NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON FDIC-ASSISTED TAXABLE ACQUISITIONS

April 30, 2010

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INTRODUCTION

This Report[1] comments on the U.S. federal income tax treatment of taxable acquisitions of failed financial institutions in which the Federal Deposit Insurance Corporation (the "FDIC") has provided financial assistance. In recent years, the number of financial institutions that have been placed into FDIC receivership has increased dramatically as a result of the financial crisis,[2] and the FDIC expects more financial institution failures in the near future.[3] Moreover, FDIC assistance to these institutions and potential acquirers of such institutions has played an important role in fostering stability in the financial system. A key feature of these FDIC-assisted acquisitions has been the availability of loss guarantees (commonly referred to by the FDIC as loss sharing) that reimburse an acquirer of a failed financial institution's assets for a certain portion of the acquirer's expected losses on its acquired assets.[4]

Section 597[5] grants the Department of Treasury ("Treasury") wide latitude to promulgate regulations determining the treatment of any transaction in which federal financial assistance ("FFA") is provided. FFA includes any money or other property provided to a bank or domestic building and loan association by the FDIC.[6] Regulations promulgated under Section 597 address the treatment of a wide range of transactions involving different forms of FFA, including special rules that apply to (i) taxable transfers, (ii) loss guarantee arrangements, and (iii) debt and equity instruments issued to the FDIC.

FDIC-assisted acquisitions (either with or without loss guarantee arrangements) are highly structured agreements designed by the FDIC, and taxpayers have virtually no ability to modify these agreements in light of tax considerations or otherwise. Accordingly, our recommendations are designed to provide taxpayers with needed certainty of the tax

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[1] The principal author of the Report is Gary B. Mandel. Substantial contributions were made by Jonathan Goldstein, Andrew B. Purcell and Yaron Z. Reich. Helpful comments were made by Noah D. Beck, Peter H. Blessing, Andrew W. Needham, and Michael L. Schler.

[2] Prior to 2008, there were, on average, 3.6 failures per year between 2001 and 2007. In 2008 there were 25 failures, and in 2009 there were 140 failures. *See* FDIC, Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html.

[3] Eric Dash, *At F.D.I.C., Bracing for a Wave of Failures*, N.Y. Times, Feb. 23, 2010, at B1.

[4] Deloitte & Touche LLP, M&A Industry Advantage Series: FDIC-Assisted Assets May Be an Opportunity for Midsized Institutions, Oct. 28, 2009, at 1, *available at* http://www.deloitte.com/view/en_US/us/Industries/Banking-Securities-Financial-Services/article/2f4589a93d194210VgnVCM200000bb42f00aRCRD.htm. Of the 166 failed institution acquisitions that took place from 1/1/2008 to 2/15/2010, 105 included a loss guarantee arrangement.

[5] Except as otherwise indicated, all references herein to sections are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), or to Treasury Regulations promulgated thereunder.

[6] Section 597(c)(2). FFA also includes similar payments made by the Federal Savings and Loan Insurance Corporation or the Resolutions Trust Corporation. Section 597(c)(1).

consequences as to such arrangements. The scope of the Report is deliberately narrow and does not address the myriad of issues that may be present with respect to FFA arrangements other than taxable agency-assisted acquisitions.[7]

Our recommendations can be summarized as follows:

1. We agree with the approach embodied in the existing regulations that all taxable assisted acquisitions (whether in the form of asset or stock acquisitions) should be treated as taxable asset acquisitions. Furthermore, we believe regulations should be issued implementing the general principles that (i) an acquirer's basis in the acquired assets is equal to its full purchase price, and (ii) proceeds from the disposition of the acquired assets are, in general, first offset by basis and the excess is included in income when recognized.

2. We believe the basis step-up and six year inclusion rules of the existing regulations create a lack of symmetry between economic and tax consequences and that the regulations should be amended to eliminate these rules. In this regard, we would propose adopting one of two approaches described herein so as to better match basis increases and income inclusions.

3. We believe that the regulations should retain the rule that losses on assets covered by a loss guarantee arrangement should not be allowed below their highest guaranteed value.

4. We believe the regulations should be amended to (i) eliminate the general rule that ignores debt or equity issued to an agency in a taxable acquisition (under general tax principles such debt or equity would be included in the acquirer's purchase price), and (ii) include anti-abuse rules that would (A) disregard debt issued to an agency to the extent that there is no reasonable expectation of full payment at the time of issuance and (B) defer any loss on an acquired asset until the acquirer has either repaid a corresponding amount of the agency debt or included in income a corresponding amount (either by reason of cancellation of indebtedness or otherwise).

Part I of this report provides background on Section 597 and the regulations promulgated thereunder. Part II discusses the rules applicable to taxable assisted acquisitions, the legislative purpose behind these rules and describes typical loss guarantee arrangements. Part III highlights certain distortions and uncertainties present under the existing regulations. Part IV sets forth our specific recommendations.

I. BACKGROUND

A. Prior Law

[7] For example, the general definitions under Treas. Reg. § 1.597-1, as well as the definition of taxable transfers in Treas. Reg. § 1.597-5(a), are imprecise and cause uncertainties in the application of the rules.

Prior to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), Section 597(a) excluded from gross income FFA received by a troubled financial institution (such as a bank or a thrift). While former Section 597(c) required a reduction in certain tax attributes of the institution equal to 50% of the excluded FFA, former Section 597(b) provided that the adjusted basis of the institution's assets was not reduced. In addition, under former Section 368(a)(3)(D) certain federally assisted acquisitions involving financial institutions were generally permitted to qualify as tax-free reorganizations under Section 368(a)(1)(G) (a "G" reorganization") without regard to whether the acquirer was a historic creditor of the failed institution. Finally, special rules applicable to troubled thrift institutions under Section 382 provided that the normal limitations on the carryover of net operating of losses ("NOLs") and the utilization of built-in losses did not apply in most circumstances.[8]

In a prior report, we pointed out that these provisions permitted a so-called "double dip"—the concurrent exclusion from income of FFA and the ability to utilize NOLs and built-in losses to which the assistance was integrally related.[9] To take advantage of this "double dip," virtually every acquisition of a troubled financial institution prior to FIRREA's enactment was structured to qualify as a "G" reorganization.[10]

B. Enactment of FIRREA

Congress enacted FIRREA during the savings and loan crisis of the 1980s to provide bailout funds to financial institutions and to provide a consistent framework for the taxation of entities receiving such assistance. In addition, the legislative history indicates that Congress determined that the double dip treatment inappropriately subsidized troubled financial institutions, and to remedy that result, FIRREA eliminated both the exclusion from income of FFA and the special rules governing the transfer of NOLs and built-in losses.[11] As enacted by FIRREA, Section 597(a) grants Treasury wide latitude to Treasury to promulgate regulations to determine the tax treatment of "any transaction in which Federal financial assistance is provided with respect to a bank or domestic building and loan association . . . ."[12] The statute sets forth the principles Treasury should use in promulgating these rules. First, in taxable asset acquisitions regulations should provide (i) "that Federal financial assistance shall properly be taken into account by the institution from which the assets were acquired" and (ii) "the proper method for allocating basis among the assets so acquired (including rights to receive Federal financial assistance)."[13] For transactions other than taxable asset acquisitions, the statute

[8] Former Section 382(l)(5)(F) made the Section 382 limitation inapplicable to a tax-free acquisition of a troubled financial institution in which its depositors acquired deposits in the acquiring financial institution having a fair market value equal to at least 50% of the fair market value of the total deposits and outstanding stock of the acquiring institution.
[9] New York State Bar Association Tax Section, Report on Section 597 Proposed Regulations (1993), *available at* 93 TNT 37-100.
[10] Jerred G. Blanchard, Jr., *The Taxation of Federally Assisted Acquisitions of Troubled Financial Institutions*, 44 Tax Law. 1037, 1039 (1991).
[11] *See* H.R. Rep. No. 101-54(II), *reprinted at* 1989 U.S.C.C.A.N. 351, 356 [hereinafter House Report].
[12] Section 597(a).
[13] Section 597(b)(1).

specifies that regulations shall provide for the "proper treatment of Federal financial assistance and appropriate adjustments to basis or other tax attributes in connection with such assistance."[14] Finally, Section 597(b)(3) provides that regulations shall not "permit the utilization of any deduction (or other tax benefit) if such amount was in effect reimbursed by nontaxable Federal financial assistance" in any type of transaction.

