I. Stealth Fiscal Policy via the Income Tax Code

Abstract:

Looking at conventional legislative enactments such as TARP and EESA understates the change in fiscal policy that followed the Great Recession. Other, less obvious, legal mechanisms implicitly created "stealth" fiscal policies, with far less attention. For example, IRS technical interpretations of tax law changed in response to the financial crisis and Great Recession. In total, the two largest IRS technical rulings reduced revenue by as much as $100 billion [1]-- much greater than TARP's $27 billion cost. This paper examines the IRS's implicit fiscal policy, which provides a concrete example of a regulatory law and macroeconomic intervention.[2] I then evaluate the wisdom of the IRS's policy from a macroeconomic perspective. I argue that a shortage of aggregate demand or risk of financial crisis does not support all legal interventions designed to address these problems. Instead, legal decisionmakers should ask both 1. How does the proposed intervention affect aggregate demand or the risk of financial crisis? and 2. How does the proposed intervention compare with possible alternative interventions for accomplishing the same goal.

[1] GM $18.6 billion. Ramseyer and Rasmussen page 12. Citigroup Citigroup, for
example, claimed ''tax assets'' of $46.1 billion at the end of 2009. R and R at 12, AIG, AIG
claimed ''Deferred tax assets: Losses and tax credit carryforwards''
of $26.2 billion at the end of 2009. R and R at 13. Wells Fargo, Willens says Wells Fargo's entire $17.96 billion in tax breaks could easily have come from the Wachovia deal -- adding up to considerably more than what Wells Fargo paid to acquire the bank.

[2] In "Can the Treasury Exempt Its Own Companies from Tax? The $45 Billion GM NOL Carryforward", 2011 Cato Papers on Public Policy, ,J. Mark Ramseyer and Eric B. Rasmuse provide an excellent analysis and powerful critique of these tax rulings. Ramseyer and Rasmussen do not examine the IRS actions from a macroeconomic policy perspective, however.

The boundaries between monetary policy, financial regulation, and fiscal policy are porous. Consider the $700 billion Troubled Asset Relief Program (TARP). TARP authorized government spending—fiscal policy—to support financial institutions—assisting monetary policy and financial regulation.

TARP provides a straightforward example of law's sensitivity to financial crises. In ordinary times, Congress does not authorize the use of public money to support financial institutions. But during the financial crisis of 2008, Congress did just that. Like many pieces of legislation, TARP's path to passage was tortuous. The bill was rejected by the House of Representatives on September 29th. Following a 7% plunge in the stock market the following day, TARP was finally approved by the House on October 3.

Many observers consider TARP a success—a view I share. The U.S. financial system ultimately stabilized and rebounded—without the prolonged period of decreptitute that has characterized the Japanese financial system since the early 1990s and the European financial system since the financial crisis. Because of this rebound, TARP cost far less than the $700 billion that was budgeted. Once financial institutions recovered, they repaid the investments provided under TARP. TARP's cost to the public fisc is currently estimated at only $27 billion.[3] The Euro zone also enacted laws that implicitly supported the financial systems of member states.[4]

TARP was far from the only U.S. legislative response to the 2008 financial crisis and the onset of the Great Recession. In addition to resolving financial crises, it is widely accepted within macroeconomics that fiscal policy should respond to the business cycle under specific conditions. When interest rates approach the zero lower bound, expansionary fiscal policy (higher government spending and lower taxes) is prescribed. And during the Great Recession, law followed this prescription. The US passed EESA a $700 billion stimulus in 2009. Similarly, the G20 issued a statement calling for coordinated expansionary fiscal policy.

But looking at conventional legislative enactments such as TARP and EESA (and their analogues in other nations) understates the change in fiscal policy that followed the Great Recession. Other, less obvious, legal mechanisms implicitly created "backdoor" fiscal policies, with far less attention. For example, IRS technical interpretations of tax law changed in response to the financial crisis and Great Recession.[5] And one of these rulings was issued on September 30, 2008—after the initial rejection of

[3] See Congressional Budget Office, "Report on the Troubled Asset Relief Program—April 2014, available at https://www.cbo.gov/publication/45260.

