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SPECIAL REPORT
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Section 597 and FDIC Financing: A Toxic Mix

by Eli Dubin

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In this report, Dubin examines the tax treatment of purchasers of loan assets from banks in FDIC receivership, focusing on the negative consequences of combining FDIC purchase money financing with other forms of FDIC assistance, particularly loss-sharing agreements.

The views expressed here are the author's and not those of Sullivan & Cromwell.

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The bank[1] failures of recent months have brought renewed attention to the workings of section 597 and the related Treasury regulations (the section 597 rules). Those rules are intended to ensure that assistance provided by the FDIC is properly taxed to its recipient. The section 597 rules generally apply to banks in receivership and are therefore relevant only in times of bank crises. Because those crises occur infrequently, the scope and application of the rules have not drawn much attention from commentators and practitioners. Moreover, transactions that implicate the section 597 rules are typically completed on a tight timeline, driven entirely by nontax concerns. So when there is ambiguity for which the purchaser would like clarity, there is generally no time to obtain a ruling from the IRS before the closing, and the added tax risk introduces additional cost for a purchaser.

As currently interpreted, the section 597 rules can produce counterintuitive results that are not justified based on sound tax policy and that increase the costs of auctioning the assets of a failed bank. This report describes the background and operation of the section 597 rules and how they apply to the purchaser of the assets of a failed bank. It then examines the ramifications of using purchase money financing provided by the FDIC and demonstrates how the operation of the section 597 rules in that context is inconsistent with general tax principles. It also explores the severe timing mismatches, as well as potential character mismatches, that can result from combining loss-sharing agreements and purchase money financing from the FDIC.

[1] Use of the term "bank" throughout this report includes domestic building and loan associations that are subject to the section 597 rules in the same manner as banks. Reg. section 1.597-1(b).

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I. The FDIC and Section 597

A. The FDIC Authority in a Bank Failure

In a typical bank failure, the FDIC is appointed receiver by the chartering authority and is empowered to resolve the bank's insolvency in the least costly manner. This could include a payout to depositors, accompanied by a liquidation of assets or a purchase and assumption transaction with a third-party institution.[2] Almost all bank resolutions have been completed through purchase and assumption transactions in which the FDIC sells some or all of the bank's assets to a third-party institution that assumes the bank's deposit liabilities. When the acquiring institution doesn't acquire all the assets of the failed bank, the FDIC later conducts auctions to sell them. These asset-only sales attract a wider set of buyers, including private equity firms, because a banking charter is not necessary to acquire bank loan assets. The FDIC has many tools to facilitate these sale transactions, including (1) providing financing to the purchaser in the form of a purchase money note or (2) entering into a loss-sharing agreement effectively guaranteeing the performance of the sold assets under agreed terms.[3] That authority extends to both bank and nonbank purchasers, such as private equity investors.[4]

Broadly, a loss-sharing agreement is a separate agreement between the purchaser and the FDIC under which the FDIC agrees to bear an agreed portion of any losses that a purchaser would otherwise bear in connection with the loan.[5] The losses covered by the agreement are calculated by reference to the value of the loans on the bank's books and are generally not intended to cover losses related to increased interest rates.[6] Loan assets that are covered by a loss-sharing agreement benefit from a lower risk-weighting and thus lower bank capital ratios. In other words, a loan portfolio subject to a loss-sharing agreement requires less capital to be held against it by a bank, compared with the same portfolio without the agreement.[7]

The FDIC can also utilize purchase money financing to facilitate the sale, which can be beneficial for both the purchaser and the FDIC. For the purchaser, the FDIC may be willing to lend at a rate that is more favorable than what is otherwise available to the purchaser, and from the FDIC's perspective, purchase money financing may expand the universe of potential purchasers and ultimately bring about a better purchase price for the assets.

B. Section 597

Before 1981, the general view was that assistance provided by the FDIC or similar agencies was excludable from gross income as a non-shareholder capital contribution under section 118,[8] but it had zero basis in the hands of the recipient under section 362(c).[9] As part of the response to the savings and loan (S&L) crisis of the early 1980s, the Economic Recovery Tax Act of 1981 added section 597 to the code. It provided that any money or other property received from the Federal Savings and Loan Insurance Co. (FSLIC) was excluded from gross income

[2] FDIC, *Crisis and Response: An FDIC History, 2008-2013*, at 177-178 (2017).

[3] Federal Deposit Insurance Act (FDIA) section 13(c), 12 U.S.C. 1823(c).

[4] Private equity investors acquire a significant percentage of failed bank assets. During the crisis years of 2008-2013, private-equity-backed acquirers purchased at least 22 percent of the assets of all failed banks. FDIC, "Private-Equity-Backed Acquisitions of Failed Banks, 2008-2013," Rep. No. 2021-01, at 20 (June 2021).

[5] William R. Baxter, Ryan D. Sheller, and Robert F. Storch, "FDIC Loss-Sharing Agreements: A Primer," FDIC Supervisory Insights (Summer 2010) (FDIC primer). Generally, losses from bulk sales are allowed only if approved by the FDIC before the sale. *Id.* at 3.

[6] *Id*. at 5. One example is the shared-loss agreement between the FDIC and First-Citizens Bank and Trust Co. on commercial loans of former Silicon Valley Bridge Bank NA purchased by First-Citizens. *See* FDIC release PR-23-2023 (Mar. 26, 2023). *See also* FDIC "Shared Loss" (last updated July 5, 2023).

[7] 12 C.F.R. section 217.32(a)(1)(ii); RIN 7100-AD 87, 78 F.R. 62018, 62083 n.127 (Oct. 11, 2013) (final rule revising capital requirements for banks, indicating that a loss-sharing agreement should generally be treated as a conditionally guaranteed exposure eligible for 20-percent-risk weighting). *See also* Matt Levine, "JPMorgan Got a Deal on First Republic," Bloomberg (May 1, 2023).

[8] *See* LTR 8243025; and 127 *Cong. Rec.* S.17128 (daily ed. July 23, 1981) (letter from Richard T. Pratt, chair, Federal Home Loan Bank Board, to Sen. Rudy Boschwitz). The current version of section 118 provides that a contribution by a governmental entity is not treated as a capital contribution. Section 118(b)(2). That provision was added by section 13312(a)(3) of the Tax Cuts and Jobs Act of 2017.

[9] Janet R. Spragens, "Saving the Savings and Loan Industry: Tax Consequences of Financial Assistance Payments to Troubled Thrifts," 15 *J. Corp. Tax.* 217, 229 (1988).

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"regardless of whether any note or other instrument is issued in exchange therefor" and that no reduction in the basis of the assets of an S&L would be made as a result of that assistance.[10] The quoted language appears to have been driven by the fact that the FSLIC's primary form of assistance at the time was income capital certificates, which were issued in exchange for notes.[11] However, the exact purpose of the language is unclear since there would be no income event regardless of whether the form of the note was disregarded.

After Treasury expressed opposition to this provision,[12] section 597 was repealed by the Tax Reform Act of 1986, effective as of 1989.[13] In 1988 the Technical and Miscellaneous Revenue Act of 1988 extended the effective date of the repeal to January 1, 1990, and in the interim, section 597 was amended to provide that assistance payments from the FDIC to banks were also excluded from gross income.[14]

In 1989 Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which amended section 597.[15] As amended, section 597 provides a sweeping grant of authority to Treasury to issue regulations providing for federal financial assistance (FFA) to be properly "taken into account" by the failed bank and providing for the allocation of basis among the acquired assets.[16] The statute defines FFA broadly to include any money provided by the FDIC or other similar agencies in connection with the purchase of assets from a failing bank "regardless of whether any note or other instrument is issued in exchange therefor."[17]

According to the legislative history, Congress amended section 597 because it believed that providing tax subsidies to financially troubled institutions was an inefficient way to help them.[18] The legislative history does not indicate any intent to impose taxes on taxpayers in excess of the economic benefit resulting from any money received from the FDIC, nor does it indicate that Congress intended for amounts not includable in income under general federal income tax principles to be included in income under section 597.

Pending the issuance of regulations, the House committee report accompanying the amendments provided interim guidance for taxable asset acquisitions from failed banks. It provided that any assistance would be treated as provided to the failed bank before the transfer but that it was anticipated that those income inclusions would generally be offset by net operating losses of the failed bank.[19] The report noted that the assistance payments "generally will be taxable to the acquiring financial institution only to the extent that they exceed basis properly allocable to such payments."[20] The report also specified that basis allocations for certain types of assistance payments should be adjusted to reflect their economic substance.[21] It did not address purchase money financing or the general rule under section 597 disregarding the issuance of a note.