The legislative history provides additional guidance on how Treasury should exercise its authority under Section 597. First, Congress intended that FFA generally would be deemed to have been received by the troubled institution immediately before the acquisition even in situations where the assistance is paid directly to the acquiring institution. Second, Congress expected that any taxable income from the receipt of FFA generally would be offset by the troubled institution's NOLs and built-in losses. Together, these principles result in an expectation that (i) the troubled financial institution would generally have no net tax liability resulting from the actual or deemed receipt of FFA, and (ii) FFA payments generally will be taxable to the acquiring institution only to the extent they exceed basis properly allocable to such payments—in other words, where the acquiring institution has economic gain.[15] These principles form the basis for our recommendations in this Report.

C. Regulations Under Section 597

1. Principles of Section 597

Treasury and the IRS issued proposed regulations under Section 597 in 1992[16] and promulgated final regulations that generally adhered to the approach of the proposed regulations in 1995.[17] As a result of the relative dearth of financial institution failures after their issuance, the regulations had limited practical application until the recent wave of FDIC-assisted acquisitions. The preamble to the proposed regulations indicates that the regulations were intended to reflect the following four principles derived from the legislative history of FIRREA:

> First, FFA 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 . . . would bear the burden of the tax.[18]

2. Inclusion of FFA

[14] Section 597(b)(2).
[15] House Report, *supra* note 11, at 358.
[16] Treatment of Acquisition of Certain Financial Institutions; Certain Tax Consequences of Federal Financial Assistance to Financial Institutions, 57 Fed. Reg. 14804, 14805 (Apr. 23, 1992) [hereinafter Preamble to Proposed Regulations].
[17] T.D. 8641, 1996-6 I.R.B. 4.
[18] Preamble to Proposed Regulations, *supra* note 16.

The regulations define FFA as "any money or other property" provided by certain government agencies, including the FDIC, to a financial institution.[19] Treasury Regulations Section 1.597-2 provides the general rules applicable to FFA and requires that, subject to certain exceptions, all FFA is includible as ordinary income when received or accrued in accordance with the recipient's method of accounting.[20] There are two important exceptions to this general rule. First, certain amounts received under a loss guarantee are included in the amount realized on the covered asset rather than included in gross income.[21] The second exception—intended to match the inclusion of FFA in income with the recognition of losses—allows a portion of FFA to be deferred until the institution recognizes losses.[22] If an institution defers its inclusion of FFA, it must establish a deferred FFA account.[23] Amounts in this account are included in income as the institution recognizes losses.[24] The FFA deferral provisions do not apply to acquirers in a taxable transfers (discussed below).[25]

II. Taxable Transfers

A. General Rules

The regulations provide special rules for the treatment of "taxable transfers," which may take the form of either actual or deemed asset transfers. An actual asset transfer is defined as a transaction in which an entity transfers to a transferee (other than a bridge bank[26]) (i) any deposit liability, if FFA is provided in connection with the transaction, or (ii) any asset for which an agency has any financial obligation (including pursuant to a loss guarantee).[27]

With respect to stock acquisitions, the proposed and final regulations create a deemed asset transfer regime (similar to a Section 338 deemed asset transfer, but involving some important differences described below). In particular, a deemed asset transfer will result if a

[19] Treas. Reg. § 1.597-1(b).
[20] Treas. Reg. § 1.597-2(a)(1).
[21] Treas. Reg. § 1.597-2(d).
[22] Treas. Reg. § 1.597-2(c). Specifically, the formula limits the amount of FFA an institution must include currently in income to the sum of (i) liabilities less aggregate adjusted basis at the beginning of the taxable year (representing losses already recognized) and (ii) the amount by which the excess for the taxable year of deductions (other than NOLs and capital loss carryovers) over gross income (without regard to FFA) is greater than the excess at the beginning of the taxable year of aggregate adjusted basis over liabilities (representing current taxable year losses of creditors' capital). A different inclusion formula applies to institutions with continuing equity. Treas. Reg. § 1.597-2(c)(3).
[23] Treas. Reg. § 1.597-2(c)(4)(i).
[24] Treas. Reg. § 1.597-2(c)(4)(ii)-(iii).
[25] Treas. Reg. § 1.597-2(c)(1).
[26] The provisions of the regulations relating to bridge banks are beyond the scope of this Report. A bridge bank is an institution that is organized by an agency to hold assets and liabilities of a failed institution pending the failed institution's acquisition or liquidation. Treas. Reg. § 1.597-1(b). Since a bridge bank is controlled by an agency, the assets it holds are unlikely to be covered by a loss guarantee.
[27] Treas. Reg. § 1.597-5(a)(1)(i).

specified stock purchase event occurs "[i]n connection with" a transaction in which FFA is provided.[28]

As a result of the deemed asset transfer, the "new entity"[29] will not inherit any of the old institution's historic tax attributes (such as NOLs) or the historic (high) basis of its assets.[30] The preamble to the proposed regulations indicates the deemed asset transfer rule was intended to implement the policies reflected in the legislative history by (i) conforming the tax consequences of various forms of acquisitions, (ii) fostering the matching of FFA income with an institution's losses by triggering the recognition of built-in losses, and (iii) preventing another taxpayer from purchasing the tax attributes of a troubled financial institution.[31]

Importantly, any "net worth assistance"[32] is treated as having been received by the old institution immediately before a taxable transfer and included in the old institution's income as FFA. Accordingly, the acquirer is treated as having purchased this net worth assistance in the taxable transfer.[33] This outcome applies regardless of whether the acquirer or the new entity received the net worth assistance directly or indirectly.[34]

B. Legislative Intent on Taxable Acquisitions

The legislative history relating to the taxation of acquirers indicates that Congress intended that FFA generally would be taxable to the acquirer only to the extent the FFA payments exceed the basis properly allocable to such payments.[35] Congress expected that, in the case of an acquisition of assets covered by loss guarantees, basis would "be allocated to the specified assets (or pool of assets), in an amount equal to their fair market value as adjusted to reflect the capital loss guarantee . . . ."[36] The House Report further expanded on the anticipated consequences of loss guarantee payments:

> The committee intends that amounts received under the capital loss guarantee will be treated as amounts received from the disposition of the guaranteed asset. Thus, the committee expects that, in most cases, there will be no taxable income from the receipt of a payment pursuant to a capital loss guarantee and the disposition of the specified asset because the sum of the amount received from the disposition of

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[28] Treas. Reg. § 1.597-5(b). A specified stock purchase event occurs if stock transfers cause an institution or its consolidated subsidiary to leave or enter a consolidated group or to experience a 50% or more ownership shift. Treas. Reg. § 1.597-5(b)(2).

[29] The regulations use the term new entity to refer to the deemed transferee in a deemed asset transfer. Treas. Reg. § 1.597-1(b).

[30] In addition, the deemed asset transfer rule tiers down through any consolidated subsidiaries of the acquired institution. Consequently, the consolidated subsidiaries will be deemed to have engaged in asset transfers. Treas. Reg. § 1.597-5(b).

