



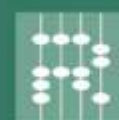
Weigh Tax Implications Before Buying Failing Bank

WHITE PAPER

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As the real estate market began to decline, with a resulting rise in credit defaults, analysts and financial commentators suggested the potential for multiple bank failures as financial institutions would be required to write down the value of their mortgage assets.

Maryland's financial institutions are not immune to this situation. In fact, there is a strong possibility that some Maryland banks are at risk for failure. These economic conditions have created an environment where well-capitalized and financially stable financial institutions can acquire weaker, vulnerable financial institutions at bargain prices. Therefore, a key component of the financial analysis undertaken by an acquiring company is a comprehensive evaluation of the tax implications of the potential purchase.

Given current economic conditions, it should be expected that any financial institution being considered for acquisition will have losses associated with its mortgage portfolio that may not have been reported for tax purposes at the time of acquisition. Prior to Sept. 30, a company acquiring the stock of another company with loan losses would write off the loan for tax purposes with the loss subject to limitations.

These limitations would mean that a company with significant losses built into the assets it is acquiring would be restricted in claiming those losses for tax purposes. In some cases, this limitation had a major impact on the purchase decision. As the economy and the financial sector continued to decline, the government recognized that it could not afford to bailout, recapitalize or take over every ailing financial institution. In an effort to facilitate the acquisition of weaker, less economically viable financial institutions by other private institutions, the Internal Revenue Service issued a notice modifying existing tax provisions.

The new IRS provisions allow acquiring companies to deduct losses associated with loans or bad debts. These include additions to tax bad debt reserves related to acquired assets without the limitations previously imposed. This modification can significantly impact the economic analysis and expected tax benefits for the acquiring corporation. Depending upon the portfolio value of the financial institution being acquired, the purchaser may be able to eliminate its current tax liability and also have excess losses carried back to an earlier year and then brought forward. There is speculation that banks like PNC and Wells Fargo will take advantage of the new pronouncements and apply them to recent acquisitions.

The issuance of the notice has sparked some controversy. Some lawmakers have expressed concern that Treasury has overstepped its authority and disregarded congressional intent with the notice. Treasury Secretary Henry Paulson has said he believes the issuance of the notice was legal and within the authority of the IRS. A bill was recently introduced that seeks to determine if, by issuing the notice, the IRS exceeded its authority. The bill as written keeps the notice issued by the IRS in effect until Congress makes its determination on whether to override the notice.

This new provision only applies to losses associated with loans or bad debts. If a financial institution incurred operating losses in earlier years, or has net operating loss carryovers at the time of acquisition, limitations will still apply to these losses. It is not necessary to have a complete change in ownership to have the loss limitation rules apply. They will apply as long as there is a "significant" change in ownership. For private banks that are currently raising additional capital, it will be important to structure transactions so that they do not violate the new rules. It should be noted that the purchase of stock by the government is not considered when determining if there is a change in ownership.