Shortly after passage of the amendments to section 597, the IRS issued Notice 89-102, 1989-2 C.B. 436, providing preliminary guidance. Like the committee report, the notice did not address purchase money financing or the general rule under section 597 disregarding the issuance of a note.

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[10] Economic Recovery Tax Act of 1981, section 244.

[11] *See* 127 *Cong. Rec.* S.17128, *supra* note 8. An income capital certificate provided for annual income payments in exchange for notes from the FSLIC, but only if the S&L had sufficient net income. The S&Ls were allowed to treat the certificates as permanent equity and the notes from the FSLIC as cash equivalents. 46 F.R. 45593 (Sept. 4, 1981) (final rules defining securities constituting permanent equity). *See* FDIC, *An Examination of the Banking Crises of the 1980s and Early 1990s*, 173-174; and "Pratt Discusses the Bank Board's Proposed Thrift Institutions Restructuring Act," 14 *Fed. Home Loan Bank Bd. J.* 2 (Oct. 1981). In 1982 Congress authorized a modified form of the income capital certificate, the "net worth certificate," which the FSLIC and the FDIC could purchase from S&Ls and insured banks, respectively. Garn-St. Germain Depository Institutions Act of 1982, sections 202 and 203.

[12] Spragens, *supra* note 9, at 226.

[13] TRA 1986, section 904(b)(1).

[14] TAMRA section 4012.

[15] FIRREA section 1401(a)(3)(A).

[16] Section 597(b).

[17] Section 597(c).

[18] H.R. Rep. No. 101-54 (pt. 2) at 25 (May 22, 1989).

[19] *Id*. at 27.

[20] *Id*.

[21] *Id*. at 28-29. It provided that basis be allocated first to cash contributions or notes issued by the FDIC and that the fair market value of assets covered by capital loss guarantees or income maintenance agreements be adjusted to reflect their FMV, including the value of those guarantees or agreements.

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In 1992 Treasury and the IRS issued proposed regulations under section 597 (FI-46-89). The preamble described four principles that the regulations are intended to reflect, which it 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.[22]

In 1995 Treasury and the IRS issued final regulations under section 597 (T.D. 8641). The final regulations did not change the fundamental approach of the proposed regulations or the principles they were intended to reflect. However, they implemented some changes to the operation of the section 597 rules, particularly to the scope of acquisitions subject to the rules and to the adjustments to amounts included in income under those rules.[23]

II. Operation of Section 597 Regulations

A. Federal Financial Assistance

The general rule is that all FFA is includable in ordinary income at the time that the FFA is received or accrued.[24] FFA includes any money or property provided to an institution (for example, a bank) by an agency (for example, the FDIC) under specified statutory authorities or similar provisions of law.[25] However, the amount included in income in a given year is limited by a formula that is intended to limit the inclusion to previously recognized losses and losses in the current year.[26] A bank that defers the inclusion of FFA under these rules must establish a deferred FFA account and include that deferred FFA in income in later years, but only to the extent that the bank's losses are greater than the value of its remaining equity.[27]

If a bank or any member of its affiliate group makes a payment of money or property to the FDIC (other than for FDIC deposit insurance premiums), the bank first reduces the amount of FFA that would be included in income in the year of that payment, and it then reduces the balance in the deferred FFA account.[28] If the payment was greater than the remaining FFA to be included in income, the bank can deduct that excess, but only to the extent of prior FFA income inclusions.[29] Any

[22] Preamble to FI-46-89, 57 F.R. 14804, 14805 (Apr. 23, 1992).

[23] *See* preamble T.D. 8641, 60 F.R. 66091, 66093 (Dec. 21, 1995). In 2015 Treasury and the IRS issued proposed regulations amending the section 597 regulations. REG-140991-09. Those amendments are largely irrelevant to the subject of this report, and they were adopted as final in 2017 with only non-substantive changes. T.D. 9825.

[24] Reg. section 1.597-2(a).

[25] Reg. section 1.597-1(b). The specified statutory authorities are section 406(f) of the National Housing Act (12 U.S.C. section 1729(f)); section 21A(b)(4) of the Federal Home Loan Bank Act (12 U.S.C. section 1441a(b)(4)); and section 11(f) and 13(c) of the FDIA (12 U.S.C. section 1821(f) and 1823(c)). FDIA section 11(f) authorizes the FDIC to pay insured deposits, and FDIA section 13(c) authorizes it to provide assistance to insured depository institutions. The term "institution" refers to a bank or domestic building and loan association, and the term "agency" refers to the Resolution Trust Corp., the FDIC, or any similar instrumentality of the U.S. government. For convenience, this report refers to the FDIC and "agency" interchangeably. It is unclear whether a Federal Reserve bank or a Federal home loan bank would be treated as a "similar instrumentality" for this purpose.

[26] Reg. section 1.597-2(c)(2). The specific formula limits the amount included in income to the sum of (1) the excess, at the beginning of the tax year, of the bank's liabilities over its adjusted bases in its assets, and (2) the amount by which the excess of the bank's deductions (excluding NOL and capital loss carryovers) is greater than the excess of its assets over its liabilities. This formula applies only to banks that are in receivership or being sold. The inclusion of FFA for banks that are not in receivership or being sold is limited by a different formula. Reg. section 1.597-2(c)(3).

[27] Reg. section 1.597-2(c)(4)(ii) and (iii). The bank's remaining equity is the sum of the bases of (1) the bank's assets less its liabilities *plus* (2) its taxable income in subsequent years and *minus* (3) the bank's losses in those subsequent years. Reg. section 1.597-2(c)(4)(iii)(A)(2). If a bank is not in receivership or being sold, it includes an amount equal to its current losses. A bank can also elect to include the entire balance of its deferred FFA account in income in any year in which it is no longer in receivership and no agency has the right to appoint any of its directors. Reg. section 1.597-2(c)(4)(v).

[28] Reg. section 1.597-2(d)(5)(i).

[29] Reg. section 1.597-2(d)(5)(ii).

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additional amounts are deductible by a failed bank to the extent that they exceed the amount that the bank was required to pay to the FDIC for amounts paid by the FDIC to insured depositors.[30] For purchasers (or deemed purchasers) of the bank's assets, any adjustments to FFA exceeding prior and future FFA income inclusions are treated as an adjustment to the purchase price of those assets.[31]

The section 597 regulations use the term "loss guarantee" to describe loss-sharing agreements (and any other agreement under which the FDIC guarantees or agrees to pay a specified amount on disposition or charge-off of loan assets), and they use the term "covered asset" to describe assets covered by a loss guarantee.[32] Although payments made under a loss guarantee are included in the definition of FFA,[33] they are not subject to the FFA inclusion rules described above. Instead, the payments under the loss guarantee are included in the amount realized for the covered asset.[34] In other words, if assets covered by a loss-sharing agreement are sold for $100 million and the FDIC is required to pay the seller $20 million under the terms of the loss-sharing agreement, the seller will be treated as realizing $120 million on the sale.

B. Taxable Transfers

The section 597 regulations provide special rules applicable to sales of loan assets of the failed bank. Those rules implement the principle that the tax consequences of an assisted sale should not depend on its form. Accordingly, they treat stock transactions in which control of the bank is transferred as deemed asset sales to a new entity, which is treated as having purchased the assets of the failed bank in an asset sale.[35]

These section 597 rules apply to taxable transfers. Three types of transactions are treated as taxable transfers for purposes of the section 597 regulations: (1) a transaction in which deposit liabilities are assumed and FFA is provided in connection with the transaction;[36] (2) a transaction in which assets for which an agency could have a financial obligation, such as loan assets covered by a loss-sharing agreement, are transferred;[37] and (3) a deemed transfer of assets to a new entity.[38]

The rules provide that any "net worth assistance" provided to Acquiring (defined as a corporate transferee in a taxable transfer[39]) is treated as having been received by the failed bank before the transfer and then sold to Acquiring.[40] Net worth assistance is money or property that the FDIC provides as an integral part of a taxable transfer.[41] Although this rule requires the transferor to include the net worth assistance in income as FFA, that inclusion generally is nontaxable because the inclusion of FFA will typically be offset by NOLs and other losses.[42]

Example 1. Bank A, a failed bank, has $10 billion of deposit liabilities, and its loan assets have a book value of $12 billion and a fair market value of $8 billion. The FDIC auctions Bank A, and Bank B agrees to purchase Bank A's loan assets in exchange for the assumption of Bank A's deposit liabilities and a $2 billion cash payment from the FDIC. The $2 billion is included in Bank A's gross income. That inclusion will be offset by the $4 billion loss triggered by the sale of the loan assets. For the purchaser (Bank B), the $2 billion is treated as an asset included in the sale, and Bank B's purchase price of $10 billion (that is, the $10 billion of assumed deposit liabilities) will be allocated among the $8 billion of loan assets and the $2 billion of cash (net worth assistance).