[31] Preamble to Proposed Regulations, *supra* note 16, at 14807.

[32] Net worth assistance is defined as money or property an agency provides as an integral part of a taxable transfer, other than FFA that accrues after the date of the taxable transfer. Treas. Reg. § 1.597-1(b),

[33] Treas. Reg. § 1.597-5(c)(1).

[34] Treas. Reg. § 1.597-5(c)(1).

[35] House Report, *supra* note 11, at 358.

[36] House Report, *supra* note 11, at 358.

> the asset and the guarantee will not exceed the amount of basis allocated to those assets. On the other hand, where the amount realized from the disposition of the asset exceeds the amount so allocated (*e.g.*, where the value of the asset has appreciated over the guaranteed value), the committee expects that there will be taxable income because the amount realized from the disposition of the specified asset (and the guarantee, if any) exceeds the basis allocated to those assets.[37]

The House Report included an example addressing the treatment of loss guarantee payments. In return for assuming deposit liabilities of a failed institution in the amount of $100, an acquiring financial institution receives cash assistance payments of $40 and loan portfolio assets. The loan portfolio assets are subject to a loss guarantee that provides that the acquiring financial institution will realize at least $60 from the principal of the loan portfolio assets and that the income from the loan portfolio assets will be equal to at least the current market rate of interest (*i.e.*, an income maintenance agreement). The House Report specifies that, as a result of the loss guarantee and the income maintenance agreement, the fair market value of the loan portfolio is $60.

In the example, the acquirer allocates $40 of its $100 basis to the cash assistance payments and $60 to the loan portfolio assets and the loss guarantee. The House Report went on to describe the consequences that would apply upon the receipt of loss guarantee payments or upon the realization of amounts that exceed basis:

> There is no taxable income arising from any amounts received pursuant to the capital loss guarantee because the amounts received under the capital loss guarantee will only increase the amounts received directly from the loan portfolio assets to $60. The amount realized from the capital loss guarantee and the loan portfolio assets is $60 which is equal to the acquiring financial institution's basis in those assets and, accordingly, no income or gain is realized. If, however, the acquiring financial institution realizes $70 from the loan portfolio assets (and, consequently, no amounts are received pursuant to the capital loss guarantee), the acquiring financial institution would realize income of $10 because the amount realized from the loan portfolio assets (*i.e.*, $70) exceeds the acquiring financial institution's basis in the loan portfolio assets (*i.e.*, $60) by $10.[38]

Although the House Report's example departs from the typical FDIC loss guarantee arrangement in a number of ways,[39] the example does highlight the goal that an acquirer's taxable income from amounts realized on a covered asset should reflect the economic income of the taxpayer.

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[37] House Report, *supra* note 11, at 358.
[38] House Report, *supra* note 11, at 361-62.
[39] *See infra* text accompanying notes 55-57 . First, the House Report did not contemplate the possibility that the acquirer's purchase price for assets subject to a loss guarantee could depart from their guaranteed value. Second, the House Report did not acknowledge that receipt of a loss guarantee payment could result in a total amount realized that exceeds guaranteed value. As Examples 1 and 2 below illustrate, however, this may indeed be possible since the loss guarantee calculates payments by reference to the old financial institution's book value for the covered asset, not to the acquirer's cost basis (or tax basis as increased to reflect the covered asset's guaranteed value).

The regulations address the possibility that purchase price might be less than guaranteed value and that the total amount realized with respect to an asset might exceed its guaranteed value through the basis step-up rule and the six-year inclusion rule. Although the preamble to the proposed regulations does not discuss the reason for increasing the acquirer's basis in a covered asset beyond the purchase price and adopting a corresponding recapture regime,[40] presumably it was based on the rationale that the acquirer should be required to accrue income with respect to the gain that will eventually result because of the loss guarantee payment.

C. Debt or Equity Issued to an Agency

The general approach to the regulations is that debt or equity instruments issued by an institution to an agency (an "instrument") are not treated as outstanding for any purposes of the Code while held by any agency.[41] In a taxable transfer, instead, the cash or other property that an institution receives from an agency in exchange for the instrument is treated as net worth assistance taxable to the old institution in the taxable transfer.[42] Since net worth assistance is not included in an acquirer's basis for the acquired assets, the acquirer does not take a full purchase price basis in the acquired assets. On the date an agency transfers the instrument, the instrument is treated as having been newly issued to the holder with an issue price equal to the cash and fair market of property paid by the new holder for the instrument,[43] and the acquirer is treated as having transferred this amount directly to the agency.[44] As described in Part III.B below, this special rule disregarding instruments issued to an agency creates distortions between economic and taxable income.

Notably, the rule disregarding instruments issued to an agency is not limited to taxable transfers, and indeed appears to have been devised primarily for institutions that are in agency receivership and have not (yet) been acquired in a taxable transfer.[45] In adopting the rule, Treasury and the IRS were likely concerned about the difficulty of accurately valuing these instruments. The preamble to the proposed regulations indicates that the rule treating amounts as FFA regardless of whether the institution issued an instrument in exchange was intended to make an agency's decision to accept an instrument tax neutral.[46] The preamble also states that "[d]isregarding the issuance of equity or debt instruments further the general principles that all FFA should be taxed and that economically equivalent transactions should be treated uniformly."[47] Underlying this rationale is a concern that the debt or equity instruments issued in

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[40] *See* Preamble to Proposed Regulations, *supra* note 16, at 14807 (discussing regulations' modification of general Section 338 allocation principles).
[41] The rule encompasses all debt instruments, stock, warrants or other rights to acquire stock of the institution. Treas. Reg. § 1.597-3(b).
[42] Treas. Reg. § 1.597-1.
[43] Treas. Reg. § 1.597-3(b).
[44] Treas. Reg. § 1.597-2(d)(4)(iii)(B).
[45] *See* Treas. Reg. § 1.597-2(e), Example 1(ii).
[46] Preamble to Proposed Regulations, *supra* note 16, at 14805.
[47] *Id.; cf.* Treas. Reg. § 1.597-2(e), Example 1(ii) (seeking to achieve neutrality between situations in which the institution issues a note to the agency in exchange for assistance and those in which it does not).

exchange for FFA may not represent valuable consideration or, in the case of debt instruments, do not represent a meaningful obligation. Giving the instrument no effect until an actual payment on the instrument is made (or a third party purchases the instrument from the agency), reflects the concern that no payments may be forthcoming. In a taxable transfer, however, it does not seem that such concern should be present with respect to bona fide seller financing provided by the FDIC.

When payments are made to the agency with respect to any instrument, the regulations treat the payments as an adjustment to its FFA to the extent the payment exceeds the amount of money and fair market value of property the agency provides in exchange.[48] Adjustments to FFA are first treated as a reduction to FFA includible in income for the taxable year.[49] Second, the balance in the deferred FFA account[50] is reduced (but not below zero). Third, a deduction is allowed, but limited to (i) the amount of FFA included in income for prior taxable years minus (ii) the amount of deductions previously allowed under Treasury Regulations Section 1.597-2(d)(5)(ii).[51] Any excess is included as an adjustment to the purchase price paid in the taxable transfer.[52] Since an acquirer in a taxable transfer will have received little or no FFA,[53] the payments on an instrument generally result in an increase in purchase price for the acquired assets. In effect, an acquirer's payments on a disregarded instrument— including interest, principal, dividend or redemption payments—will be capitalized in the acquired assets.

