



### Let Uncle Sam Pay for Your Acquisition: A Special Exclusion from IRC §382

On September 30, 2008, while the credit markets were coming unwound following the nationalization of Fannie Mae and Freddie Mac, AIG was being rescued by the federal government, and Lehman Brothers was failing, the Treasury issued Notice 2008-83 (the “Notice”), which provided a new interpretation of an otherwise restrictive tax law—Internal Revenue Code (“IRC”) §382. This new interpretation—enacted autonomously by the Treasury Department, without the consent of Congress—is a significant change in application of IRC §382 that adds a significant amount of value to bank acquisitions. Although this may not trigger an all-out M&A boom—as specific circumstances must exist to realize the benefit—the new interpretation could become a “game changer” for a number of potential buyer-seller combinations. In fact, this is the *sole* reason that Wells Fargo went from not placing a bid on Wachovia to offering \$7 a share and outbidding Citigroup in the 23rd hour (we analyze the §382 benefit for Wells Fargo below). The bottom line is that the new interpretation of §382 boosted Wells tax benefit from \$2.6 billion to \$25.1 billion, a *ten-fold* increase.

It is not new that companies can reap tax benefits through merger and acquisition activity. Companies often opportunistically seek to offset their own income through the net unrealized built-in-losses (NUBILs) and net operating losses (NOLs) of the companies they acquire. The availability of such benefits is restricted by §382, which aims to prevent acquisitions for the sole or primary purpose of “trafficking” such tax benefits to the acquirer. However, the Notice, a new and likely just temporary interpretation of §382, drastically eases the restrictions for acquirers of banks and thrifts.

Prior to the new interpretation, the framework of §382 greatly restricted the usage of pre-acquisition losses generated by the target. One requirement—specific to NUBILs—was that at least a *minimum* amount of NUBILs must have existed for tax benefits to be recognized at all. Specifically, the target institution must have brought over NUBILs of the lesser of \$10 million or 15% of the fair market value of the target’s assets at the time of the acquisition. Almost paradoxically, another major restriction placed an *upper* limit on the amount of acquired losses—for both NUBILs and NOLs combined—that may have been used in a given year. This limit is calculated as the long term tax-exempt bond rate (approximately 4% to 5%) times the fair market value of the target institution. As a result of this upper limit, it typically diminished the value of existing NOLs by over 50% once applying a discount rate over the 20 year carry forward. This is the most burdensome restriction of §382. Finally, all §382 losses had to be used on a prospective, or carry forward, basis, and any unused losses may have been carried forward up to 20 years. To ultimately recognize any bad loan-related loss, loans must be disposed of or charged off. For institutions with less than \$500 million in assets, additions to bad debt reserves alone also qualify as realized losses.

## Will Notice 2008-83 Become a “Game Changer”?

Now, with the issuance of Notice 2008-83, the Treasury treats pre-acquisition NUBILs of target banking institutions as though they were generated post-acquisition, hence they are exempt from §382 treatment altogether. This impacts NUBIL tax benefits in two ways:

- Because they are not subject to §382 in *any way*, NUBILs now can be deducted without either a lower or upper limit in any given year. Only pre-acquisition NOLs would still be subject to §382.
- Also, as they are now treated as generated post-acquisition, NUBILs are like any other ordinary loss, and hence can be carried back or forward at the election of the acquirer.

In real terms, NUBILs are now vastly more valuable. Whether carrying back or forward, the removal of the limit allows an acquirer to use the entire slug of NUBIL deductions as soon as desired rather than over multiple years (as long as an acquiring company has the income to offset), hence increasing their present value. Furthermore, below are additional useful points we believe an acquirer should consider regarding this Notice:

- The carry back or forward option furthers the flexibility by allowing an acquirer access to an immediate refund check from the IRS or the opportunity to delay the tax benefit to future years when a higher marginal tax rate may be in place.
  - If carrying back, the structure of the transaction determines if it is the buyer or seller’s standalone income that can be offset.
  - If the seller survives as a separate subsidiary, then the *seller’s* previous income can be offset; if the seller does not survive as a separate subsidiary, then only the buyer’s previous income can be offset.
- In addition to determining if it is the seller’s or buyer’s previous income that is offset, it should also be noted that there will have to be actual positive income in one or both of the last two years for the carry back to be applicable at all.
- As for the carry forward, the consolidated pro forma income can be offset as a whole regardless of whether a separate subsidiary exists of the legacy selling institution.

## Wells Fargo and Wachovia: Reaping the Benefits of Notice 2008-83

The Notice to interpret §382, essentially allowing a different application §382 for acquirers of banks, was a key factor of the Wells Fargo and Wachovia transaction, announced on October 3, 2008. Under the legacy §382, Wells would have been limited to both the pre-acquisition NOLs *and* the post-acquisition NUBILs. With an estimated \$38 billion in pretax NOLs for Wachovia in 2008 (based on a \$38 billion reported loss through the third quarter), and another \$74 billion in Wachovia NUBILs that Wells would write off after assuming control, there would be a total of \$112 billion in total losses associated with the target institution. However, as Wells only paid \$15 billion for Wachovia, the limit dictates that just \$675 million per year could be used by the pro forma Wells to offset future income. Under such a limit, it would have taken 166 years (\$112 billion/\$675 million) to fully exhaust the combined tax benefit if such time were allowed—unfortunately, the benefit terminates after a carry forward of 20 years. That said, only \$13.5 billion (\$675 million\*20 years) of \$112 billion of losses could have been used to offset income in aggregate. However, when factoring in a discount rate over a 20 year period, the usable losses become even less valuable. With \$38 billion in NOLs, there is *more* than enough NOL to fully exhaust this \$13.5 billion allowable deduction on its own. Therefore, previously, if there would have been any NUBIL recognition by Wells after the deal closed—which we know is the case—there would have been no tax benefit to Wells.