The amount realized by the selling bank in a taxable transfer is equal to the consideration paid (or deposit liabilities assumed) for the assets, or, in the case of a deemed asset sale, the grossed-up basis of the acquired stock plus the amount of

[30] Reg. section 1.597-2(d)(5)(iii)(A).

[31] Reg. section 1.597-2(d)(5)(iii)(B).

[32] Reg. section 1.597-1(b). For convenience, this report refers to loss-sharing agreements and loss guarantees interchangeably.

[33] Reg. section 1.597-1(b).

[34] Reg. section 1.597-2(d)(2).

[35] Reg. section 1.597-5(b). The specific transactions in which control is deemed transferred include those in which a corporation disaffiliates from a consolidated group, becomes a member of another consolidated group, or issues stock sufficient to dilute the prior ownership to less than 50 percent.

[36] Reg. section 1.597-5(a)(1)(i)(A).

[37] Reg. section 1.597-5(a)(1)(i)(B).

[38] Reg. section 1.597-5(a)(1)(ii).

[39] Reg. section 1.597-1(b).

[40] Reg. section 1.597-5(c)(1).

[41] *Id.*

[42] *See* H.R. Rep. No. 101-54 (pt. 2) at 27; and preamble to REG-140991-09, 80 F.R. 28872, 28873 (May 20, 2015).

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liabilities assumed or taken subject to in the transfer, plus other "relevant items."[43] That amount realized is allocated under the principles of reg. section 1.338-6(b), (c)(1), and (c)(2).[44] However, the allocation rules are revised to provide that covered assets are treated as Class II assets.[45]

Acquiring's purchase price is equal to the cost of the assets acquired, but the section 597 regulations state that "FFA provided in connection with a Taxable Transfer is not included in the New Entity's or the Acquiring's purchase price for the acquired assets."[46] The section 597 regulations further provide that the basis in the acquired assets is also allocated under the rules of reg. section 1.338-6(b), (c)(1), and (c)(2), with the identical modifications concerning covered assets being treated as Class II assets.[47] Net worth assistance is treated as an asset acquired by Acquiring or the new entity in the taxable transfer, and no basis is allocated to any loss-sharing agreement or similar item.[48]

Finally, the section 597 regulations provide that the basis of Class I and Class II assets is considered equal to their FMV, and if the FMV exceeds the purchase price of the acquired assets, that excess must be included ratably as ordinary income over a six-year period beginning in the year of the taxable transfer (unless accelerated by a change in method of accounting).[49] The FMV of a covered asset is its "expected value," which is equal to the sum of (1) the price that would be paid for any covered asset in the absence of a loss guarantee (third-party price) and (2) the amount that the FDIC would be required to pay if the covered asset were sold in the market.[50]

The operation of these rules is illustrated in Example 2.

Example 2. Bank A has deposit liabilities of $76 billion and loan assets with a book value of $100 billion. A third party would be willing to pay $60 billion for the loan assets. Bank B assumes the deposit liabilities in exchange for the loan assets. The FDIC enters into a loss-sharing agreement with Bank B under which the FDIC will absorb 80 percent of any losses exceeding $5 billion. If all the loan assets were disposed of for $60 billion in compliance with the terms of the loss-sharing agreement, the FDIC would be required to pay Bank B $28 billion — that is, 80 percent of the loss of $35 billion ($40 billion less the $5 billion first-loss tranche). Because the loan assets are covered assets, their FMV is $88 billion (the expected value). Because the $88 billion FMV of the loan assets exceeds the value of the purchase price by $12 billion, the rules described above would require that $2 billion each year be included in ordinary income over the six-year period beginning in the year of the taxable transfer.

This application of the section 597 rules is reasonable. It reflects the intent expressed in the legislative history that FFA be taxable to a purchaser of assets in a taxable transfer to the extent that the assistance exceeds the basis properly allocable to that payment.[51] Bank B in this instance is paying $76 billion for an asset that has an economic value of $88 billion because of assistance provided by the FDIC, and it is consistent with general income tax principles that Bank B be taxed on the difference between what it pays and what it gets.

[43] Reg. section 1.597-5(c)(2). The grossed-up basis is equal to the acquirer's basis in the stock divided by the percentage of the bank's value that the stock represents. For example, if the acquirer assumes 85 percent of the stock for $85, the grossed-up basis would be $85 divided by 85 percent, or $100.

[44] Reg. section 1.597-5(c)(2) and (3).

[45] Reg. section 1.597-5(c)(3)(ii). Class II assets are actively traded personal property (including U.S. government securities and publicly traded stock), certificates of deposit, and foreign currency. Reg. section 1.338-6(b)(2)(ii).

[46] Reg. section 1.597-5(d)(1).

[47] Reg. section 1.597-5(d)(2)(ii).

[48] *Id*.

[49] Reg. section 1.597-5(d)(2)(iii).

[50] Reg. section 1.597-1(b). Because a loss-sharing agreement generally covers multiple assets, the section 597 regulations provide that the amount that the FDIC would have to pay for any specific asset is determined using the percentage of losses that the FDIC would be required to pay if all assets covered by a loss-sharing agreement were disposed of at their market price as determined at the time of transfer (the average reimbursement rate).

[51] H.R. Rep. No. 101-54 (pt. 2) at 27.

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C. Disregarding Debt or Equity Issuances

Section 597 specifies that money or property provided by the FDIC is treated as FFA "regardless of whether any note or other instrument is issued in exchange therefor."[52] This drafting mirrors the language of section 597 before its amendment in 1989, which provided that "gross income of a bank does not include any amount of money or other property received from the [FDIC] . . . regardless of whether any note or other instrument is issued in exchange therefor."[53]

The section 597 regulations address the rule disregarding debt or other instruments in two places. The first is in the definition of FFA, which provides that money or property provided by an agency to an institution (or a direct or indirect owner of stock in an institution) is FFA "regardless of whether the Institution or any of its affiliates issues Agency a note or other obligation, stock, warrants, or other rights to acquire stock in connection with Agency's provision of the money or property."[54] The section 597 regulations also provide a separate rule specifying that debt instruments, stock, warrants, or other rights to acquire stock of an institution (or any of its affiliates) that an agency or a controlled entity[55] receives in connection with a transaction in which FFA is provided "are not treated as debt, stock, or other equity interests of or in the issuer for any purpose of the Internal Revenue Code while held by an Agency or a Controlled Entity."[56] Because any such instruments are disregarded and the amounts paid by an agency for those instruments are treated as FFA, any payments from the bank to the agency in respect of those instruments should be treated as adjustments to FFA under the rules described above.[57]

The basis for this rule is that "economically equivalent transactions should be treated uniformly" and that it "furthers the general principles that all FFA should be taxed," according to the preamble to the 1992 proposed regulations.[58] The preamble also noted that under this rule, an agency's decision regarding whether to take any type of instrument of the recipient as consideration for FFA is tax neutral.[59] This rule makes sense in the context of an instrument issued by a failed bank, whose debt or equity likely has no meaningful economic value.[60] The example provided in the section 597 regulations relates to a debt instrument issued by a bank in receivership and illustrates the economic neutrality between a failed bank issuing a note in exchange for FFA or receiving the FFA outright.[61] In the context of financing provided by the FDIC to a purchaser, however, this rule, if applied in the same way, would not seem to have any logical basis. It is to that application of the section 597 rules that the next part of this report turns.

III. Purchase Money Financing

A. Disregarding Purchase Money Financing

As mentioned, the legislative history of section 597 does not appear to have contemplated that the rule disregarding debt instruments would apply to purchase money financing provided to a third-party purchaser. The first clear indication of that view appears in the preamble to the final section 597 regulations promulgated in 1995.[62]

The rules proposed in 1992 concerning adjustments to FFA were less comprehensive than those ultimately promulgated in 1995. The proposed rules provided that adjustments to FFA were limited to the amount of FFA otherwise includable for the tax year and the balance of the

[52]Section 597(c).

[53]Former section 597(a) (before amendment by FIRREA).