D. Loss Guarantees

1. Description of FDIC Loss Guarantee Arrangements

For roughly two decades, the FDIC has included loss guarantees as a feature in transactions involving the purchase and assumption of troubled financial institutions' assets and liabilities. Under these arrangements, the FDIC agrees to assume a portion of any loss on a specified pool of acquired assets. In the words of the FDIC, the use of a loss guarantee "reduces the immediate cash needs of the FDIC, is operationally simpler and more seamless to failed bank customers and moves assets quickly into the private sector."[54]

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[48] Treas. Reg. § 1.597-2(d)(4)(i).
[49] Treas. Reg. § 1.597-2(d)(5)(i).
[50] *See supra* text accompanying note 25. As noted there, the deferred FFA account is not applicable to taxable transfers.
[51] The above FFA adjustment rules generally require the institution to have received FFA (*i.e.*, FFA that was not included in the amount realized on a covered asset) in order to be entitled to any tax benefit for the institution's payment to an agency. The preamble to the final regulations recognized that these rules provide "limited relief for payments made to Agency by New Entity or Acquiring, because they receive little or no FFA." T.D. 8641, 1996-6 I.R.B. 4.
[52] The purchase price adjustment is to be allocated among the acquired assets in accordance with Treasury Regulations Section 1.338-6 and -7. Treas. Reg. § 1.597-2(d)(5)(iii); *see infra* text accompanying notes 60-65 (discussing the allocation of purchase price in a taxable transfer).
[53] *See* T.D. 8641, 1996-6 I.R.B. 4.
[54] FDIC, Loss-Share Questions and Answers, http://www.fdic.gov/bank/individual/failed/lossshare /index.html.

The typical FDIC loss guarantee arrangement provides for reimbursement of 80% of any losses incurred by a taxpayer up to a stated threshold amount (generally, the FDIC's estimate of the total projected losses on covered assets), and 95% of the losses in excess of the stated threshold amount.[55] FDIC loss guarantee arrangements also require a financial institution to make payments to the FDIC equal to a portion of any recoveries on covered assets that had previously been charged off.[56] Losses are calculated by reference to the book value of the assets rather than the purchase price or the fair market value of the assets at the time of transfer.[57]

> Example 1: New Bank purchases a pool of covered assets for a purchase price of $800. The book value of the assets in the old bank's hands is $1000, and the FDIC agrees to reimburse New Bank for 80% of book losses relating to the asset pool to the extent those losses do not exceed $400 (*i.e.*, the threshold amount) and 95% of losses above that amount. Covered asset A (which has a book value of $100) is sold to a third party for $90 before the threshold amount of losses has been recognized. The loss for purposes of the FDIC guarantee calculation is $10 ($100 book value minus $90 amount realized), and the FDIC makes a reimbursement payment of $8.
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> Example 2: Same as Example 1, except that the sale of covered asset A occurs at a time when $400 in book losses (*i.e.*, losses exceed the threshold amount) have already been recognized. Here the FDIC will make a loss guarantee payment of $9.50 ($100 book value minus $90 amount realized multiplied by .95).

2. Loss Guarantee Rules

Under the regulations, a loss guarantee is defined as an agreement pursuant to which an agency guarantees or agrees to pay a financial institution a specified amount upon the disposition or charge-off (in whole or in part) of specific assets, an agreement pursuant to which a financial institution has a right to put assets to an agency or at a specified price or a similar arrangement.[58] Among other items, FFA explicitly includes loss guarantee payments.[59]

Although the regulations under Section 597 governing actual and deemed asset transfers generally look to principles employed under Section 338 to determine the basis of the acquired assets, they also contain special rules distinct from the regime under Section 338. Assets covered by a loss guarantee are treated as Class II assets for purposes of the Section 338 basis allocation,[60] the fair market value of which is deemed to be not less than the asset's guaranteed

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[55] FDIC, *supra* note 54.
[56] Purchase and Assumption Agreement among FDIC, as receiver of First DuPage Bank, FDIC and First Midwest Bank, Exhibit 4.15B: Commercial and Other Assets Shared-Loss Agreement, § 2.1(b)(ii) (October 23, 2009) [hereinafter FDIC Loss Guarantee Agreement], *available at* http://www.fdic.gov/bank/individual/failed/firstdupage_P_and_A.pdf.
[57] *See*, *e.g.*, FDIC Loss Guarantee Agreement, *supra* note 56, at § 2.1(b)(i).
[58] *Id.*
[59] *Id.*
[60] Treas. Reg. § 1.597-5(c)(3)(ii), (d)(2)(ii). For purposes of Section 338, Class II assets only include actively traded personal property (within the meaning of Section 1092(d)(1)), certificates of deposit and foreign currency. Treas.

value (the "guaranteed value").[61] If the fair market value of the Class I[62] and Class II assets acquired in an actual or deemed asset transfer is greater than the acquirer's purchase price for the assets, the basis of the Class I and Class II assets nonetheless equals their deemed fair market value (the "basis step-up rule").[63] Under a FDIC loss guarantee, the guaranteed value is based on the book value in the hands of the old financial institution.[64] Since the covered asset may have declined substantially in value in the hands of the old financial institution without a corresponding change in book value, the asset's highest guaranteed value will often exceed its purchase price, creating a potential windfall for taxpayers.

To address this, the regulations require a corresponding income inclusion equal to the amount of the basis step-up, effectively offsetting any potential windfall from the basis step-up. Specifically, the regulations provide that the amount by which the fair market value of the Class I and Class II assets exceeds the purchase price is included ratably as ordinary income by the acquirer over a period of six taxable years beginning in the year of the transfer (the "six-year inclusion rule").[65]

FFA provided under a loss guarantee is included in the amount realized to the extent that the total amount realized does not exceed the greater of (i) the property's fair market value or (ii) the guaranteed value at the time of transfer (the "amount realized rule").[66] Any loss guarantee payment in excess of this amount is treated as FFA and will be subject to inclusion in income as FFA. A loss guarantee payment will therefore be treated in one of three ways: (i) as a return of basis, which may reflect both the acquirer's purchase price and any increase under the basis step-up rule (and taken into account as income under the six-year inclusion rule), (ii) as amount realized in excess of the acquirer's basis, includible in income as gain, or (iii) as FFA, includible in income.[67]

III. Distortions and Uncertainties Under the Regulations

A. Basis Step-Up and Six-Year Inclusion

Reg. § 1.338-6(b)(2)(ii). This definition would exclude the nonactively traded loans and other real estate assets generally covered by an FDIC loss guarantee.

[61] Treas. Reg. § 1.597-5(c)(3)(ii). The guaranteed value is "not less than the greater of the asset's highest guaranteed value or the highest price at which the asset can be put." *Id.*

[62] Class I assets are cash and general deposit accounts. Treas. Reg. § 1.338-6(b)(1).

[63] Treas. Reg. § 1.597-5(d)(2)(iii).

[64] *See*, *e.g.*, FDIC Loss Guarantee Agreement, *supra* note 56, at § 2.1(b)(i).

[65] Treas. Reg. § 1.597-5(d)(2)(iii). The taxpayer must include the entire amount to be recaptured upon the occurrence of an acceleration event under Section 481. *Id.* Section 481 acceleration events include the taxpayer's ceasing to engage in the trade or business for which the change was made. A taxpayer's conduct of a trade or business is deemed to cease if substantially all the assets of the trade or business are transferred to another taxpayer. Rev. Proc. 2008-52, § 5.04(c)(3), 2008-36 I.R.B. 587.

[66] Treas. Reg. § 1.597-2(d)(2).

[67] The FFA loss deferral rules do not apply to loss guarantees paid to acquirers in taxable transfers. Treas. Reg. § 1.597-2(c)(1).

The basis step-up and six-year inclusion rules may create a mismatch in the timing of a taxpayer's economic and taxable income. The six-year inclusion rule produces either a timing benefit or timing detriment to the taxpayer or to Treasury depending on the expected life of the purchased loan portfolio or the taxpayer's holding period for the loan portfolio.

