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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR

FROM:

SUBJECT: Entity X

This Chief Counsel Advice responds to your memorandum dated April 19, 1999. This document is not to be cited as precedent.

LEGEND:

Entity X =
Entity Y =
Entity Z =

ISSUE:

Whether Entity Z should be included as a member of the consolidated group under the provisions of I.R.C. § 597, such that the debtor, Entity X, would be liable for Entity Z's tax liability.

CONCLUSION:

In accordance with the provisions of I.R.C. § 597, and the Treasury Regulations thereunder, is liable for the taxes incurred by Entity Z.

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FACTS:

The debtor is the parent of an affiliated group filing a consolidated return. Its subsidiary, Entity Y was a thrift institution. On _____, the Office of Thrift Supervision appointed the Resolution Trust Corporation (“RTC”) Conservator of Entity Y. On _____, the RTC was appointed Receiver of Entity Y. Entity Z was chartered by federal thrift regulators as a mutual savings association. Following its appointment as Receiver of Entity Y, the RTC transferred all of the assets and liabilities of Entity Y to Entity Z. Between _____, Entity Z received assistance from the RTC under FIRREA.

The debtor filed consolidated returns that included the operations of Entity Z in its group. Tax was assessed based on the returns. The debtor, _____, now challenges the validity of the Service’s claim for taxes on various grounds. You have asked us to comment on one of the debtor’s arguments.

The debtor contends that Entity Z is not a “bridge bank” within the meaning of § 1.597-1(b) because Entity Z did not continue the operation of Entity Y’s business and because Entity Z is a mutual institution without outstanding stock and therefore the debtor’s group could not be deemed to own the stock of Entity Z. With respect to the continued operation argument, the debtor’s chairman provided an affidavit to the effect that:

Prior to the imposition of the conservatorship of the RTC, Entity Y’s primary business was earning income based on the

On and after _____, Entity Z failed to carry on the operations of such business.

The former president of Entity Y, in his affidavit, testified that the RTC, as conservator of Entity Y, liquidated its

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The debtor also argues that Entity Z was not a bridge bank because Entity Z was a mutual association. It argues that, because Entity Z had no stock outstanding, the debtor could not be deemed to own at least _____ of the stock of Entity Z, and therefore cannot have several liability for Entity Z's income tax liability.

Entity Z is a "Bridge Bank" under § 1.597-1(b).

Section 1.597-1(b) defines the term "Bridge Bank" for the purposes of the regulations under § 597. It provides that the term "Bridge Bank" means "an Institution that is organized by Agency to hold assets and liabilities of another Institution and that continues the operation of the other Institution's business pending its acquisition or liquidation," and that is one of several types of bank or thrift institutions. The debtor does not dispute that Entity Y and Entity Z are "Institutions," that Entity Z was organized by "Agency" to hold assets and liabilities of Entity Y, or that Entity Z was chartered under one of the specified statutes. The debtor, however, argues that Entity Z did not continue the operation of Entity Y's business, even though it concedes that all of Entity Y's assets and liabilities were transferred to Entity Z.

Entity Y did business as a thrift institution. Entity Z did business as a thrift institution. Moreover, by assuming all of Entity Y's liabilities, Entity Z inherited all of Entity Y's depositor and customer relationships. To an account holder walking in the door, the changeover from Entity Y to Entity Z would have been nearly imperceptible.

The debtor argues that Entity Y's "primary business" was _____, and that Entity Z did not continue "such business." Firstly, that argument is factually off base. Entity Y was under conservatorship for over _____ before the receivership was instituted and assets transferred to Entity Z. It is clear from the affidavits that FSA's more speculative assets were sold by Entity Y during the conservatorship. By the time Entity Z was set up, Entity Y already had changed its investment philosophy. The debtor's statement of facts concedes that all of Entity Y's assets were transferred to Entity Z. The requirement that a bridge bank continue the operation of the transferor institution's business cannot mean that new institution must resume activities abandoned years before by the old one.

Secondly, the debtor's construction of the definition is too narrow and would frustrate the obvious purpose of the regulations. The use of bridge banks is about rehabilitating banking and thrift institutions. Entity Y was a thrift institution. Entity Z was a thrift institution that succeeded to Entity Y's deposits. That is a continuation of its business as a thrift. Section 1.597-4 confers a benefit on failed and failing institutions by deferring the overall incidence of taxation on their rehabilitation at least until assistance is provided (and further to the extent of unrealized losses on the institution's portfolio). Some institutions fail because they engage in risky lending or investments. Their asset portfolios have to change in rehabilitation. It makes no sense to deny such institutions

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the benefit of § 1.597-4 merely because they must dispose of assets or change their lending philosophy; those institutions need it most.

