CPP will be treated as "pure" preferred stock described in Code Section 1504(a)(4). Thus, changes in the ownership of such stock generally will be disregarded in determining if an ownership change has occurred. However, if Section 382 is triggered for other reasons, the annual limitation under Section 382 generally should be determined by taking into account the value of such purchased shares.

- Stock warrants that Treasury acquires as part of the CPP will be treated as options -- not as stock -- for tax purposes, and such options will not be deemed exercised under Treasury Regulation § 1.382-4(d)(2). In addition, the receipt of shares by Treasury upon the exercise of the warrant, like the direct purchase of shares discussed above, should not count as an increase in Treasury's percentage ownership of the loss corporation for purposes of determining whether a change in ownership has occurred, but such shares apparently will be favorably treated as outstanding for purposes of determining the percentage interest of *other* shareholders in the loss corporation.

- Finally, Section 382 normally provides that certain capital contributions cannot be used to avoid or increase any limitation under Section 382. However, Notice 2008-100 specifically provides that these anti-abuse rules will not apply to capital contributions made by Treasury to a loss corporation pursuant to the CPP.

A second notice issued by the IRS on October 14, 2008, provides that until contrary guidance is issued, no amount furnished by Treasury to a financial institution pursuant to TARP will be treated as federal financial assistance ("FFA") within the meaning of Section 597 of the Code. Generally, section 597 provides that FFA is includible as ordinary income to the recipient at the time the FFA is received or accrued. However, Notice 2008-101 clarifies that payments to financial institutions under TARP will not be treated as FFA and, accordingly, will not be subject to the ordinary income inclusion rules of Section 597.

These two notices supplement four previous notices recently issued by the IRS that also provide relief to financial institutions under Section 382 in various circumstances.

- Notice 2008-76, which is limited to Fannie Mae and Freddie Mac, generally suspends ownership change testing under Section 382 for any testing date on or after the date of purchase by the US government of stock or an option to acquire stock in Fannie Mae or Freddie Mac under the Housing and Economic Recovery Act of 2008.

- Notice 2008-78 relaxed the Section 382 limitation by providing certain safe harbors under which the anti-abuse capital contribution rules discussed above would not apply.

- Notice 2008-83 provided that, for purposes of Section 382, a bank's deductions with respect to losses on loans or bad debts will not be treated as a built-in loss or deduction that is attributable to periods before the change date (and thus will not be subject to any limitations on their use under Section 382). This latter Notice apparently enabled Wells Fargo to make a superior bid for the purchase of Wachovia because a reported $74 billion of Wachovia losses could be triggered post-purchase and used to shelter taxable income without the application of Section 382.

- Finally, Notice 2008-84 extended the principles of Notice 2008-76 to other loss corporations generally by providing that Section 382 testing would be suspended while the US government or an agency thereof is a direct or indirect owner of a more than 50% interest in the loss corporation.

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