Consider the following examples:

> Example 3: On January 1, 2010, Bank acquires a loan portfolio (subject to an FDIC loss guarantee) of a failed financial institution in exchange for assuming $60 of its deposit liabilities. The loan portfolio's book value in the hands of the failed financial institution is $100, and the loan portfolio's guaranteed value under the FDIC loss guarantee is $90. Under the basis step-up rule, Bank's basis in the loan portfolio will equal $90,[68] and the six-year inclusion rule provides that the $30 excess of basis over Bank's $60 purchase price is included ratably as ordinary income over six taxable years.[69] On January 1, 2011, Bank collects on the entire loan portfolio and realizes a total of $92 (including loss guarantee payments). Bank has recognized $32 of economic income, but as a result of the basis step-up and six-year inclusion rules it has $5 of taxable income in 2010 and $7 of taxable income in 2011 ($5 included under the six-year inclusion rule and the $2 excess of total amount realized over basis). This disparity in economic and taxable income will not be fully corrected until Bank has recognized $5 in each of the next five taxable years. The disparity produces a windfall for the taxpayer in this example.[70]
>
> Example 4: Same as Example 3, except that Bank does not collect on the loan portfolio until 2020. Here Bank must include $5 in income for six years beginning in 2010, even though the realization of the gain as a result of the FDIC loss guarantee does not occur until 2020. The disparity in this example produces a windfall for the government.[71]

As shown by the two examples, the basis step and six-year inclusion rules create a mismatch in the timing of a taxpayer's economic and taxable income, resulting in a timing benefit or timing detriment (and corresponding windfall) to the taxpayer or to Treasury depending on the expected life of the purchased loan portfolio. Further

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[68] Treas. Reg. § 1.597-5(d)(2)(iii).

[69] *Id.*

[70] Bank would be required to accelerate its inclusions under the six-year inclusion rule upon the occurrence of a Section 481 acceleration event, including if Bank ceased to engage in the trade or business. *See* Treas. Reg. § 1.597-5(d)(2)(iii); Rev. Proc. 2008-52, § 5.04(c)(3), 2008-36 I.R.B. 587 (describing Section 481 acceleration events). This acceleration, however, will not occur as a result of Bank's collection of the loan portfolio in 2011 if Bank has a pre-existing business of which the loan portfolio is merely a part, or if Bank sells a portion of the loan portfolio and continues to operate the business with respect to the remaining portfolio.

[71] FDIC loss guarantees typically remain in place for eight or ten years depending on the class of asset, *see* FDIC, *supra* note 54, but it may be possible for an arrangement to have a longer term. In addition, the six-year inclusion rule would result in distortions similar to those in Example 4 if an acquirer does not collect under the loss guarantee but instead makes its recoveries after the loss guarantee has expired.

mismatch can occur where, in addition to assets covered by a loss guarantee, the acquirer has purchased other assets (such as securities portfolios or real estate). In such a case, the entire purchase price would be allocated to the covered assets (to the extent of the loss guarantee), thereby resulting in an acceleration of income in respect of proceeds received in respect of the other assets (to the extent tax basis was shifted from those other assets to the assets covered by the loss guarantee).

B. Debt or Equity Issued to an Agency

The effect of the rule disregarding the issuance of an instrument to an agency on bona fide debt or equity financing provided by the FDIC in a taxable transfer is to create a mismatch in the timing of economic and taxable income. Payments on disregarded instruments issued by an acquirer—including interest, principal, dividend or redemption payments—generally result in an increase in purchase price for the acquired assets.[72] Depending on the timing of payments on the instrument and whether the acquirer continues to operate a business after collecting on the loan portfolio, the mismatch may be material.

Consider the following example:

Example 5: On January 1, 2010 Bank acquires a loan portfolio with a fair market value of $100 and assumes deposit liabilities of $20 of a failed financial institution. The loan portfolio is not subject to a loss guarantee. General market conditions have made the availability of financing scarce, and in order to facilitate the acquisition the FDIC agrees to provide Bank with $80 in exchange for a five-year note of Bank with an $80 face value that provides for adequate stated interest. Under general U.S. federal income tax principles, the note would be properly classified as indebtedness. Since Bank has acquired the assets of the failed financial institution in a taxable transfer,[73] the FFA—*i.e.*, the $80 received in exchange for the note—is treated as received by the old institution, and is taxable to the old institution as net worth assistance immediately before the taxable transfer.[74] Accordingly, as net worth assistance, the $80 is excluded from Bank's purchase price for the acquired assets, which will be $20 (the assumed deposit liabilities).[75] Bank's basis in the acquired assets will therefore equal $20.

Over the course of 2010, Bank receives $6 of interest income from the loan portfolio. In addition, Bank makes $4 of interest payments on the note, which rather than being deductible, increases its basis in the acquired assets to $24.[76] On December 31, 2010, Bank sells one half of the value of the loan portfolio for $50 and uses $40 of the proceeds from sale to pay down the note. The $40 payment to

[72] Treas. Reg. § 1.597-2(d)(5)(iii)(B). The purchase price adjustment is to be allocated among the acquired assets in accordance with Treas. Reg. § 1.338-6 and -7.
[73] Treas. Reg. § 1.597-5(a)(i).
[74] Treas. Reg. § 1.597-5(c)(1)
[75] Treas. Reg. § 1.597-5(d)(1).
[76] Treas. Reg. § 1.597-2(d)(5)(iii)(B); *see also* Treas. Reg. § 1.338-7(b).

the FDIC will be allocated pro rata to increase the total basis of the loan portfolio, with $20 allocated to the sold loans.[77] Thus, Bank's basis in the sold loans will be $32. Note that the net proceeds to Bank are $12 ($50 sale proceeds plus $6 of interest income less $4 interest payments less $40 principal repayment) and, assuming that the note is properly treated as bona fide debt, Bank's economic income is $2, while Bank is taxed on $24 of income.

Over the next four years, Bank makes $2 of interest payments each year on the FDIC instrument, which will increase the basis in the sold loans and the remaining loans on a pro rata basis. Accordingly, Bank will have a $1 ordinary loss in each year on account of the basis increase in the sold loans, and $1 is capitalized into the basis of the remaining assets (which, as a result, have a total basis of $36 at the end of 2014). On January 1, 2015, Bank sells the remaining assets for $50 and uses $40 of the proceeds from sale to repay the remaining balance on the note. $14 of the payment increases the basis of the loans sold in 2015 to $50 (their fair market value at the time of the acquisition), and Bank accordingly recognizes no gain or loss on the sale of the loans in 2015.[78] $14 of the payment increases the basis of the loans sold in 2010 to $50 (their fair market value at the time of the acquisition), and Bank is allowed a $14 ordinary loss in 2015.[79] The remaining $12 of the payment—which reflects the amount of interest[80] paid on the FDIC instrument—is allocated to goodwill since the basis previously allocated to the loan portfolio will equal its fair market value at the time of acquisition. This basis redetermination of goodwill in 2015 allows Bank to take a $4.80 amortization deduction in 2015 that reflects the increased amortization deductions that would have been allowed in previous years if $12 had been allocated to goodwill in 2010. The remaining $7.20 of goodwill would be amortized at $0.80 per year through 2024.

As Example 5 demonstrates, the rule that disregards debt or equity issuances by an institution (including an acquirer in a taxable transfer) to an agency creates distortions between economic and taxable income. The reduction of the acquirer's basis in the acquired assets below its actual purchase price will often cause the acquirer to recognize significant amounts of taxable

[77] Treas. Reg. § 1.338-7(b), (d)(1). Under Treasury Regulations Section 1.338-7(d)(1), if an adjustment increases the purchase price, the adjustment is allocated among all of the acquired assets as if the adjusted purchase price had been the original purchase price, and any increase attributable to any asset that had been disposed of (or a depreciable or amortizable asset) is taken into account under general principles of tax law that apply when part of the cost of an asset not previously taken into account in basis is paid or incurred after the disposition. In effect, when a disposed (or depreciable or amortizable) asset is allocated additional basis, the acquirer will reduce gain or increase loss if the adjustment occurs in the same taxable year as the disposition, or include a loss in the year of the adjustment if the disposition and the adjustment occur in different taxable years. *See* Treas. Reg. § 1.338-7(e), Example 1(vi).