[4] The Euro zone provided support for financial institutions in a more roundabout fashion. National governments provided assistance to their own struggling financial institutions. Because this support for the financial system overwhelemed the fund raising capacity of several European countries (e.g. Greece, Ireland, Portugal, Cyprus) the Euro zone enacted the European Financial Stability Facility and European Stability Mechanism. These mechanisms "rais[ed] funds in capital market to finance loans for euro area member states." http://www.efsf.europa.eu/about/index.htm.

[5] See, e.g., Binayaim Applebaum, Washington Post 2009, available at http://www.washingtonpost.com/wp-dyn/content/article/2009/12/15/AR2009121504534.html.

TARP but before its subsequent passage. In total, the two largest IRS technical rulings reduced revenue by as much as $100 billion [6]-- much greater than TARP's $27 billion cost.

This chapter explains the IRS's implicit fiscal policy, which provides a concrete example of a regulatory law and macroeconomic intervention.[7] I then evaluate the wisdom of the IRS's policy from a macroeconomic perspective. I argue that a shortage of aggregate demand or risk of financial crisis does not support all legal interventions designed to address these problems. Instead, legal decisionmakers should ask both 1. How does the proposed intervention affect aggregate demand or the risk of financial crisis? and 2. How does the proposed intervention compare with possible alternative interventions for accomplishing the same goal.

A. Net Operating Losses

When businesses lose money, the income tax code allows them to deduct this loss against taxable profits in previous or future years for the purpose of calculating income tax liability. These deductions are called net operating losses (NOLs).

To illustrate, assume that corporate income tax rates are 35%. Suppose a company loses $80 in Year 1. The company does not pay any income tax that year because it has no income. But the government does not send the company a check to subsidize the company's loss. Instead, the company has a net operating loss $80 for year 1. Suppose that the company earns $200 in year 2. At a 35% income tax rate, the company should pay $70 in income taxes. But over two years, the company's total profits are -$80+$200=$120 rather than $200. If the company pays $70 in tax in year 2, then it has paid too much in taxes over its first two years.

The net operating loss comes to the rescue. The company "carries forward" its $80 in NOLs from year 1 into year 2. The company can subtract this $80 NOL from its year 2 profit of $200 for purpose of calculating income taxes. The company therefore pays taxes on $200-$80=$120 of income in year 2. Its year 2 tax liability is .35*$120=$42. The NOLs allow the company to be taxed at a rate that reflects its true income over the two years ($120) while avoiding the oddity of sending a government check to subsidize a money losing corporation in Year 1.

NOLs can be "carried back" as well as carried forward. Suppose our company made $20 in taxable profits in Year 0 and paid $7 in income taxes. When the company loses $80 in Year 1, it can "carryback" these losses to Year 0. The company would carry back $20 in losses from Year 1 to Year 0. Its

---

[6] GM $18.6 billion. Ramseyer and Rasmussen page 12. Citigroup Citigroup, for
example, claimed ''tax assets'' of $46.1 billion at the end of 2009. R and R at 12, AIG, AIG
claimed ''Deferred tax assets: Losses and tax credit carryforwards''
of $26.2 billion at the end of 2009. R and R at 13. Wells Fargo, Willens says Wells Fargo's entire $17.96 billion in tax breaks could easily have come from the Wachovia deal -- adding up to considerably more than what Wells Fargo paid to acquire the bank.

[7] In "Can the Treasury Exempt Its Own Companies from Tax? The $45 Billion GM NOL Carryforward", 2011 Cato Papers on Public Policy, ,J. Mark Ramseyer and Eric B. Rasmuse provide an excellent analysis and powerful critique of these tax rulings. Ramseyer and Rasmussen do not examine the IRS actions from a macroeconomic policy perspective, however.

revised taxable income for Year 0 would now be zero, as the NOLs from year 1 offset the income from Year 0. As a result, the company would receive a refund of $7 from the government for its overpayment of tax of $7 in Year 1. This would leave the company with $60 in NOLs to carry forward to Year 2.

NOL carryback are preferred to NOL carryforwards. NOL carryback produce an immediate refund. NOL carryforwards, by contrast, produced a delayed tax benefit in the future.

Because they shelter income from income tax liability, NOLs (whether carried forward or back) are an asset. Congress and the IRS do not want NOL assets to be "trafficked"—used by a company that is different from the one that sustained the loss. Allowing trafficking in NOLs undermines the restriction on government subsidies to loss making companies. In our example, suppose the company closes after Year 1 and has no liquidation value. It would carryback $20 in NOLs and get an income tax refund of $7 for Year 0. But this leaves our company with $60 in unused NOLs. A profit-making company would want to buy the loss-making company for its $60 in NOLs , which could shelter the profit making companies income.