[54]Reg. section 1.597-1(b).

[55]A controlled entity is an entity controlled by an agency, such as a bank in agency receivership. Reg. section 1.597-1(b).

[56]Reg. section 1.597-3(b).

[57]Preamble to FI-46-89, 57 F.R. at 14806.

[58]*Id*. at 14805.

[59]*Id*.

[60]*See* New York State Bar Association Tax Section, "Report on FDIC-Assisted Taxable Acquisitions" (Apr. 30, 2010) (NYSBA report).

[61]Reg. section 1.597-2(e), Example 1(ii).

[62]In LTR 9222012, the IRS took the view that a note issued to the Resolution Trust Corp. by a purchaser was disregarded under section 597(c) and therefore treated as provided to the target immediately before the sale of the assets of the target under Notice 89-102. However, it is not completely clear whether the purchaser at issue in the ruling was a third-party purchaser.

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deferred FFA account, and that any excess could be deducted to the extent of previous FFA inclusions.[63] In the preamble to the final section 597 regulations, Treasury and the IRS acknowledged that the relief provided under the proposed regulations was limited with respect to a new entity or acquiring entity because they receive little or no FFA.[64] However, the preamble explained that an assisted acquisition could result in income to a new entity or acquiring entity in the form of built-in gain because "an instrument issued to Agency by a New Entity or Acquiring is, in effect, disregarded. If a New Entity or Acquiring issues its instrument to Agency in connection with the acquisition of an Institution, the value of the instrument is not included in the purchase price."[65] It further explained that the rule providing that adjustments to FFA by a new entity or Acquiring are treated as an adjustment to the purchase price paid in a taxable transfer was intended to provide a basis adjustment in that scenario.[66]

In 2010, after a wave of bank failures, the New York State Bar Association Tax Section issued a report commenting on the application of the section 597 rules to taxable acquisitions of failed financial institutions.[67] The report gives the following example of how the rule disregarding debt instruments operates in the context of a taxable transfer:

> 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, 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. 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). Bank's basis in the acquired assets will therefore equal $20.[68]

In that example, the acquisition is a taxable transfer because deposit liabilities are being assumed, but the assets are not covered assets. Therefore, the rule requiring an inclusion in income over six years does not apply. Rather, the assets simply have an artificially low basis, the basis of the acquired assets will be increased pro rata by each payment to the FDIC, and the portion of the payment equal to the interest on the note will be allocated to goodwill.[69] As the NYSBA Tax Section report explains, this application of the rules results primarily in a timing mismatch. The reason for that is that even though the purchaser may be required to include more than its economic gain on the disposition of a loan asset as a result of its having an artificially low basis, the purchaser will increase its basis in the remaining loan assets and recognize additional losses on the previously sold assets as it makes payments on the FDIC note.[70]

If a nonbank purchaser were subject to the above application of the section 597 rules, it would seem to similarly result primarily in a timing mismatch. The artificially inflated gain would be recognized on the sale of capital loan assets, and the losses realized as a result of later adjustments to the basis of the remaining or previously sold loan assets would similarly be capital losses.[71] The interest expense, which would be an ordinary deduction, would be amortized as

[63] Former prop. reg. section 1.597-2(d).

[64] Preamble to T.D. 8641, 60 F.R. at 66092.

[65] *Id*.

[66] *Id*. *See* reg. section 1.597-2(d)(5)(iii)(B).

[67] NYSBA report, *supra* note 60.

[68] *Id*. at 14.

[69] *Id*. at 15. *See* reg. section 1.597-2(d)(5)(iii)(B).

[70] *Id*. *See* reg. section 1.338-7(b), (d)(1), and (e), Example 1(vi).

[71] Section 1221(a).

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goodwill instead, resulting similarly in ordinary losses, but deferred over a 15-year period.[72]

The NYSBA Tax Section report notes, however, that if both purchase money financing and a loss-sharing agreement are provided, more significant mismatches can occur.[73]

To illustrate the effect of these rules, particularly the effect of combining purchase money financing and loss-sharing agreements, consider examples 3, 4, and 5.

Example 3. Bank A is a failing regional bank. It has a portfolio of loan assets with a book value of $200 billion and deposit liabilities of $140 billion, with additional liabilities of $40 billion owed to the Federal Reserve. The loan assets have declined in market value because of rising interest rates and now have an FMV of $175 billion. Bank A is placed in FDIC receivership, and the FDIC seeks to have another bank assume Bank A's deposit liabilities. Bank B agrees to assume Bank A's deposit liabilities and to pay an additional $30 billion in exchange for Bank A's loan assets. Bank B finances the purchase using cash deposits.

In Example 3, section 597 will not apply to Bank B, which will have paid a purchase price of $170 billion for the loan assets (that is, $30 billion in cash plus $140 billion in assumed deposit liabilities) and will have a corresponding $170 billion basis in the loan assets. This result is consistent with the general application of the federal income tax rules for financed purchases. The borrowing from depositors is not a taxable event, and the borrowed funds are included in the purchase price of the assets, thereby generating basis for the purchaser in the assets.

Example 4. The facts are the same as in Example 3, except that, rather than using cash on hand, Bank B finances $30 billion of the purchase price by issuing a $30 billion note to the FDIC. The note has a five-year term and bears 3 percent interest.

Here, section 597 applies. Because the note issued by Bank B to the FDIC will be disregarded in determining Bank B's purchase price and its basis in the loan assets, Bank B will have a basis of $140 billion in the loan assets.

In Example 4, the rule would result in an artificially low basis in the loan assets and could give rise to an acceleration of income on disposition of the loan assets. Initially, payments on the note would increase the basis in the loan assets and, to the extent that Bank B had already recognized gain on the disposition of some or all of the loan assets, would entitle Bank B to an ordinary loss deduction.[74] Thus, if the bank doesn't dispose of the loan assets until the FDIC loan is repaid, the section 597 rules are perhaps of no consequence.[75] However, if Bank B disposes of the loan assets, the result is instead gain followed by an *Arrowsmith*-type loss.[76] After the value of the payments made on the note causes the sum of the deposit liabilities assumed and the payments made under the note to exceed the FMV of the loan assets, additional payments would be allocated to goodwill and could be amortized over 15 years.[77] For a nonbank purchaser without a trade or business (such as a private equity fund with unblocked foreign investors) purchasing loan assets subject to a loss-sharing agreement, it is not clear how or whether they would be entitled to a deduction for excess payments, given that they may be unable to allocate any amounts to goodwill.[78]

This rule is inconsistent with general tax principles regarding purchase financing. Under general tax principles, Bank B would include the $30 billion borrowed from the FDIC in its purchase price, which would give rise to additional basis in the purchased assets. The note issued by Bank B to the FDIC should be debt for tax purposes because it is expected to be repaid to the FDIC, and there is no discernible reason why purchase money financing provided to the purchaser by the FDIC should be treated differently from a tax perspective than purchase money financing provided by any other lender or by the bank's depositors.

[72]Section 197(a). *But see infra* text accompanying notes 85-86, noting that such amortization deductions may not be available for all nonbank purchasers and may not fully net against the amount that would have been deductible as interest.

[73]NYSBA report, *supra* note 60, at 16.

[74]*See supra* note 70.

[75]This example assumes that no election to accrue market discount on any of the loan assets under section 1276(b)(2) was made.

[76]*See Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

[77]*See supra* note 72.

[78]*See infra*, text accompanying notes 85-86.

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Example 5. As in Example 4, Bank B purchases loan assets with a book value of $200 billion and an FMV of $175 billion from Bank A in exchange for assuming $140 billion of deposit liabilities and $30 billion cash, which it finances through a note issued to the FDIC. Further, the FDIC and Bank B enter into a loss-sharing agreement. In this example, the FDIC will absorb 80 percent of any loss on the loans exceeding $5 billion. If the loan assets were sold at their current FMV in accordance with the terms of the loss-sharing agreement, the FDIC would be required to pay $16 billion to Bank B.

Under these facts, the consequences under the section 597 rules will be as follows: The purchase money financing provided by the FDIC will be disregarded in determining Bank B's purchase price. Therefore, its purchase price for the loan assets will be $140 billion. Because the loan assets are covered by a loss-sharing agreement, Bank B will be required to include the difference between (1) its $140 billion purchase price for the loan assets and (2) the sum of (A) the FMV of the loan assets ($175 billion) and (B) the $16 billion value of the loss-sharing agreement, which is the amount that the FDIC would be required to pay Bank B if the loan assets were sold for their FMV of $175 billion,[79] as ordinary income over the six-year period beginning in the year of the transfer. The difference between $140 billion and $191 billion (the sum of $175 billion and $16 billion) is $51 billion. Accordingly, Bank B will be required to include $51 billion in ordinary income over the six-year period ($8.5 billion per year). Bank B's basis in the loan assets will be $191 billion.