[78] Treas. Reg. § 1.338-7(b), (d)(1). The asset allocation rules of the Section 338 regulations (including Treasury Regulations Section 1.338-6(c)(1)'s fair market value limitation) apply as if the redetermined purchase price were the purchase price on the acquisition date. Treas. Reg. § 1.338-7(b).

[79] *See* Treas. Reg. § 1.338-7(e), Example 1(vi).

[80] Note that the same treatment would result in the case of dividends paid to the FDIC on an equity instrument. In effect, the current rules cause dividends paid to be deductible.

income upon the disposition of the assets, even though it may have little or even negative net proceeds from its investment. The 2010 result in Example 5 creates primarily a timing mismatch as the payments to the FDIC are capitalized into both the assets disposed of in 2010 and the remaining assets. In addition, payments of interest (and, where the FDIC instrument is equity, dividends) to the FDIC would become amortizable goodwill (which would defer interest deductions but permit the eventual deduction of dividends).

More significant mismatches can result in circumstances where the FDIC provides both financing and a loss guarantee. For example, if in Example 5, the loan portfolio were subject to an FDIC loss guarantee, the difference between the Bank's $20 purchase price (determined without taking into account the FDIC note) and the guaranteed value of the loan portfolio would be required to be taken into income over six years. Moreover, it is not clear under the existing regulations when or how Bank should take into account for tax purposes the principal payments that it makes on the FDIC note.[81] Furthermore, the mismatches may be exacerbated if, in addition to a loan portfolio that is subject to an FDIC loan guarantee, Bank in Example 5 were to acquire a substantial amount of other assets (such as securities or real estate) of the failed financial institution that are expected to be held by Bank for a longer period than the loan portfolio. In that case, while the loan portfolio would have a basis equal to its market value, the other assets would have no basis initially, but would be allocated basis as Bank makes principal payments on the FDIC note, and such basis would not be recovered until those other assets are disposed of, collected or written-off.

C. Uncertainties

1. Mere Provision of a Loss Guarantee

The regulations do not address whether merely providing a loss guarantee as opposed to receipt of a payment under a loss guarantee constitutes FFA at the time the loss guarantee is entered into. We acknowledge that this uncertainty applies in very limited circumstances because (i) most transactions will also include the receipt of other forms of FFA, and (ii) FDIC-assisted acquisitions have predominantly been effected through asset transfers rather than stock purchases.[82] The question, we believe, is whether deemed asset treatment is appropriate. On the one hand, one goal of the legislative history, to including FFA in income at the time the institution's losses are recognized, would not be served by applying the deemed asset transfer rules.[83] On the other hand, not applying the deemed asset rules allows an acquirer to retain the

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[81] While it would make sense, at a minimum, that principal payments on the FDIC note should give rise to "real" basis and offset current and prior year income inclusions under the six-year income inclusion rule, the existing regulations do not provide any such guidance. In the absence of guidance, principal payments on the FDIC note may be allocated to goodwill (or, if acquirer also acquired other assets in the transaction, to such other assets). *See* Treas. Reg. §§ 1.597-2(d)(5)(iii)(B, 1.338-6(c)(2).

[82] The FDIC makes the transaction documents in FDIC-assisted acquisitions available online. See FDIC, Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html. As shown on the Appendix attached to this Report, all of the 140 total FDIC-assisted whole-bank acquisitions that took place in 2009 were structured as acquisitions of the failed institutions assets. However we do recognize that deemed asset acquisition treatment would apply with respect to a consolidated subsidiary, the stock of which is acquired in an asset acquisition of a failed institution.

[83] House Report, supra note 11, at 356-58.

historically high tax basis which can offset any economic income attributable to future guarantee payments; the result is arguably inconsistent with legislative intent to tax economic income of the acquirer. Thus, we believe it is appropriate to apply the deemed asset transfer rule to these situations.

2. Two-Tiered Loss Arrangement

It is unclear how the determination of guaranteed value, the basis step-up rule and the six-year inclusion rule apply to an FDIC loss guarantee. The FDIC uses a two-tiered calculation in which it will reimburse 80% of losses relating to a pool of assets to the extent losses do not exceed a threshold amount, and then 95% of losses thereafter.[84] The regulations deem the fair market value of a covered asset to be not less than the asset's highest guaranteed value. For any single asset, the highest amount which could be paid pursuant to a loss guarantee arrangement would be 95% of its book value, since the taxpayer would be reimbursed for 95% of the asset's book value if losses have exceeded the threshold amount. Therefore, the regulations arguably require taxpayers to use the 95% figure in calculating an asset's guaranteed value (at least for an aggregate amount of assets up to the threshold amount).

Using a 95% guaranteed value creates a mismatch between tax and economic results. Under the basis step-up and six-year inclusion rules, if the fair market value of Class I and Class II assets acquired (which will include assets covered by a loss guarantee) is greater than the taxpayer's purchase price for the acquired assets the basis of the Class I and Class II assets equals their fair market value.[85] If the fair market value of each asset were determined using the 95% loss sharing tranche, the following distortions would result: (i) fair market value of the pool of covered assets would equal 95% of book value notwithstanding that if all assets became worthless the FDIC would only be required to pay the weighted average of the two-tiered loss guarantee arrangement, and (ii) the six-year inclusion rule would require income inclusions on all covered assets based on a 95% guaranteed value, even though the FDIC's guarantee does not ensure a 95% recovery on each individual asset. Despite this uncertainty, it seems the proper calculation of guaranteed value for purposes of applying these rules would be to determine the fair market value of covered assets for purposes of the basis step-up and six-year inclusion rules using a pooled approach that references the weighted average of the two-tiered loss guarantee. This approach should avoid the distortions noted above and match the tax consequences with the economics of the FDIC's loss guarantee arrangements.

For example, assume that the book value of a covered asset equals $100, and the covered asset is part of a pool of assets with a book value of $1000. The FDIC agrees to reimburse the taxpayer for 80% of book losses relating to the asset pool to the extent those losses do not exceed the threshold amount of $400, and 95% thereafter. The covered asset's guaranteed value for purposes of the basis step-up rule and the six-year inclusion rule would accordingly be $89 (($100 x .80 x .4) plus ($100 x .95 x .6)).

3. Applicability of Regulations to Joint Ventures

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[84] *See supra* text accompanying note 55.
[85] *See supra* text accompanying notes 60-65.

The FDIC may enter into joint venture arrangements with investors with respect to distressed assets or may enter into participation agreements with respect to such assets that are treated as partnerships under general income tax purposes. Typically, the investor will pay an up-front amount to the FDIC – representing a portion of the value of the assets – to acquire the assets (or an interest therein), and proceeds received in respect of the assets are divided between the FDIC and the investor in accordance with a specified sharing ratio (which typically directs all or most of the proceeds to the FDIC until it recovers a certain amount). The investors may or may not be financial institutions or affiliates thereof, and these arrangements may or may not be in connection with a larger transaction that otherwise is a "taxable transfer" to a financial institution in which FFA is provided.

Where these arrangements are part of a larger transaction in which FFA is provided, their treatment under the existing regulations is uncertain in several respects, including whether these arrangements are subject to the rule that disregards debt and equity interests received by the FDIC. That rule applies to "stock … of an Institution (or any of its affiliates) that Agency …receives in connection with a transaction in which FFA is provided."[86] It is not clear, *inter alia*, whether this provision is intended to cover actual or deemed partnership interests or only "stock" in a corporation.