The price the owners of the loss making company receive for their company represents an implicit government subsidy on their losses. The only reason the profitable company writes a check to the owners of the money losing company is because the profitable company will get a tax benefit from the lossmaking company's NOLS.

To avoid implicit an implicit subsidy for unprofitable corporations, the income tax code restricts the transferability of net operating losses.[8] While NOLs can be carried "backwards" up to two years or "forward" up to 20 years to reduce positive income tax liability within any of those years for the same company, NOLs cannot be applied directly to reduce tax liability for a different company that merges or acquires a company with NOLs.

Section 382 of the Income Tax Code limits the use of NOLs from a company that has been acquired by a different company. If the acquirer shuts down the acquired company's business within two years, then the acquirer cannot use any of the NOLs from the acquired company that were accumulated before the company was acquired.[9] This prevents the purchase of a loss-making company solely for the purpose of using NOLs. And even if the acquiring company continues the business of the acquirer, demonstrating that the acquisition of NOLs was not the only purpose of the acquisition, the acquirer can only use a very limited amount of the acquired company's NOLs in any year.[10]

---

[8] 26 U.S.C. Section 382."

[9] 26 U.S.C. Section 382(c) which provides that "if the new loss corporation [which would include a corporation that just buys another corporation's NOLs] does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date, the section 382 limitation for any post-change year shall be zero."

[10] 26 U.S.C. Section 382(b) provides that the acquirer of the company with NOLs can use the acquired company's NOLs so long as the NOLs do not exceed the value of the acquired company multiplied by "the long term tax exemt rate." For example, suppose our company, call it "A" with $80 in NOLs was worth $100 before it was acquired in March 2015. The long term tax exempt rate was 2.19% in March 2015, see IRS Revenue Ruling 2015-4, available at http://www.pmstax.com/afr/rr20154.pdf. The acquiring company can only use $100*.0219=$2.19 of A's NOLs in

Section 382(h) prevents another form of loss trafficking. A company may have "unrealized built in" losses. That is, the company has assets that are worth less than the amount paid for those assets. For example, suppose that our hypothetical company bought assets for $120. The assets then went down in value to approximately $40 in Year 1 due to a rapid market decline. On the company's books, however, the assets appear at their initial acquisition costs ($120). Unrealized losses could happen when market values decline more rapidly than accountants can update the company's accounts.

Without Section 382(h), unrealized losses could be trafficked in the following manner. A profitable corporation acquires our corporation that has unrealized losses of $80 (the difference between the purchase price of $120 and the estimated market value of $40). The loss making company has no other assets. After the acquisition has been completed, the assets are sold for their market value of $40. This results in a loss of $80. This loss would not be subject to ordinary Section 382 rules because the official loss occurred after the acquisition was completed. As a result, the losses could be used to shelter the profitable companies gains from income tax. The acquired company had no NOLs to be restricted because its losses were implicit.

Section 382(h)(1)(B) prevents such unrealized losses from being trafficked. Like NOLs, unrealized losses in loss making corporations have limited tax shelter benefits to acquiring corporations. Whether the profitable corporation acquires a company with NOLs or a company with no NOLs but lots of unrealized losses, the tax value of such losses to the profitable company is quite restricted.

The preceding discussion has been a highly technical walk through a complicated provision of the tax code. It is hard to imagine that there are multi-billion dollar issues of fiscal policy lying behind these rules. But there are. This chapter considers two IRS technical rulings on Section 382 that cost the public fisc tens, and possibly hundreds, of billions of dollars. The technical rulings enabled the IRS to conduct its own backdoor expansionary fiscal policy.

B. IRS Notice 2008-83

1. Wells Fargo and Wachovia

Wells Fargo's purchase of Wachovia was among the largest mergers of financial companies during the 2008 financial. Unlike many mergers, the Wells Fargo/Wachovia combination received no explicit government financial backing. But the government's role in this merger was as large or even larger than its explicit role in some other rapid mergers in 2008, such as the Bear Stearns/JP Morgan merger or the Bank of America/Merrill Lynch combination. The merger benefited from an incredibly favorable IRS ruling concerning Wachovia's net operating losses (NOLs). This ruling alone may have been worth over $20 billion, more than the approximately $13 billion that Wells Fargo paid for Wachovia.

