

GLOBAL TAX UPDATE

IRS Issues Guidance to Address Transactions in Distressed Market Conditions

October 3, 2008

The Internal Revenue Service (the “Service”) recently issued guidance intended to address certain situations arising as a consequence of the current market developments. In particular, the Service issued three notices announcing that Treasury Regulations will be issued regarding the treatment of net operating losses under various circumstances. The Service also released rules that confirm nonrecognition treatment to securities lenders on certain transactions in default.

Loss Corporations in which the United States Takes a Greater than 50 Percent Interest

The Service issued Notice 2008-84 on September 26, 2008, announcing plans to write regulations under Section 382(m) of the Internal Revenue Code of 1986, as amended (the “Code”) relating to the acquisition by the United States of a greater than 50 percent interest in a corporation with net operating losses (a “Loss Corporation”). Such regulations will clarify the impact of a change of ownership on a Loss Corporation and the applicability of the loss limitation rules of Code Section 382 where the major-

ity interest in such corporation is acquired and held by the United States government.

Specifically, the notice indicated that the term “testing date” (as defined in Treasury Regulations section 1.382-2(a)(4)) would not include any date as of the close of which the United States directly or indirectly owns a “more-than-50-percent interest” in the corporation. For purposes of these new regulations, a “more-than-50-percent interest” means a greater than 50 percent ownership of the total value of shares of the corporation’s stock or greater than 50 percent ownership of the total voting power of all classes of stock of a corporation. The Service indicated that based on these new regulations “[t]he loss corporation will be required to determine whether there is a testing date and, if so, whether there has been an ownership change for purposes of Code Section 382, on any date as of which the United States does not directly or indirectly own a more than 50 percent interest in the loss corporation.”

The regulation to be issued will be effective for any tax year ending on or after September 26, 2008.

Anti-Stuffing Regulations to be Issued for Loss Corporations

On September 26, 2008, the Service also issued Notice 2008-78, announcing that regulations would be issued to deal with capital contributions made to a Loss Corporation during the two years preceding a change of ownership in such Loss Corporation.

Under Code Section 382(l)(1), except as provided in regulations, capital contributions received by a corporation in the two years prior to an ownership change are presumed to be part of a plan a principal purpose of which is to avoid or increase the loss limitation of Code Section 382(a). Such capital contributions are not taken into account in calculating the limitation on losses applicable to such Loss Corporation. No regulations have been issued under Code Section 382(l)(1); accordingly, with very narrow exceptions, Loss Corporations have been required to reduce their equity value for purposes of computing their loss limitation by the amount of capital contributions within the two-year period.

In contrast with the presumption set forth in the statute, the notice states that the Service will not presume a contribution to be part of a plan simply because of timing. This change suggests that capital contributions received by a Loss Corporation in the two years preceding an ownership change may be counted in calculating the loss limitation imposed on such corporation following such ownership change, as long as the contribution was not made with a principal purpose of avoiding or increasing the loss limitation, a determination to be made under a “facts and circumstances” test.

The Notice also set out four safe harbors from the application of Code Section 382(l)(1) where, if applicable, such capital contributions would not be treated as part of a plan a principal purpose of which is to avoid or increase the loss limitation of Code Section 382(a):

1. A capital contribution would not be considered part of a plan if:
 - The contribution is made by a person who is neither a controlling shareholder immediately before the contribution nor a related party;
 - No more than 20 percent of the total value of the loss corporation’s outstanding stock is issued in connection with the contribution;
 - There was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and
 - The ownership change occurs more than six months after contribution.
2. A capital contribution would not be considered part of a plan if:
 - The contribution is made by a related party, but no more than 10 percent of the total value of the loss corporation’s stock is issued in connection with the contribution; or the contribution is made by a person other than a related party;
 - In either case there was no agreement, understanding, arrangement or

substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and

- The ownership change occurs more than one year after the contribution.
3. Capital contributions made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of Treasury Regulations sections 1.355-7(d)(8) or (9), respectively.
 4. A capital contribution would not be considered part of a plan if:
 - It is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss); or
 - It is received before the first year from which there is a carryforward of net operating loss, capital loss, excess credit or excess foreign taxes (or in which a net unrealized built-in loss arose).

The Notice states that, pending further guidance, taxpayers may rely on the rules set forth in the Notice.

Certain Loss Assets of Banks Not Treated as Built-In Losses for Purposes of Code Section 382(h)

On October 1, 2008, the Service issued Notice 2008-83 providing that any proper deduction by a bank after an ownership change with respect to losses recognized on loans or bad debts (including deductions for

a reasonable addition to a reserve for bad debts) shall not be treated as a built-in loss or a deduction attributable to the period prior to the ownership change. As such, such losses would not be subject to the limitation on recognized built-in losses imposed by Code Section 382(h). This treatment of deductions is only available to banks (as defined in Code Section 581(a)) that are treated as such immediately prior to and after the ownership change date.

Banks may rely on the Notice until further guidance is provided.

Nonrecognition Treatment to Securities Lenders on Deals that Default

In Revenue Procedure 2008-63, released September 26, 2008, the Service indicated that when a securities loan is terminated because of the bankruptcy of the borrower or an affiliate of a borrower, no gain or loss will be recognized if the lender applies the collateral to the purchase of identical securities.

Securities lenders loan their securities to borrowers pursuant to agreements that generally provide for the return of identical securities and payments equivalent to distributions made with respect to the securities. Under Code Section 1058, such lenders do not generally recognize gain or loss on the exchange of securities under this type of securities lending arrangement. However, if the borrower defaults under the agreement, the lender often uses the collateral provided under the lending agreement to purchase identical securities.

As a result of current credit market conditions, many lenders expressed concern that they would face an unanticipated taxable event when the securities were repurchased with collateral proceeds following a borrower default.

The Revenue Procedure provides that pursuant to an otherwise valid securities loan agreement where a borrower defaults as a direct or indirect result of the bankruptcy of the borrower (or a borrower affiliate), the purchase of identical securities by the lender with the collateral (or proceeds therefrom) within 30 days after a default is treated as an exchange of rights pursuant to Code Section 1058(a). Thus, the lender receives similar treatment under such circumstances as it would have had it received the identical securities from the borrower upon termination of the loan.

The Revenue Procedure is effective for taxable years ending on or after January 1, 2008.

If you have any questions, or would like additional information about these topics, please contact the Mayer Brown lawyer with whom you regularly work or one of the contacts below.

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