If the FDIC's investment in a partnership-type joint venture were disregarded, significant distortions would arise. For example, the non-FDIC partner(s) would be allocated 100 percent of income, notwithstanding the FDIC's ownership percentage. Distributions of cash flow to the FDIC may or may not result in an offsetting current deduction, depending on the nature of the assets and the application of the complex rules of the regulations.[87]

IV. Recommendations

A. General Principle

We agree with the approach embodied in the existing regulations that all taxable assisted acquisitions (whether in the form of asset or stock acquisitions) should be treated as taxable asset acquisitions. We believe such treatment is appropriate because, consistent with legislative history, it matches an acquirer's taxable income with its economic income and avoids any potential windfalls either to taxpayers or to Treasury. Furthermore, we believe regulations should be issued implementing the general principles that (i) an acquirer's basis in the acquired assets is equal to its full purchase price, and (ii) proceeds from the disposition of the acquired assets are, in general, first offset by basis and the excess is included in income when recognized. We believe this general statement furthers the purpose of Section 597 with respect to taxable acquisitions of matching taxable income with economic income, eliminates the unnecessary complexity of the current regulations, and avoids timing distortions and uncertainties under the current regulations. We believe this general principle can be implemented through the adoption of the specific proposals contained under the remaining recommendations.

[86] Treas. Reg. § 1.597-3(b).

[87] *See* Treas. Reg. § 1.597-2(d)(iii) and the discussion in Example 5 and the variations thereon, above, of analogous mismatch problems in the context of an FDIC note.

The consequences of adopting these principles both in situations where an agency has provided a loss guarantee for acquired assets and where the acquirer has issued an instrument to an agency can be illustrated as follows:

Example 6: On January 1, 2010, Bank acquires a loan portfolio (subject to an FDIC loss guarantee) of a failed financial institution in exchange for assuming $60 of its deposit liabilities. The loan portfolio's book value in the hands of the failed financial institution is $100, and the loan portfolio's guaranteed value under the FDIC loss guarantee is $90. On January 1, 2011, Bank collects on the entire loan portfolio and realizes a total of $92 (including loss guarantee payments). Under the regulations, Bank increases its basis in the loan portfolio to $90 because of the loan portfolio's guaranteed value, and would also be required to include $5 in each of the 2010-2015 taxable years. Because of the step-up in basis to $90, Bank only has $2 of taxable gain from its amount realized.[88] In contrast, under our approach Bank would allocate only its $60 purchase price to basis to the assets in the loan portfolio (and would be relieved of any income inclusion requirement), but, depending on which alternative recommendation discussed below is adopted, would either (i) recognize $32 of gain upon making total collections of $92 on the loan portfolio or (ii) (a) include in income each year a portion of the $30 difference between purchase price and guaranteed value in 2010, based on the weighted average life of the loan portfolio, and receive a corresponding increase in basis equal to such inclusion, and (b) recognize gain equal to $32 less the amount recognized in (a) as gain upon collection.

Example 7: On January 1, 2010 Bank agrees to acquires a loan portfolio with a fair market value of $100 and assume deposit liabilities of $20 of a failed financial institution. The loan portfolio is not subject to a loss guarantee. General market conditions have made the availability of financing scarce, and in order to facilitate the acquisition the FDIC agrees to provide Bank with $80 in exchange for a five-year note of Bank with an $80 face value that provides for adequate stated interest. Under general U.S. federal income tax principles, the note would be properly classified as indebtedness.

Under the regulations, the note is treated as FFA (and taxable to the failed financial institution) and disregarded while held by the FDIC, which has the effect of denying Bank any basis for the portion of its purchase price financed by the note. If Bank collects $50 on half of the loan portfolio and makes a corresponding $40 principal payment on the note, only one-half of the basis increase from the payment to the FDIC will be available to offset Bank's amounts realized on the asset; the remainder will be capitalized into the basis of the remaining acquired assets.[89] Accordingly, Bank may recognize gain from its

[88] *See supra* Part III.A.
[89] Treas. Reg. §§ 1.338-6(b)(2), (c)(1); 1.338-7(b).

collection on the loan portfolio, even though it has not recognized any net proceeds.

Under our approach, the note would still be treated as FFA and taxable to the failed financial institution. Bank would be afforded a full $100 purchase price basis in the loan portfolio (*i.e.*, its basis would not be reduced by the portion of its purchase financed by the note). Accordingly, Bank's gain or loss from each asset in the loan portfolio will be based on its economic income from the asset.

By treating all agency-assisted acquisitions (including those involving only the provision of a loss guarantee) as taxable asset acquisitions, the regulations will ensure that a primary goal of Section 597—taxing the old institution on its receipt of FFA in connection with the recognition of its historic losses[90]—is accomplished. Because the old institution's built-in losses and other historic tax attributes have been eliminated in the asset transfer, we believe an acquirer should be taxed in a manner similar to that which would apply under general U.S. federal income tax principles, since those principles reflect the acquirer's economic income.

We believe any special concerns that Treasury and the IRS might have involving agency assistance to failed financial institutions are not present in the context of taxable acquisitions. These acquisitions involve a competitive auction processes that should ensure financing and loss guarantee arrangements between the FDIC and the acquirer will be at arm's length terms such that special and complex rules are not needed to prevent abuse. Section 597(b) sets forth the principle (adopted by the regulations as well) that in an agency-assisted acquisition, FFA should be taken into account by the old institution, not the acquirer. The regulations' focus on taxation of the old institution rather than the acquirer provides support for our recommendation that the acquirer should not be subject to special rules.

Eliminating the special rules applicable to acquirers in agency-assisted acquisitions would also eliminate the uncertainties and difficulties that taxpayers face in applying the regulations described in Part III.C. Specifically, discarding the basis step-up and six-year inclusion rules would eliminate the difficulty of determining a covered asset's guaranteed value at the time it is acquired in light of the FDIC's two-tiered, pooled approach for loss guarantees.[91] The uncertainty surrounding the proper treatment of debt or equity issued in joint venture arrangements[92] would also be eliminated if the regulations were to treat instruments issued to an agency by an acquirer in a taxable transfer according to their form.

B. Specific Recommendations

1. Repeal of Basis Step-Up and Six Year Inclusion Rules

It is likely under the six-year inclusion rule the taxable income of a taxpayer would not match the timing of its economic income. In particular, although the six-year

[90] *See* House Report, *supra* note 11, at 358; *supra* text accompanying note 15.
[91] *See supra* Part III.C.2.
[92] *See supra* Part III.C.3.

period roughly aligns with the expected life of an FDIC loss guarantee,[93] the six-year inclusion rule produces either a timing benefit or timing detriment to the taxpayer or Treasury depending on the expected life of the purchased loan portfolio. As discussed below, we have proposed two alternative approaches that would address such asymmetry by matching basis increases and income inclusions.

Specifically, we would eliminate the rule permitting an immediate basis step-up in connection with the acquisition. Instead, the acquirer would take an initial basis in the acquired assets equal to its purchase price. We believe that result is consistent with the economics of the transaction and therefore better conforms with the regulations' goal of matching. We believe the IRS and Treasury can take one of two approaches with respect to income inclusions associated with the difference between the purchase price and guaranteed value.

One approach would be to include income as actual payments are made on the loan portfolio (including loss guarantee payments).[94] Such treatment is consistent with the form of the transaction and is consistent with the treatment of similar arrangements such as put options and market discount obligations,[95] and has the benefit of simplicity and administrative ease.