As with many financial companies, Wachovia incurred large losses during 2008 and beforehand. Wachovia's acquisition of many adjustable rate mortgages through its purchase of Golden West

---

2015, 2016, 2017, etc.. Because NOLs can only be carried forward 20 years, the acquiring company will not be able to use all of company A's NOLs.

Financial in 2006 led to heavy losses during the subprime mortgage crisis of 2007-2008. In the second quarter of 2008, for example, Wachovia reported a loss of $8.9 billion.

During the widespread financial panic of September 2008, Wachovia was under severe strain. On September 27, depositors withdrew over 1% of total deposits and Wachovia's share price plunged 27%.[11] This pressure drew concern from the Federal Deposit Insurance Corporation (FDIC), which strongly encouraged Wachovia to enter merger discussions with both Citigroup and Wells Fargo. Citigroup agreed to purchase Wachovia for $1 per share on September 29. Citigroup's purchase was contingent upon FDIC support. Providing such support required the first-ever application of the "systemic risk exception" established in the FDIC Improvement Act of 1991 (FDICIA).[12]

The FDIC ultimately invoked the "systemic risk exception" for the first time, agreeing to absorb any Citigroup losses in excess of $42 billion stemming from the Wachovia acquisition.[13] In order to induce the FDIC to take this unusual step, the Treasury Department agreed to take the unusual step of explicitly committing to fund all government losses from the proposed transaction. If the Treasury Department had not made this commitment the FDIC would have been the first to bear losses out of its Deposit Insurance Fund.[14] At the meeting at which the FDIC approved its support for Citigroup's acquisition of Wachovia, FDIC Chairman Sheila Bair remarked that "Well, I think this [FDIC support] is, you know . . . one option of a lot of not-very-good options …. I have acquiesced in that decision based on the input of my colleagues, and the fact the statute gives multiple decision makers a say in this process. I'm not completely comfortable with it but we need to move forward with something, clearly, because this institution is in a tenuous situation.

While the negotiations between Citigroup and Wachovia were proceeding, the IRS issued "Notice 2008-83: Application of Section 382(h) to Banks" on September 30, 2008. Because asset values had plunged in 2008, Wachovia, and most other banks had many unrealized losses. (Consider the value of mortgage loans owned by Wachovia on houses whose value was now less than the face value of the mortgage). Ordinarily, Section 382(h) would restrict the tax shelter value of such unrealized losses if Wachovia were acquired. Indeed, that is the point of Section 382(h).

IRS Notice 2008-83, however, said otherwise. The notice concluded that if a bank acquired another bank with unrealized losses and the acquiring bank subsequently realized those losses by selling the assets, then Section 382(h) would not be interpreted to restrict the ability of those unrealized built

---

[11] For citations, use http://en.wikipedia.org/wiki/Wachovia.

[12] In ordinary times, the FDICIA requires the FDIC to choose the "least cost method" reorganization to the FDIC's insurance fund. Citigroup's proposal may not have been the least cost method. The systemic risk exception allows the FDIC to bypass the least cost method if it "would have serious adverse effects on economic conditions or financial stability" and if bypassing the least cost method would "avoid or mitigate such adverse effects." https://www.fdic.gov/news/news/speeches/archives/2007/chairman/spmay0307.html. Citigroup's requirements may not have been the least cost method of resolving Wachovia, but Federal Reserve officials encouraged the FDIC to invoke the "systemic risk" exception. FDIC Report at 368-369.

[13] In return for this support, Citigroup issued preferred stock to the FDIC. FCIC Report.

[14] FCIC Report at 369.

in losses to shelter profits at the acquiring bank. As a result, Wachovia's billions of dollars in unrealized losses could now be acquired by a profitable bank and used to shelter the profitable bank's income.