In Example 5, disregarding the FDIC note results not in an artificial reduction in basis, but rather in an artificial inflation of basis and an inclusion of $30 billion in ordinary income over six years for a loan from the FDIC that would otherwise be respected as debt for tax purposes. Moreover, as the NYSBA Tax Section report notes, it is unclear how the purchaser would account for repayment of the FDIC note in that example.[80] The most sensible position, according to the report, would be that principal payments on the FDIC note give rise to increased basis and offset prior- and current-year inclusions under the six-year inclusion rule. The report further notes, however, that there is no guidance on the question, and it concludes that in the absence of guidance, principal payments may be allocated to goodwill.[81] If the repayments are allocated to goodwill, that goodwill would be amortized over 15 years from the date of the purchase of the loan assets,[82] so the purchaser would be required to include the principal amount of any financing over six years beginning in the year of the taxable transfer but would only be able to amortize the repaid amounts over a 15-year period beginning at the time of the purchase of the loan assets.

For a bank purchaser, this scenario results in massive inclusions of income that will be reversed only by subsequent loss or amortization deductions in later years. Given the size of the inclusions, it may be many years before those losses can be fully used, resulting in a substantial time value cost. For a nonbank purchaser, this application can result in a severe character mismatch as well because nonbank purchasers aren't subject to the special character rules of section 582. Under section 582, any loan assets of a bank are treated as ordinary assets.[83] Accordingly, any loss on the disposition of the loan assets will not be a capital loss, and the character of the loss will match the character of the ordinary income included in the six-year period beginning in the year of the taxable transfer. However, a nonbank purchaser would generally be expected to be holding the acquired loan assets as a capital asset. The inclusion of income over the six-year period beginning in the year of the taxable transfer is an ordinary income inclusion.[84] However, if repayments on the FDIC

[79] There would be a $25 billion loss from the $200 billion book value, the first-loss tranche of $5 billion would be absorbed by Bank B, and the FDIC would be required to pay Bank B 80 percent of that loss.

[80] NYSBA Tax Section, *supra* note 60, at 16.

[81] *Id*. Although there are detailed rules in reg. section 1.597-2(d)(5) regarding making adjustments to FFA, those rules do not apply in this context because the six-year inclusion rule does not relate to an inclusion of FFA. The rule requires inclusion, over six years, of the excess of the FMV of the Class II assets over the purchaser's basis, but it does not treat that amount as FFA. An *Arrowsmith* type of analysis might apply to allow the purchaser to take deductions for the payments in an amount equal to any previously included income under the six-year inclusion rule (and adjust any remaining inclusions).

[82] Section 197(a).

[83] Section 582(c)(1).

[84] Reg. section 1.597-2(d)(2)(iii).

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note would result in an increased basis in the loan assets, that would only allow the purchaser to recognize a capital loss — which is less valuable than an ordinary loss — on the disposition of the loan assets. A nonbank purchaser may not have capital gains and therefore would be unable to use the capital losses.

This concern may be exacerbated for a private equity fund with foreign investors, who generally have less use for U.S. capital losses. In that case, those investors will have substantial inclusions of phantom income in the six-year period beginning in the year of the taxable transfer and may never get to offset those income inclusions with a corresponding deduction in a later year. Moreover, even if repayments of the purchase money financing are allocated to goodwill, which would generate ordinary income deductions, the character mismatch concerns will not be mitigated. Private equity funds with foreign investors take great pains to ensure that they are not engaged in a trade or business regarding their holding loan assets,[85] and a trade or business is a prerequisite for allocating amounts to goodwill.[86]

B. Recommendation and Response

As demonstrated by the examples above, the results under section 597 when a purchaser borrows money from the FDIC run counter to the purpose of the section 597 rules, and the results are further exacerbated if a loss-sharing agreement is entered into. It makes sense, of course, and is consistent with general tax principles, to not treat as debt a note issued by an entity with no means of repayment. And that indeed is what the definition in section 597(c) and the general rule under the section 597 regulations are intended to address, since obligations of a bank in receivership are generally not meaningful and should therefore not be respected.[87] Therefore, in the context of a bank in FDIC receivership issuing a debt instrument, this rule is consistent with Congress's intent that troubled financial institutions not receive more favorable treatment than other taxpayers.[88]

But in the context of a debt instrument issued by a purchaser of a failed bank, this concern is not applicable. The purchasing bank will generally be a creditworthy entity, and the debt is usually secured by the purchased loan assets.

The NYSBA Tax Section report recommended that the section 597 regulations be amended to "eliminate the general rule that ignores debt or equity issued to an agency in a taxable acquisition" and that Treasury and the IRS instead issue antiabuse rules that would disregard debt issued by an acquirer for which there is no reasonable expectation of payment at the time of issuance and defer any loss on an acquired asset until a corresponding amount has been included in income or has been repaid.[89] Even that rule is arguably unnecessary given general tax principles under common law, but it does allow for section 597(c) to retain some (albeit arguably redundant) meaning.

In the preamble to the 2015 proposed regulations (REG-140991-09), Treasury and the IRS appear to have explicitly rejected that recommendation from the NYSBA Tax Section report. The preamble notes that one commenter, presumably the NYSBA Tax Section, had supported eliminating the current rule disregarding any debt instruments, which the preamble described in parentheses as "resulting in an Institution's debt or equity issued to Agency being included in Acquiring's purchase price."[90] The preamble then stated that, after considering the comment, Treasury and the IRS believed that such a change would be inconsistent with section 597(c), which specifies that all amounts provided

[85] Kimberly S. Blanchard, "Cross-Border Tax Problems of Investment Funds," 60 *Tax Law.* 583 (2007); David R. Sicular and Emma Q. Sobol, "Selected Current Effectively Connected Income Issues for Investment Funds," 56 *Tax Law.* 719 (2003). Alternatively, foreign investors will invest through blocker corporations, but that introduces an additional layer of tax for those investors. Another concern for private equity funds with foreign investors in this context is whether the amounts included as ordinary income over six years under this rule are subject to fixed or determinable annual or periodic withholding. There appears to be no rule providing that they are not.

[86] Reg. section 1.197-2(b)(1).

[87] NYSBA report, *supra* note 60, at 9.

[88] H.R. Rep. 101-54 (pt. 2) at 25.

[89] NYSBA report, *supra* note 60, at 23-24.

[90] Preamble to REG-140991-09, 80 F.R. at 28878.

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by the FDIC are FFA regardless of whether an instrument was received in exchange, and that "the current rule eliminates any issues for Agency and the IRS relating to valuation of the debt or equity interests."[91]

Treasury and the IRS appear to have misunderstood the recommendation of the NYSBA Tax Section report. The recommendation that would result in an institution's debt or equity issued to an agency being included in Acquiring's purchase price[92] is the recommendation to eliminate the general rule that ignores debt or equity issued to an agency *in a taxable acquisition*[93] — not elimination of the rule disregarding debt or equity instruments generally. The justifications offered by Treasury and the IRS appear to relate only to retaining the general rule disregarding debt or equity instruments, and they have no salience in the context of a debt instrument issued by a purchaser in an acquisition of assets.

C. Technical Difficulties

There are several technical difficulties with applying the rule disregarding debt instruments under the section 597 rules to purchase price financing. One is that the preamble to the section 597 regulations, as well as the NYSBA Tax Section report, arguably don't go far enough in describing the surprising treatment of purchase price financing. The preamble seems to suggest that the only consequence of disregarding the debt instrument issued to the FDIC is that the purchaser will have an artificially low basis in the loan assets.[94] However, on a closer read of the section 597 regulations, the application of this rule to purchase price financing would seem to give rise to phantom income (or basis in phantom assets) for the following reason.

The regulation specifying that any net worth assistance provided to Acquiring is treated as received by the bank in FDIC receivership immediately before the taxable transfer also provides that the net worth assistance "is treated as an asset of the transferor that is sold to the new entity or Acquiring in the taxable transfer."[95] The preamble and the example in the Tax Section report do not seem to give any effect to this provision. If the section 597 rules require that a debt instrument issued by a purchaser be disregarded, then the cash provided to the purchaser in exchange for a note should be required to be treated as an asset of the bank provided in the purchase, and therefore a portion of the purchase price paid by the purchaser should be allocated to the cash provided as purchase money financing.