But the Notice issued by the Treasury allows this NUBIL recognition to be treated completely independent of §382 by deeming it generated *post-acquisition* by the pro forma entity. As such, the NUBIL tax benefit can be *fully* utilized to the extent of annual income rather than be limited to the §382 limit of \$675 million; moreover, this benefit can now be carried back or forward at the discretion of Wells.

First, with the carry back, both Wells and Wachovia had positive net income in 2006 and 2007 to offset. However, as this is a forward “Type A” reorganization where Wachovia will be merged into a Wells subsidiary and cease to exist as a separate entity, it will be treated as though Wachovia never existed as a taxpayer prior to the acquisition. Therefore, the NUBIL losses carried back by the pro forma Wells can only offset Wells’ standalone income, not that of Wachovia. Going forward, however,

the NUBIL loss will offset the consolidated income of the combined entity.

In calculating the value of the overall tax benefit to Wells on a pro forma basis, we estimate positive profitability for the pro forma franchise over the next 20 years, a 5% earnings growth rate, and 30% cost savings of legacy noninterest expenses of Wachovia. Using a 33% effective tax rate and a 7% discount rate, we project that the present value of *post-Notice* tax benefits under §382 would be \$25.1 billion, a \$22.5 billion increase over the *pre-Notice* tax benefits of \$2.6 billion. The Notice essentially creates a tax benefit for Wells that is nearly ten times the benefit available under the pre-Notice §382. In fact, it was the funds generated from the forthcoming tax refund alone that allowed Wells to pay for the Wachovia acquisition. Absent the refund, Wells would not have had the capital to do the deal. Clearly, the removal of NUBILs from the scope of §382 creates considerable hidden value for acquirers when absorbing a distressed depository institution. Potential acquirers should also be aware that, as part of the proposed economic stimulus package, the Obama Administration and Congressional Democrats are proposing to extend the two-year carry back period for NOL usage to five-years—although this part of the legislation is still in preliminary stages and would likely face heated opposition.

However, the good times may not last forever. For the last month or so, Congress has been questioning whether or not the Treasury had the legal authority to enact the Notice. Two bills that were introduced in late November aim to reverse the Notice. One bill, authored by Bernard Sanders (I-VT), attempts to declare the Notice null and void retroactively to the Notice's original issue date. The other bill, authored by Lloyd Doggett (D-TX), also aims to nullify the Notice, but only on a prospective basis, hence preserving the benefits of the Notice for those mergers and acquisitions that were announced or completed in the interim period. In speaking with various contacts, it is our view that if legislation is passed to nullify the Notice, Congress will *not* make it retroactive but, instead, would only make the changes prospective.

### **Other M&A Accounting Changes**

Besides the §382 Notice, there are other M&A accounting changes that recently have taken effect, which are likely to have an impact on the banking industry and the overall financial services sector. Of interest is the issuance by the Financial Accounting Standards Board

(FASB) of SFAS 141R, Business Combinations, a year ago to take effect in the first quarter of 2009. SFAS 141R brings material changes to M&A accounting, specifically with regard to the valuation measurement date, earnouts and transaction costs. First, in a deal in which stock consideration was issued, the acquirer's stock was previously valued at the *announcement* date for accounting purposes. With the enactment of SFAS 141R, this valuation is now performed at the *close* of a transaction. While the perceived impact of the deal's public disclosure on the acquirer's stock would still be priced into the deal terms, any unrelated events between the deal announcement and the deal close affecting the stock price would now affect aggregate consideration recorded for the transaction. As a result, more or less goodwill (or gain, in the event of a bargain purchase) would be recorded than under the old rule. Second, cash earnouts that had reduced goodwill will be recorded through earnings going forward. This may result in volatile reported earnings for an acquirer from period to period. Finally, transaction-related costs from attorneys, financial advisors, and other sources can no longer be capitalized and similarly must be channeled through earnings.

As the banking environment continues to deteriorate for much of the industry, the federal government is encouraging and subsidizing consolidation—as evidenced by the Notice on §382. Consolidation opportunities will continue to emerge and those well positioned and capitalized will be able to take advantage of a variety of business and acquisition opportunities. Specifically, if you want to benefit from the Notice on §382, we suggest you act quickly given the bills before Congress seeking to revoke it. Hovde Financial has the background and experience needed to assist institutions in this opportunistic environment, and should you have any questions on §382, other accounting changes, or you see acquisition opportunities in your market which you would like to discuss, please feel free to contact us in Washington, D.C. at 202.775.8109, in Chicago at 847.991.6622, in Los Angeles at 310.535.9200, in Palm Beach at 561.279.7199, in Austin at 512.478.7575, or in Dallas at 972.888.1660 for a thorough discussion and analysis.



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