Two days after Notice 2008-83 was released, Wells Fargo, which had made a bid for Wachovia contingent on explicit FDIC support only one week earlier,[15] bid $7 per share for Wachovia. The new Wells Fargo offer was not contingent on FDIC support. Because Wells Fargo's offer was worth seven times the value of Citigroup's and involved no government support, Wachovia's board chose to accept the Wells bid and this decision was approved by regulators on October 3—only 4 days after Notice 2008-83 was issued. Although there may have been several reasons for Wells Fargo's decision to alter its bid, Notice 2008-83 was almost certainly a critical factor.[16]

2. Evaluating Notice 2008-83.

Notice 2008-83 was greeted with hostility.[17] The critiques emphasized the high potential cost of the Notice; early estimates placed the Notice's cost to the fisc at over $100 billion.[18] (Though these estimates were revised sharply lower.)

Even more importantly, critics were enraged that Notice 2008-83 represented an "unsupervised, non-transparent, unaccountable exercise of lawmaking"[19] by an administrative arm of the US government.[20] The IRS is supposed to "interpret" statutes rather than change them. Notice 2008-83 appears to change the explicit meaning of Section 382(h).

Does Notice 2008-83 deserve this criticism? In ordinary times, I think yes. The IRS's "interpretation" of 382(h) allowed unrealized losses to be used by an acquirer, in contrast to the natural understanding of Section 382(h). In addition, the IRS's unconventional interpretation was implemented via a "quick and easy to draft"[21] notice rather than through issuing a formal regulation. The formal regulatory process is a slower moving but more rational process for expansive interpretations of statutes.

But times were not normal. The IRS was operating in a financial crisis and wanted to "encourage strong banks to acquire weak banks." Faced with a financial crisis for which the legislative process is ill adapted, the IRS chose to act unconventionally. The IRS's Notice obviated the need for a legally questionable FDIC/Treasury bailout of Wachovia via merger with Citigroup.

---

[15] FCIC Report at 368-69.
[16] FCIC Report at 370.
[17] For a summary of the criticisms, see Rich Delmar, memorandum for Inspector General Eric M. Thorson, "Inquiry Regarding IRS Notice 2008-83," September 3, 2009, pp. 3, 5, 11–12.
[18] See http://www.jonesday.com/files/Publication/3feb30bb-253d-40f6-89b9-9e543a0622e2/Presentation/PublicationAttachment/6764f6b7-b547-4020-b67f-a151ff60a3d7/Revisiting%20Notice.pdf.
[19] http://taxprof.typepad.com/taxprof_blog/2008/11/nols-and-the-rule-of-law.html
[20] See, e.g., Amit R. Paley, A Quiet Windfall For U.S. Banks: With Attention on Bailout Debate, Treasury Made Change to Tax Policy, WASH. POST, Nov. 10, 2008, at A01 (discussing many interviews with tax lawyers who considered the Notice to exceed Treasury's scope of authority).
[21] Delmar memo at 4.

Notice 2008-83 didn't simply create an "unsupervised, non-transparent, unaccountable exercise of lawmaking" from nothing. Instead, the Notice just moved this activity from one place (the FDIC and Treasury) to another (the IRS).

Notice 2008-83 should be evaluated against this backdrop. Was Notice 2008-83 better than an FDIC/Treasury bailout of Wachovia and Citigroup? Even here, the answer is unclear.

As a policy matter, I would argue that Notice 2008-83 was better than the government subsidized Citigroup/Wachovia bailout. Wells Fargo, which received TARP money but quickly repaid it, was almost certainly a better acquirer for Wachovia than Citigroup, which continued failing government stress tests through 2014.

Moreover, Section 382 is far from an unambiguous statute. The statute's goal is to prevent "loss trafficking" but Section 382(h) does so in a clunky way, denying legitimate tax deductions. The degree of overtaxation was especially acute in 2008 because of the dramatic, but hard to quantify, plunge in asset values. Some markets had simply frozen up, so that assets could not be sold at any price. Wachovia, for example, had genuine unrealized losses in September 2008. Its mortgages were worth less than their official value because of the plunge in asset values, but it was hard to know much the assets were worth because the market had collapsed. If Wachovia had remained as an independent company and returned to profit, then it would have been able to deduct these losses in full when the market functioned and the assets were sold at a loss. .