Example 6. Bank A is a failing regional bank. It has a portfolio of loan assets with a book value of $100 billion and deposit liabilities of $40 billion, along with additional liabilities of $50 billion. The loan assets have declined in value because of rising interest rates and now have an FMV of $85 billion. Bank B agrees to assume the deposit liabilities and pay an additional $45 billion, which it finances using purchase money financing provided by the FDIC. That financing is treated as $45 billion of ordinary income of Bank A, which is offset by its losses on the sale of the loan assets. Bank B is then treated as buying Bank A's loan assets and the $45 billion of net worth assistance for $40 billion. Bank B would allocate $40 billion of the purchase price in the same manner that the purchase price is allocated under the rules of reg. section 1.338-6(b), (c)(1), and (c)(2).[96] Because the debt instrument is disregarded and the net worth assistance is therefore treated as cash provided by the FDIC, all the purchase price would be allocated to the net worth assistance.[97] Because the net worth assistance exceeds the purchase price by $5 billion, the purchaser should have an income inclusion of $5 billion included ratably over the next six years.[98]

In the example provided in the NYSBA Tax Section report, that application of the rule results in there actually being a zero basis in the loan assets and a $20 basis in the cash provided as purchase money financing, because the $20 actually paid would be allocated to the phantom

[91] *Id.*

[92] *Id.*

[93] NYSBA report, *supra* note 60, at 23.

[94] *See supra* note 64.

[95] Reg. section 1.597-5(c)(1).

[96] Reg. section 1.597-5(d)(2)(i).

[97] Reg. section 1.338-6(b)(1).

[98] Reg. section 1.597-5(d)(2)(iii).

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asset of $80 "received" from the FDIC. The purchaser would be required to include $60 in income over the six years following the purchase.

This provision makes sense in the context of other forms of true economic assistance, such as cash assistance payments paid to the purchaser by the FDIC to bring the net worth of the failed bank up to zero. As the legislative history explains, Congress expected that those payments would result in no tax liability for the transferor bank and that the acquiring entity would allocate basis to those cash assistance payments.[99]

Example 7. Bank A has deposit liabilities of $100 billion and loan assets with an FMV of $60 billion. To induce Bank B to assume those deposit liabilities, the FDIC pays Bank B $40 billion. That $40 billion is net worth assistance and is treated as FFA received by Bank A and included in gross income, but it is presumably immediately offset by the loss triggered by the sale of the loan assets. Bank B treats the $40 billion received as an asset sold to it in exchange for its assumption of the $100 billion of deposit liabilities and accordingly allocates $60 billion of basis to the loan assets and $40 billion of basis to the net worth assistance.[100] In other words, Bank B is getting $40 billion of cash, and therefore a portion of its purchase price should be allocated to that asset.

In the context of purchase money financing, however, there is no sense in treating the net worth assistance this way. To allocate purchase price to the financing provided by the FDIC is to add insult to the injury of disregarding the debt instrument in the first place. The cash provided by the FDIC is not an economic asset that the purchaser is paying for, and there is no conceivable tax policy that would justify treating it as an asset that is being purchased by the purchaser. Even the NYSBA Tax Section report and the preamble to the section 597 regulations do not seem to have extended their reading of the section 597 regulations that far.

An additional difficulty with the interpretation of the rules reflected in the NYSBA Tax Section report and the preamble to the section 597 regulations is that the rules seem to apply only when a taxable transfer exists independently of the purchase money financing. As explained above, unless there is an assumption of deposit liabilities or a sale of assets for which the FDIC has a financial obligation, no taxable transfer occurs.[101] Accordingly, the rule deeming any FFA paid to the transferor immediately before the taxable transfer will apply only if one of those conditions is met. If there exists a policy, or indeed a statutory mandate, to disregard debt instruments issued by an acquiring entity on the same grounds as exist for disregarding debt instruments issued by a failed bank in receivership, that rule should apply to an acquisition financed by the FDIC even in the absence of any assumption of deposit liabilities. The fact that it does not is further evidence that the rules were not intended to work this way.

D. Policy and Legislative Intent

As mentioned earlier and described in the NYSBA Tax Section report, it flies in the face of general tax policy to disregard any debt instruments issued by a creditworthy purchasing entity and secured by the purchased loan assets, and to include a portion of the funds provided by the lender in ordinary income as a result. The principal amount of a debt instrument that represents an actual obligation that is to be repaid is never included in gross income of a borrower.[102] Because FDIC purchase money financing represents a meaningful obligation on the part of the borrower acquiring entity, there seems to be no reason that the debt should not be subject to the general rule.

Even when the effect of this application of the section 597 rules is limited to a timing mismatch, it is inconsistent with general tax policy. The tax system could presumably have treated all debt the same way, providing that the principal amount is included in income at the time of borrowing and allowing a corresponding deduction at the time of repayment.[103] Instead,

[99] H.R. Rep. No. 101-54 (pt. 2) at 27-29.

[100] *See id.* at 29.

[101] Reg. section 1.597-5(a)(1)(i).

[102] This is sometimes referred to as the "borrowing exclusion" and appears to be common to all income tax systems worldwide. Joseph M. Dodge, "Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated," 26 *Va. Tax Rev.* 245, 247 (2006).

[103] See *id.* at 265-271, proposing such a mechanism.

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Congress chose not to require any income inclusion at the time of borrowing and to provide that canceled debt should be included in income on discharge.[104] That choice should extend to FDIC purchase money financing as well. For a character mismatch, the policy concern is even more severe. The purchaser will be required to include a large amount of phantom income in the six-year period beginning in the year of the taxable transfer — income that it may never be able to offset.

Given section 597's broad grant of authority to promulgate regulations, it would seem difficult to argue that such a rule exceeds that statutory authority. However, the result seems inconsistent with the intent of the FIRREA amendments to section 597, which, according to their legislative history, were intended to discontinue the subsidy provided to banks in FDIC receivership through the tax system and to place those banks on equal footing with other taxpayers.[105] Under this interpretation of the section 597 rules, banks that are subject to the rules because they purchased assets from a bank in FDIC receivership are in a meaningfully worse position than if they had purchased those same assets (with financing on the same terms and with a loss-sharing agreement) from a bank that is not in FDIC receivership. Moreover, the committee report accompanying the amendments to section 597 under FIRREA provided interim guidance expressing Congress's intent "that assistance payments generally will be taxable to the acquiring financial institution only to the extent that they exceed basis properly allocable to such payments."[106] This rule is inconsistent with that expressed intent because the acquiring entity is taxed on an amount exceeding the amount properly allocable to basis.[107]

[104] Section 61(a)(11).

[105] H.R. Rep. No. 101-54, at 25.

[106] *Id.* at 27.

[107] The counterargument is that the amount of basis properly allocable to an acquiring entity in a taxable transfer is calculated without reference to the debt instrument, so the assistance payments are taxed only to the extent that they exceed basis properly allocable to those payments. However, that counterargument proves too much and vitiates the expressed legislative intent. Under such a theory, instead of expressly providing an income inclusion for an amount not in excess of basis, the drafters of the section 597 regulations could always just reduce the properly allocated basis and arrive at the same result.

The arguments put forward in the preambles to both the final section 597 regulations promulgated in 1995 and the proposed 2015 regulations that the rule in section 597(c) requires that debt instruments issued by purchasers be disregarded are plainly incorrect. First, section 597(c) is a definitional provision that provides only that money or property is FFA "regardless of whether any note or other instrument is issued in exchange therefor."[108] It is section 597(b) that directs that the regulations shall provide that FFA is "properly taken into account by the institution from which the assets were acquired, and provide the proper method of allocating basis among the assets so acquired."[109] Therefore, even if section 597(c) is intended to include purchase money financing provided to a purchaser, that doesn't mean that basis in the assets acquired using that FFA should be allocated the same way that basis is allocated for actual cash assistance. Moreover, it is far from clear that the language in section 597(c) was intended to include purchase money financing as FFA. As described above, the legislative history indicates that it was not intended to be included, and the use of the phrase "regardless of whether any note or other instrument is issued in exchange therefor" was borrowed from the pre-1989 version of section 597.[110] In that context, although its exact purpose is unclear, that phrase was obviously intended to expand the scope of the exclusion from gross income.[111] Here, the use of that phrase has the exact opposite effect because it expands the inclusion in gross income. This strange drafting quirk is an indication that this reading of section 597 was unintended.