Although it is a mutual association, Entity Z is included in the debtor's consolidated group and the debtor is severally liable for its income taxes.

The definition of a Bridge Bank for purposes of the regulations under § 597 does not require that it have outstanding stock. Because the regulations were designed to describe the tax consequences of typical assisted acquisitions, it was understood that many Bridge Banks would have no stock outstanding. Examples (2) and (3) of § 1.597-5(f) illustrate cases in which assets and liabilities were transferred to a Bridge Banks. At a later time, the Bridge Bank issued stock to a new investor, triggering a taxable transfer under § 1.597-5. Because, in each example, an entity described as a "Bridge Bank" issued "100 percent" of its stock to a new investor, it is clear that prior to the stock issuance, there was no other stock outstanding from the entity described by the regulations as a "Bridge Bank." Thus, it is clear that an entity can be a Bridge Bank without having issued stock. (In fact, any issuance of stock would likely result in a taxable transfer under § 1.597-5, after which the special rules for Bridge Banks would largely cease to apply.)

Section 1.597-4(f)(1) provides that:

If an Institution is a member of a consolidated group immediately before it transfers deposit liabilities to a Bridge Bank, the Bridge Bank succeeds to the Institution's status as the common parent or, unless an election is made under paragraph (g) of this section, as a subsidiary of the group. If a Bridge Bank succeeds to an Institution's status as a subsidiary, its stock is treated as held by the shareholders of the transferring Institution, and the stock basis or excess loss account of the Institution carries over to the Bridge Bank. A Bridge Bank is treated as owning stock owned by its associated Residual Entities, including for purposes of determining membership in an affiliated group.

The debtor reads this provision to apply only to Bridge Banks that have outstanding stock. Such a reading would make little sense given the background, structure and purpose of these regulations. As noted above, the regulations were designed to describe the consequences of typical assisted transactions. Bridge Banks were interim devices used by the regulators and insurers pending a possible acquisition by new investors. (The definition of a Bridge Bank limits it to an Institution set up to continue the transferor's business "pending its acquisition or liquidation.") A typical Bridge Bank would not have stock outstanding representing a real paid-in equity interest. Under the structure of the regulations, where such an interest is obtained by a private party, a taxable transfer results and Bridge Bank treatment ceases. Under the structure of the §

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597 regulations, real stock interests bought by private parties are not disregarded and reattributed to the former owners. Section 1.597-4(f) determines the ownership of interim entities whose actual ownership is limbo.

It was understood that the former owners of a failed institution would have no actual interest in a transferee bridge bank. The stock they are deemed to own under § 1.597-4(f) always is fictional, at least in regard to them. As such, it should not matter whether the Bridge Bank is a stock institution. This reading is supported by the language of the regulation, which provides that “if an Institution is a member of a consolidated group immediately before it transfers deposit liabilities to a Bridge Bank, the Bridge Bank succeeds to the Institution’s status . . . as a subsidiary of the group.” Entity Y was an Institution; it was a member of the debtor’s consolidated group immediately before it transferred its liabilities to Entity Z; Entity Z is a Bridge Bank; and, therefore, Entity Z succeeds to Entity Y’s status as a subsidiary of the group.

Section 1.1502-6(a) does not impose any additional limitations on the inclusion of Entity Z in the consolidated group or on debtor’s liability for taxes arising therefrom. Section 1.597-4(f) says that if Entity Y was a member of the group, Entity Z succeeds to its status as a subsidiary of the group. Under normal consolidated return rules (based on § 1504), Entity Z would not be a member of the group because other group members own none of its stock. However, the regulations under § 597 provide otherwise and say that Entity Z is a member of the group. These regulations are valid legislative regulations issued in furtherance of a clear legislative purpose (discussed below). Because Entity Z is a member of the group, under § 1.1502-6(a), “the common parent and each subsidiary which was a member of the group” is severally liable for the consolidated group’s income tax. It should be noted that the debtor’s situation is not a special case beyond the intention of the FIRREA regulations --- based on past history, the drafters assumed that group members would never actually own enough stock in a bridge bank to satisfy § 1504. (The final regulations would not have provided that a bridge bank per se does not have continuing equity if the former owners could retain equity in the bridge bank.) If the rule of § 1.597-4(f) were limited to the cases the debtor urges, it would never apply.