Section 382(h) therefore presented a powerful disincentive for acquisitions in the financial industry. Suppose that, without tax considerations, Wachovia was worth $9 billion in the hands of Wells Fargo and $3.5 billion as a standalone financial firm with a high risk of failure. (An acquisition of Wachovia by Wells Fargo would therefore create $5.5 billion in value). But now suppose Wachovia had unrealized losses that would yield a tax benefit with a present value of $10 billion in September 2008 and that there was a 60% chance that Wachovia, left to its own devices, would return to profit and realize the tax benefit of these losses. If Wachovia sold to Wells Fargo, however, then Section 382(h) would forbid the use of these tax assets. Selling to Wells Fargo would therefore destroy very valuable tax assets with an expected value of 60%*$10 billion=$6 billion. After considering tax, Wachovia was worth $9.5 billion as a standalone firm ($6 billion of tax value and $3.5 billion in other value) but a maximum of $9 with Wells Fargo).

Section 382(h) therefore would have prevented a value enhancing transaction. Congress may have accepted this side effect of 382(h) in ordinary times because unrealized losses, and therefore the tax hit of a transaction, were relatively small. But, due to market turmoil, the effects of Section 382(h) were much larger than expected in September 2008. Section 382(h) was proving a large disincentive to financial institution mergers precisely when such mergers were a compelling government interest. As a result, Notice 2008-83 might have adjusted the statute to make it align with Congressional intent better than a naïve reading of the statute would imply. While it would have been better for Congress to state this explicitly, September 2008 was not the time to wait for an explanation for Congress.

Although saying that Notice 2008-83 was an extraordinary exercise of regulatory authority of the IRS does not suffice to condemn the Notice, a more subtle version of this argument proves more compelling. We expect the FDIC, Treasury Department, Federal Reserve etc,, to take extraordinary actions during financial crises. The IRS, by contrast, is not part of the financial crisis fighting team. As a result, Notice 2008-83, though no more extraordinary in September 2008 than many other regulatory actions, was taken by the wrong regulatory authority. Even a financial crisis should not be a free-for all, with every regulatory agency seeking to stem the tide. Instead, a number of focal agencies should address the crisis.

This argument proves stronger. The IRS is not the place you would expect a financial crisis to be fought. But the IRS's extraordinary actions were focused on the problem at hand. Mergers were at the heart of the regulatory response to the financial crisis. Notice 2008-83 reduced a newly salient tax obstacle to mergers. If the IRS had issued 100 rulings like Notice 2008-83 with an eye towards not collecting taxes, this would have been lawless, even for extraordinary times. But a single extraordinary Notice focused on a compelling area of interest should be applauded. Just as corporate law should adjust for financial crises, so should the law of taxation of mergers, or any other aspect of law regulating mergers (e.g., antitrust law).

Congress repealed the prospective application of Notice 2008-83 in Section 1261 of the American Recovery and Reinvestment Act of 2009. [22] Moreover, Congress found that "(2) Internal Revenue Service Notice 2008-83 is inconsistent with the congressional intent in enacting such section 382(m); (3) the legal authority to prescribe Notice 2008-83 is doubtful;" Congress allowed taxpayers, such as Wells Fargo, that had previously relied upon the Notice to retain the tax benefits of doing so.

These explicit Congressional findings do not prove that Notice 2008-83 was wrongly issued as a prospective matter. The IRS might have taken its best guess about what Congress wanted, but guessed incorrectly. Moreover, the many of the extraordinary financial firm rescue actions undertaken by the Federal Reserve and the Treasury were similarly disavowed by Congress in the Dodd Frank Act.

The repeal limited the revenue cost of the Notice. But the effect of Notice 2008-83 on the Wells Fargo/Wachovia merger was substantial. According to Citizens for Tax Justice, Wells Fargo received the largest total tax subsidies of any US corporation from 2008-2010.[23] No other financial firm was in the top 7 corporations. Notice 2008-83 was a boon to a merger completed at the heart of the financial crisis, but benefitted almost no other companies. As a result, Notice 2008-83 deserves less criticism than it has received. It may indeed have been a wise policy decision that was no more lawless than the obvious alternatives (a Treasury/FDIC bailout).