The justification set forth in the preamble to the 1992 proposed regulations for disregarding debt instruments is also plainly inconsistent with the justification for applying the rule to purchase money financing. The latter justification was that it makes an agency's decision to accept an instrument from a bank tax neutral and that it furthers the principle that economically

[108] Section 597(c).

[109] Section 597(b).

[110] *See supra* text accompanying notes 52-53.

[111] *See supra* text accompanying notes 10-11.

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equivalent transactions should be treated uniformly.[112] Here, the economically equivalent transaction for purchase money financing provided by the FDIC is a purchase financed by a third party. Therefore, this transaction is not treated uniformly with the economically equivalent transaction. Moreover, as discussed below, the existence of this rule makes the FDIC's decision to provide purchase money financing decidedly not tax neutral. These tax rules can end up making all the difference to a purchaser deciding whether to include purchase money financing in its bid (or whether to decrease its bid in respect of such purchase money financing).

As the NYSBA Tax Section report noted, this result is also inconsistent with bank regulatory policy.[113] The intent of issuing loss-sharing agreements is to reduce the FDIC's cash needs in the liquidation of a failed bank.[114] The FDIC's ability to provide purchase financing allows the agency to expand the universe of potential purchasers and facilitates a better purchase price for the loan assets. This tax treatment is inconsistent with those aims. A well-advised purchaser would either reduce the amount that it borrows from the FDIC or would choose not to enter into a loss-sharing agreement. Indeed, the bid by a nonbank purchaser to purchase loan assets covered by a loss-sharing agreement can end up being a lower bid than if those loan assets were not covered by a loss-sharing agreement, which actually increases the FDIC's cash needs in the liquidation of a failed bank.

Example 8 illustrates the perverse effect that this tax treatment can have on a purchaser's bid.

Example 8. Bank A is in FDIC receivership. The FDIC is seeking bids from bank and nonbank purchasers for loan assets with a book value of $100 billion, and the FDIC is providing purchase money financing of $60 billion. The loan assets could be sold to a third party for $70 billion. The FDIC is willing to enter into a loss-sharing agreement under which the purchaser absorbs all losses in the first-loss tranche of $10 billion and the FDIC absorbs 80 percent of losses thereafter. The loans have moderate credit risk, and there is a reasonable risk that borrowers could default on $15 billion of unpaid principal, so the loss-sharing agreement could reasonably have a value of approximately $4 billion. PE Fund is bidding for the loan assets. If it bids without a loss-sharing agreement, it is willing to bid $70 billion, which is the FMV of the loans. If it bids with a loss-sharing agreement, however, it must take into account the tax effects of the purchase money. Under these facts, PE Fund would have to include $64 billion as ordinary income over a six-year period beginning in the year of the taxable transfer, or $10.66 billion each year. That results in actual tax liability of more than $2 billion each year for noneconomic income. Even assuming that the purchaser can eventually recover that through offsetting deductions, there are serious time value concerns. Given the credit risk profile of the loan assets, the loss-sharing agreement is not reasonably expected to have downside value of more than $4 billion. Accordingly, PE Fund would reduce its bid because of the tax liability and would be willing to bid only less than $70 billion for the loan assets, increasing the FDIC's cash needs in liquidation.

IV. Potential Arguments for Purchasers

There are several arguments that certain purchasers may be able to use to successfully extricate themselves from the web of the section 597 rules, either completely or at least from the rule disregarding any debt instruments.

A. Noncorporate Purchasers

The first argument is that a purchaser that is not a corporation is not technically within the bounds of the section 597 regulations. The reason is that Acquiring is defined as a "*corporation* that is a transferee."[115] The technical argument works as follows: The definition of FFA includes money or property provided to an institution or to a direct or indirect owner of stock in an institution.[116] The

[112] Preamble to FI-46-89, 57 F.R. at 14805.

[113] NYSBA report, *supra* note 60, at 23-24.

[114] FDIC primer, *supra* note 5.

[115] Reg. section 1.597-1(b).

[116] *Id*.

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definition of institution specifies that it only includes an acquiring entity or a new entity that is a bank.[117] It can be argued that the definition of FFA includes any net worth assistance, because it provides at the end of the definition that "FFA includes net worth assistance."[118] However, one can read that not as expanding the definition beyond money or property provided to an institution or direct or indirect owner of an institution, but rather as providing examples of the previously defined term "FFA." Under that reading, the rule in the definition of FFA requiring that debt instruments be disregarded would not apply to any nonbank.

The other rule disregarding the issuance of instruments, in reg. section 1.597-3, applies to "debt instruments, stock, warrants, or other rights to acquire stock of an Institution (or any of its affiliates) that an Agency or a Controlled Entity receives *in connection with a transaction in which FFA is provided*."[119] (Emphasis added.) As discussed above, FFA only includes money or property provided to a bank, so the provision of purchase money financing would not cause a transaction to be one in which FFA is provided, unless the operation of the taxable transfer rules would cause the purchase money financing to be deemed provided to the bank transferor. Those rules apply to net worth assistance, which is not limited to amounts provided to an institution and includes any money or property provided as an integral part of a taxable transfer.[120] However, the rule requiring that net worth assistance be treated as paid to the transferor in the context of a taxable transfer applies only to "any net worth assistance that an Agency provides to . . . *Acquiring* in connection with the transfer."[121] (Emphasis added.) If one takes the view that the definition of FFA does not include net worth assistance provided to a nonbank without the operation of that rule, then a nonbank purchaser that is not a corporation could make the technical argument that it is not an acquiring entity and therefore, because no net worth assistance was deemed provided to the transferor, there is no FFA in connection with the taxable transfer. However, if any alternative forms of FFA are provided in the transaction, the rule in reg. section 1.597-3 providing for the disregarding of debt instruments "in connection with a transaction in which FFA is provided" would seem to apply to such a transaction.

The main problem with this argument is that it is extremely technical. There seems to be no policy reason for the application of the section 597 rules to depend on whether the purchaser is a corporation. The most likely explanation for the use of the term "corporation" in the definition of Acquiring is that the drafters of the section 597 regulations assumed that any purchaser of a bank or its assets would be another bank, and banks are generally treated as corporations for federal income tax purposes.[122] Interestingly, however, the definition of institution specifies that a new entity or an acquiring entity is an institution only if it is a bank, which indicates that the drafters of the section 597 regulations did contemplate a purchase by a nonbank entity. Regardless, it may be difficult for a purchaser to be comfortable that the section 597 rules do not apply based solely on this technical interpretation, given that there is no discernible reason that a corporation should be treated any differently than a noncorporate purchaser.

B. Nonbank Purchasers

Another argument available to all nonbank purchasers[123] is that the rule in the definition of FFA providing that debt instruments are disregarded is addressed specifically to

[117] *Id*.

[118] Reg. section 1.597-1(b).

[119] Reg. section 1.597-5(c)(1).

[120] Reg. section 1.597-1(b).

[121] *Id*.

[122] Reg. section 301.7701-2(b)(5).

[123] The term "bank" does not appear to be specifically defined for purposes of section 597, although the section 597 regulations refer to "a bank or domestic building and loan association within the meaning of section 597." Reg. sections 1.597-1(b) and 1.597-4(g)(4)(iv). In other contexts in which bank is undefined, such as section 881(c)(3)(A), TAM 9822007 indicates that the term should be defined by reference to section 581. The Fifth Circuit has set forth a three-part test for determining whether an entity is considered a bank within the meaning of section 581, one of the elements of which is that the entity must be a bank within the common meaning of the term, which requires that the entity must (1) receive deposits from the general public, repayable on demand or at a fixed time; (2) use deposit funds for secured loans; and (3) have a relationship of debtor and creditor between the bank and depositor. *MoneyGram International Inc. v. Commissioner*, 999 F.3d 269, 274 (5th Cir. 2021).

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institutions. It provides that "any such money or property is FFA, regardless of whether the Institution or any of its affiliates issues Agency a note or other obligation, stock, warrants, or other rights to acquire stock in connection with Agency's provision of the money or property."[124] Even though, as explained above, the rules require that any assistance provided by the FDIC be treated as provided to the bank before the transfer, if the note is purchase money financing and is issued by a purchaser that is not an institution, it doesn't seem to be subject to the rule that debt instruments be disregarded.