Given the structure and purpose of the regulations under § 597, this reading is neither illogical nor unfair. The § 597 regulations effectuate a broad grant of regulatory authority provided by Congress to insure that failed institutions would be taxed on assisted acquisitions, and that neither former owners nor new acquirors would obtain tax benefits for costs borne by the public or the insurance systems. The legislative history notes:

Although most financial assistance received by, or paid with respect to, financially troubled financial institutions would be treated as taxable, such assistance will be deemed to be received by the financially troubled institution at the time the assets of such institution are sold or transferred.

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As a result, the financial assistance generally will be offset by the net operating losses and built-in losses of the financially troubled institution. Therefore, the committee, in general, expects that an acquired financially troubled institution will have no net tax liability resulting from the receipt of (or deemed receipt of) financial assistance. *The committee recognizes that the net operating losses and built-in losses of the financially troubled institution may not always be sufficient to offset the amount of financial assistance received (or deemed received) by the troubled institution. This may occur, for example, in cases in which the financially troubled institution was a member of an affiliated group filing a consolidated return and the net operating losses of such institution were used to offset the income of other members of the affiliated group. In such a case, the financially troubled institution (or the affiliated group in which the institution is a member) may have net tax liability as a result of receiving financial assistance. In most cases, the committee considers this an appropriate result because other members of the affiliated group have received the benefit of the losses of the financially troubled institution in prior years.*

H.R. Rep. 101-54 (Part 2) 101st Cong., 1st Sess. at 27 (including n.12) (1989) [emphasis added].

The legislative history assumed that assistance typically would be provided in connection with an acquisition of the entire institution in a transaction triggering any remaining built-in losses, but this did not always occur. The overall treatment under the regulations is designed to match the income includible on the receipt of assistance with the realization of the institution's losses, regardless of the manner in which the relevant agencies resolve the failed institution (e.g., whether through an immediate assisted acquisition or by using a bridge bank, whether by transferring deposit liabilities and assets together or selling the assets separately, etc.). See Notice of Proposed Rulemaking (FI-46-89), 1992-1 C.B. 1037, 1038.

The preamble to the proposed version of these regulations introduces the treatment of bridge banks and consolidated groups as follows:

In the case of an Institution that is a member of a consolidated group, the legislative history indicates that Congress intended that FFA be included in the income of the Institution or consolidated group, at least to the extent the consolidated group benefitted from use of the Institution's losses. In order for the FFA to be included in the income of the transferor or its consolidated group, the Bridge Bank must succeed to the transferor's status, including its status in any consolidated group.

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Id., at 1039. The treatment of Bridge Banks as members of the failed institution's group is the quid pro quo for treating the Bridge Bank and the failed institution as a single entity, permitting the deferral of taxation until assistance is paid or losses are realized on the failed institution's assets. If the debtor did not find such treatment beneficial, it was in a position to elect to disaffiliate under § 1.597-4(g). Consistent with Congressional intent in enacting current § 597, neither of the two treatments available to the debtor under these regulations permits the debtor's group to benefit from prior losses and escape the commensurate tax burden on inevitable assistance resulting therefrom, a result which the debtor obviously seeks.

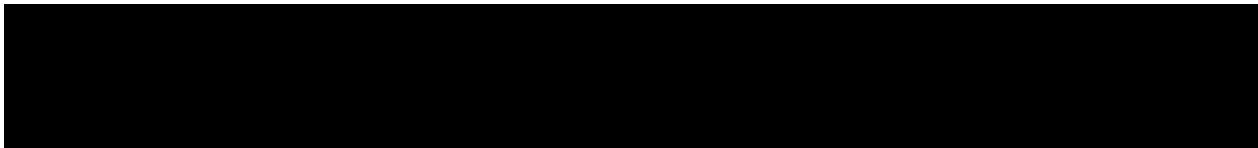
The Debtor probably is not taking a consistent position.