A second approach would be to accrue income in each year based on the weighted average life of the loan portfolio. As income is included, the basis of the remaining assets would be increased. Upon collection or disposal of an asset, any remaining income would be accelerated. This approach is analogous to the treatment of original issue discount,[96] and recognizes that at least a portion of the difference between purchase price and guaranteed value may be attributable to the compensation for the time value of money.

It should be noted that either recommended approach should preserve the character of any income inclusions as ordinary regardless of the income inclusion alternative which is chosen. Only banks and domestic building and loan associations are subject to Section 597 upon the receipt of loss guarantee payments,[97] and both of these

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[93] FDIC, *supra* note 54.
[94] *See supra* text accompanying note 88.
[95] Section 1276. We recognize that there is uncertainty as to the application of the market discount rules to distressed debt generally. However the rationale for not applying the market discount rules to distressed debt does not alter the timing of income inclusions. The mere fact that a government agency stands behind a debt instrument should not require an accrual of discount. For example, market discount on Treasury securities is not subject to any special accrual rules. We also believe the IRS should consider the consequences of the application of collateral market discount rules such as interest deferral under Section 1277.
[96] *Cf.* Section 1272(a)(6) (calculation of original issue discount for debt instruments or pools of debt instruments where principal is subject to acceleration taking account of their anticipated weighted average life).
[97] Treas. Reg. § 1.597-1(b).

institutions receive ordinary treatment upon the sale or exchange of debt instruments under Section 582(c).[98]

2. Loss-Deferral on Covered Assets

We believe that the regulations should retain the rule that losses on assets covered by a loss guarantee arrangement should not be allowed below their highest guaranteed value.

The regulations limit an institution's ability to take certain losses or deductions on assets covered by a loss guarantee. Specifically, prior to disposition an asset cannot be charged off, marked to market value, depreciated, amortized or otherwise treated in a manner that supposes an actual or possible diminution of value below the asset's guaranteed value.[99]

Although our proposal above would dispense with several rules (the basis step-up rule and the six-year inclusion rule) that hinge on a covered asset's guaranteed value, we would recommend that the regulations retain Treasury Regulations Section 1.597-3(f). This rule acknowledges that the loss guarantee insulates the taxpayer from economic loss with respect to the covered asset. Retention of this rule furthers the legislative intent of matching economic and taxable income.

3. Debt or Equity Issued to an Agency

As discussed in Part III.B, the rule that disregards debt or equity issuances by an institution (including an acquirer in a taxable transfer) to an agency generates distortions between economic and taxable income. The reduction of the acquirer's basis in the acquired assets below its actual purchase price will often cause the acquirer to recognize significant amounts of taxable income upon the disposition of the assets, even though it may receive little or negative net proceeds from its investment. As shown in Example 5 and the variations thereto discussed above, this rule defers any tax deduction by capitalizing a large portion of payments to the FDIC into the basis of the remaining acquired assets or into goodwill, creating a mismatch between taxable income and economic income. Accordingly, the timing of asset sales compared to payments to the FDIC can result in an extended deferral of tax deductions, thereby creating a windfall to Treasury.

The timing mismatch created by disregarding instruments issued to the FDIC creates a potential liquidity problem for acquirers. While the entire amount of proceeds received upon disposition of an asset is subject to tax, a portion of those proceeds are required to be paid to the FDIC and therefore the acquirer may not have a sufficient amount of remaining proceeds to satisfy its tax liability.

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[98] Section 582(c) applies to certain financial institutions, including banks, mutual savings banks, cooperative banks, and domestic building and loan associations and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law.
[99] Treas. Reg. § 1.597-3(f).

Additionally, disregarding instruments issued to the FDIC creates complexities and results in conflict with general income tax principles. For example, (i) *Deductible Dividends*: payments made to the FDIC that are in form dividends would be capitalized into the basis of the remaining assets and potentially deductible upon disposition of the assets; and (ii) *Non-deductible Interest*: payments made to the FDIC that are in form interest would not be deductible currently.

We believe that the results of disregarding instruments issued by an acquirer in a taxable transfer conflict with congressional intent to tax acquirers in accordance with their economic income from acquired assets.[100] Since FDIC-assisted acquisitions will eliminate all of an old institution's historic tax attributes—either because the acquisition involves an actual asset transfer or a deemed asset transfer—we believe the goal of matching economic and taxable is best served by giving the acquirer a full purchase price basis in its assets. Disregarding an acquirer's issuance of debt or equity does not further the legislative intent behind Section 597 of taxing the old institution on its receipt of FFA; the regulations already achieve that goal by making net worth assistance taxable to the old institution.

Therefore, we recommend that the regulations be amended to (i) eliminate the general rule that ignores debt or equity issued to an agency in a taxable acquisition (under general tax principles such debt or equity would be included in the acquirer's purchase price), and (ii) include anti-abuse rules that would (A) disregard debt issued to an agency to the extent that there is no reasonable expectation of full payment at the time of issuance and (B) defer any loss on an acquired asset until the acquirer has either repaid a corresponding amount of the agency debt or included in income a corresponding amount (either by reason of cancellation of indebtedness or otherwise). Under our proposal, any debt instruments issued to an agency in a taxable acquisition would be subject to generally applicable tax rules, including the requirement that they bear adequate stated interest.[101]

The concerns that likely led Treasury and the IRS to adopt the rule ignoring instruments issued to an agency—namely, that the issuer could avoid being taxed on FFA through the issuance of an instrument that was unlikely to yield any payments—are not present in the context of FDIC-assisted taxable acquisitions. FDIC sales of failed financial institutions' assets typically involve a competitive auction process involving multiple bidders. We believe the safeguards inherent in a typical acquisition where an acquirer has an equity investment that is junior in the capital structure to any debt or equity instrument issued to the FDIC significantly reduce the potential that the instruments are structured other than at fair market value. Although the FDIC may offer debt or equity financing in order to attract potential acquirers, there is little reason to believe that the instruments issued to the FDIC do not represent bona fide debt or equity, as the case may be. Indeed, the FDIC offers potential acquirers limited opportunities to negotiate the terms of the acquisition. Conversely, acquirers have an incentive to minimize the amount of debt or equity to the FDIC since payments to the FDIC in respect of these interests will reduce the economic profit of the acquirers and, to the extent these interests are senior to the acquirers' equity investment, could jeopardize the acquirers' ability to recoup their investment if the face

[100] *See supra* text accompanying note 15.
[101] Section 1274.

amount of the FDIC's interests substantially exceeds their fair market value. Moreover, in times of financial crisis, other sources of financing may be unavailable to a potential acquirer, thereby making FDIC financing crucial to the transaction. Where third party financing is not available due to unstable financial markets, disregarding FDIC financing and therefore subjecting such financing to adverse tax results seems antagonistic to the non-tax purpose of FIRREA, which is to promote acquisitions of failed institutions in order to stabilize the financial markets.

However, in instances where it is clear at the time of acquisition that debt issued to the FDIC is unlikely to yield any payments to the FDIC, we believe the current rules disregarding such instruments are appropriate because they are consistent with the principle of tax neutrality—that economically equivalent transactions should be taxed similarly. Therefore, we believe Treasury should provide an anti-abuse rule that would disregard debt issued to an agency to the extent there is no reasonable expectation of payment in full under the instrument at the time of issuance. We acknowledge, however, that Treasury and the IRS may be uncomfortable with relying solely on such a rule to police abuses because of the difficulty of ascertaining what the reasonable payment expectations may be at the time of issuance. Therefore, we also recommend a second anti-abuse rule that would defer any loss on an acquired asset until the acquirer has either repaid a corresponding amount of the debt or included in income a corresponding amount (either by reason of cancellation of indebtedness or otherwise).[102]

[102] If this rule is adopted, consideration will have to be given on how to properly identify a correlation between losses and payments on debt instruments (or cancellation).