The other rule disregarding the issuance of instruments, in reg. section 1.597-3, does not by its terms apply solely to an institution or an acquiring entity. However, one can argue that this rule should also technically not apply because it applies only to transactions "in which FFA is provided."[125] Although net worth assistance includes money provided to any party and, as explained above, any net worth assistance provided in a transfer from a failed bank is treated as FFA issued to the bank before the transfer, the operation of this provision suffers from a circularity issue. The rule disregarding debt instruments and therefore treating the purchase money financing as net worth assistance applies only if there is FFA provided in the transaction, and there is FFA provided in the transaction only if debt instruments are disregarded. Therefore, one can argue that this provision should not have the effect of including purchase money financing as net worth assistance by disregarding debt instruments for a purchaser that is not an institution. This argument would also seem to be unavailing if any alternative forms of FFA are provided in the transaction, because the rule in reg. section 1.597-3 providing for the disregarding of debt instruments "in connection with a transaction in which FFA is provided" would seem to apply.

This argument also suffers somewhat from seeming to be a technical loophole, but it may be less offensive, given that the rule itself seems so lacking in any policy reason and that the distinction it draws is between banks and nonbanks rather than corporations and noncorporate purchasers.

C. Failed Bank Financing

When the purchase price financing is provided by the failed bank and not directly by the FDIC and the transaction is not one in which any additional FFA is provided, the section 597 rules would seem to not disregard that financing.[126] This is because the definitional provision disregarding all debt instruments applies by its terms only to an issuance of a note to an agency (including the FDIC), but not if the note is issued to the failed bank. Reg. section 1.597-3(b), providing for disregarding debt instruments received by an agency or a controlled entity, which does apply to a note issued to the failed bank, applies only if the debt instrument was issued "in connection with a transaction in which FFA is provided." Accordingly, if no additional FFA was provided in connection with the transaction, a note issued to a controlled entity should not be disregarded, and the purchaser's basis in the purchased loan assets should include the principal amount of the note.

The IRS could assert that because payments on a loss guarantee are FFA, any transfer of covered assets that eventually gives rise to payments on a loss guarantee is a transaction "in which FFA is provided" and is therefore subject to the rule disregarding the issuance of debt instruments in reg. section 1.597-3(b). However, that seems to be a weak argument for the IRS. In that instance, the FFA is not provided "in" the transaction, and it is not even certain at the time of the transaction that any payments will ever be made on the loss-sharing agreement. It would also not seem, from the section 597 regulations,

[124] Reg. section 1.597-1(b).

[125] Reg. section 1.597-3(b).

[126] Although the purchase money note issued to the failed bank would generally also be issued to the FDIC. For example, the purchase money note issued by First-Citizens Bank in its purchase of the assets of Silicon Valley Bank is to the FDIC in its capacity as receiver for the failed bank and not in its corporate capacity. The FDIC acts in its receiver capacity as a separate legal entity from the FDIC in its corporate capacity. *See Deutsche Bank National Trust Co. v. FDIC*, 109 F. Supp. 3d 179, 185 (D.D.C. 2015); *Dababneh v. FDIC*, 971 F.2d 428, 432 (10th Cir. 1992). An issuance of a purchase money note would not seem to be an issuance to an "agency" within the meaning of reg. section 1.597-1(b). Also, the FDIC's general authority as receiver is provided under FDIA section 11(d), rather than section 11(f) or 13(d) of the act, which are the specific provisions referenced in the definition of FFA, nor does it seem to be a "similar provision of law." Reg. section 1.597-1(b).

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that later payments on the loss-sharing agreement could retroactively cause there to have been FFA. The section 597 regulations don't appear to contemplate a redetermination of a transaction in subsequent years as a transaction "in which FFA is provided," and they generally appear to require an immediate determination of whether FFA was provided in the transaction.[127]

D. All Purchasers if No FFA Is Provided

A version of the argument in the preceding section may be available even to purchasers using purchase money financing provided directly by the FDIC. That version would argue that the rule in reg. section 1.597-3 providing for the disregarding of debt instruments "in connection with a transaction in which FFA is provided" demonstrates that the financing for which the debt instrument was issued is not itself FFA. Otherwise, the provision would be redundant, because any transaction in which a debt instrument was issued would per se be one "in which FFA is provided." Therefore, in a transaction in which no other form of FFA is provided, a purchaser could argue that the rule disregarding debt instruments should not apply.

However, that version of the argument seems quite difficult. First, the rule disregarding debt instruments in the definition of FFA under the section 597 regulations simply provides that money or property provided by an agency to an institution (or a direct or indirect owner of stock in an institution) is FFA "regardless of whether the Institution or any of its affiliates issues Agency a note or other obligation, stock, warrants, or other rights to acquire stock in connection with Agency's provision of the money or property."[128] Another difficulty is that the 1995 preamble to the section 597 regulations states simply that purchase money financing will be disregarded, with no mention that additional FFA being provided is a necessary condition.[129] Accordingly, this argument would seem strong only in the context of purchase money financing provided by a controlled entity and not by an agency.

E. Technical Weaknesses

As described above, the technical argument for not applying the section 597 rules to disregard purchase money financing provided directly by the FDIC is difficult. Further, the technical arguments for excluding nonbank purchasers (including noncorporate purchasers) receiving purchase price financing from the FDIC from the scope of the section 597 rule disregarding that debt also seem rather weak. First, there is an argument that any net worth assistance is per se FFA and that, therefore, because net worth assistance is broadly defined, nonbank and noncorporate purchasers are included. Second, even if one takes the view that net worth assistance is FFA only if provided to an institution, the arguments for excluding noncorporate purchasers and nonbank purchasers from the scope of the section 597 rules or the scope of the rule disregarding debt instruments are hypertechnical and do not seem to have any basis in policy or reason. Third, the argument that the rule providing that debt instruments be disregarded does not apply seems to be of no avail in any transaction in which another form of FFA is provided.

In addition, there is some ambiguity regarding the scope of the definition of taxable transfer, and it may be read to apply to a nonbank purchaser buying a portion of a failed bank's portfolio of loan assets using FDIC purchase money financing together with a bank that is purchasing the rest of the assets and receiving some form of FFA in connection with that purchase.

Example 9. Assume that Bank A and PE Fund are jointly bidding to acquire the assets of failing Bank B. Bank A will assume the deposit liabilities of Bank B and receive some form of FFA (including purchase money financing), and PE Fund will purchase a portion of Bank B's loan assets using purchase money financing from the FDIC. For Bank A, there is clearly a taxable

[127] For example, reg. section 1.597-1(b) requires determination of the average reimbursement rate, which determines the expected value for covered assets, as of the time of the taxable transfer.

[128] Reg. section 1.597-1(b).

[129] Preamble to T.D. 8641, 60 F.R. at 66092.

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transfer because it is assuming deposit liabilities and receiving some form of FFA.[130]

However, for PE Fund, it is unclear whether its purchase of loan assets should be considered part of a transaction in which deposit liabilities are assumed and FFA is provided. On the one hand, there seems to be no reason why the applicability of the taxable transfer rules under the section 597 regulations should depend on whether a co-bidder is assuming deposit liabilities. On the other hand, the language of the regulations applies to a "transaction in which an entity transfers to *a* transferee."[131] (Emphasis added.) The use of "a" rather than "the" may indicate that the drafters of the section 597 regulations intended to include any participant in a transaction in which one of several transferees receives FFA.

V. Conclusion

Based on the foregoing, I believe that the rule disregarding debt instruments is not meant to be applied to purchase money financing. The technical difficulties, the lack of ancillary rules, and the inconsistencies with legislative intent and tax and regulatory policy are too substantial to overlook. The simplest explanation for this is that the rule that debt instruments be disregarded was never intended to apply to a debt instrument issued by an acquiring entity and that it was intended that a debt instrument issued by a purchasing entity be respected for all federal income tax purposes.

The IRS's view that the rule does apply to purchase money financing can create significant obstacles to resolution of a banking crisis, given the negative consequences to bidders using purchase money financing from the FDIC, particularly when combined with a loss-sharing agreement. Most of the technical arguments available to purchasers do not seem strong enough to provide them sufficient comfort, and those arguments may be inapplicable in many circumstances.

Treasury and the IRS should therefore amend the section 597 regulations to specify that purchase money financing provided to an acquiring entity should not have the effects described herein. In the interim, guidance should be issued providing that the current interpretation of the section 597 regulations is incorrect and that debt issued by a purchaser will be respected as debt of the purchaser for all section 597 purposes and will be included in the purchaser's basis. ■

[130] Reg. section 1.597-5(a)(1)(i)(B).

[131] Reg. section 1.597-5(a)(1)(i).

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