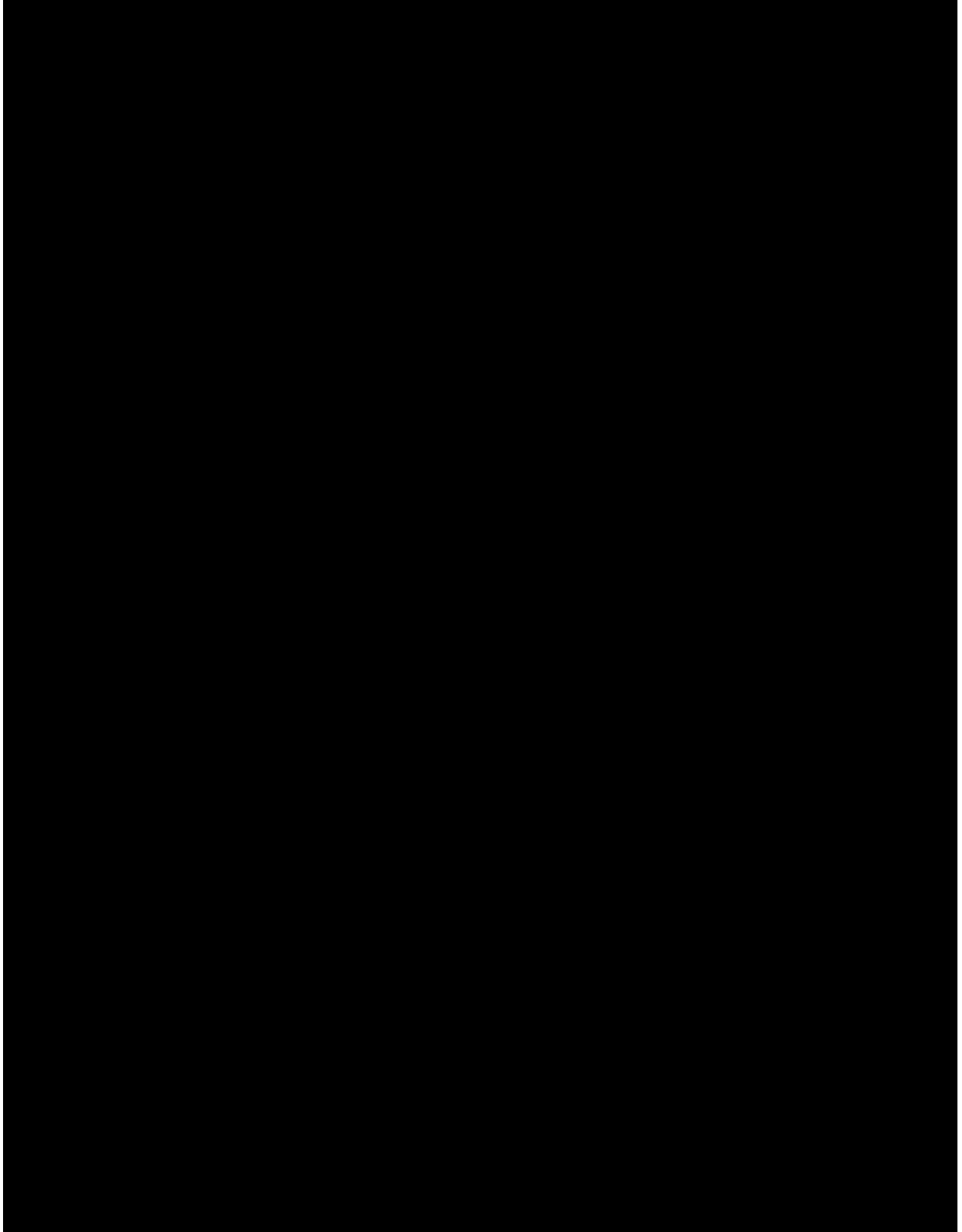
The treatment of bridge banks under § 1.597-4 is, on balance, favorable to taxpayers. If this does not appear to be the case from the debtor's arguments, it is only because, we suspect, the debtor has not applied its position consistently.

If Entity Z is a "bridge bank," Entity Y and Entity Z are deemed to constitute a single entity and that entity is treated as remaining in the debtor's consolidated group (even though there are actually two entities and the bridge bank is not, in fact, owned by group members). Because Entity Y and Entity Z are treated as a single entity, transactions between them are not taxable events. However, Entity Z's activities must be taken into account on the group's consolidated return.

If Entity Z is not a bridge bank, Entity Y and Entity Z would not be treated as a single entity, and transactions between them would constitute taxable events. Moreover, Entity Z would not be a member of the debtor's consolidated group, so transactions between Entity Y and Entity Z would not be intercompany transactions, but taxable currently. Accordingly, if the debtor is correct that Entity Z is not a bridge bank, the transfer of assets and liabilities by Entity Y (a member of debtor's group) to Entity Z is a taxable sale of the assets for the amount of the liabilities assumed. Moreover, if the RTC transferred all of Entity Y's assets and operations to Entity Z, leaving Entity Y as an empty shell, any excess loss account of the debtor in Entity Y also should be recaptured.

If the debtor seeks to change its original reporting position, which is based on treating Entity Z as a bridge bank, it is incumbent on the debtor to report the gain on the sale in the amount by which the liabilities assumed by Entity Z exceeds the basis of the assets transferred.





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