[22] Get Cite.
[23] http://www.thestreet.com/story/11306521/1/how-wells-fargo-won-the-tax-dodging-trophy.html

C. Notice 2010-2

Amazingly, Notice 2008-83 was not the only controversial multi-billion dollar regulatory intervention concerning Section 382 issued during the Great Recession.[24] Notice 2010-2 interpreted Section 382 with respect to several troubled corporations such as G.M., AIG, and Citigroup, that the Treasury Department effectively took over during the Great Recessions. Like Notice 2008-83, Notice 2010-2 provided private corporations extraordinary relief from the restrictions of Section 382. Unlike Notice 2008-83, Notice 2010-2 constitutes more problematic regulatory maneuvering. Although Section 382 contains flaws that were mitigated by Notice 2010-2, Notice 2010-2 was not issued during a time of emergency. In addition, there were obvious alternatives to Notice 2010-2. The impacts of Notice 2010-2 were opaque, however, while the alternatives would have been politically salient. Moreover, the flaws in Section 382 would have been better addressed by a broader regulation that affected companies with or without Treasury control. In total it hard to avoid the impression that, with Notice 2010-2, IRS regulations changed for political convenience rather than because of legitimate policy considerations.

As discussed above, Section 382 limits the use of Net Operating Losses (and unrealized losses) when the ownership of a company changes. Ordinarily, a change in ownership occurs between one private party and another. But during the Great Recession, the Federal Government, led by the Treasury Department and funded by TARP, became an important/majority shareholder in several companies. After a series of bailouts and bailout modifications, the Treasury became a 92% owner of AIG in 2010. After General Motors' (GM) bankruptcy reorganization in 2009, the Treasury Department owned 61% of GM. And, as of June 2009, Treasury owned 33.6% of Citigroup.

AIG, GM, and Citigroup each had considerable amounts of NOLs. AIG listed "Deferred tax assets: Losses and tax credit carryforwards" of $26.2 billion at the end of 2009.[25] Citigroup claimed tax assets of $46.1 billion. And GM listed $18 billion worth of NOLs in 2010. Each company's losses were much greater than the value of their tax assets. At a corporate income tax rate of 35%, a company needs approximately $51 billion ($51 billion*.35=$18 billion) in losses in order for its tax assets to be worth $18 billion.[26]

While AIG, GM and Citgroup all had monumental losses—valuable because the losses would shelter future profits from taxes-- Section 382 threatened the practical value of these tax assets. With all three companies, the Treasury's purchase and subsequent sale of partial or complete corporate control triggered Section 382(g).[27] Section 382 provides (roughly) that if 50% or more of a company gets

---

[24] The analysis in this subsection draws heavily upon Ramseyer and Rasmussen. Unlike R and R, I view Notice 2010-2 within the broader context of tax/financial regulation issued in response to the Great Recession.

[25] Ramseyer and Rasmussen at 8.

[26] Tax assets are not discounted to reflect the fact that they will reduce tax in the future rather than in the present. In addition, the value of tax assets are not adjusted for the probability that they will not be used due to a lack of profits. See Ramseyer and Rasmussen.

[27] Two changes of control occurred for the purpose of Section 382 with respect to each company. The first occurred when Treasury increased its stake in the company from zero to greater than 50%. For AIG and Citgroup, both transactions appeared to trigger Section 382 change of control provisions. With respect to GM, only the sale of stock from the Treasury to the public or back to GM should have triggered Section 382(g). Treasury's initial

exchanged from one bloc of large shareholders to another bloc, then the NOLs from that company can only be used at a very slow rate.[28] As a result, Section 382(g) threatened one of the most valuable assets owned by AIG, GM, and Citi—their ability to avoid taxes on future profits by using NOLs.

Notice 2010-2 eliminated this threat to AIG, GM, and Citigroup's NOLs. The Notice effectively said that Section 382's change of control triggers did not apply when the Treasury, rather than some other entity, purchased[29] or sold[30] stock in a company. While a private 92% shareholder of AIG that sold its stake to a third party would have restricted AIG (or a successor company) from using NOLs, the fact that Treasury, rather than a private entity, purchased 92% of AIG and then sold its stake meant that Section 382 did not apply. AIG or a successor company could use its NOLs without restriction, even though more than 50% ownership of the stock had changed hands from one shareholder to another.

A reading of Section 382 provides nothing to indicate that Treasury was intended to be treated differently than other entities. Indeed, Section 382(n) explicitly contemplates the sale of a government stock in a financial company acquired as a result of TARP. Section 382(n) does not exempt a sale by the Treasury from Section 382's restrictions.

Notice 2010-2 was extremely valuable to AIG, GM, and Citigroup. Instead of choosing between Treasury support with NOL restrictions or trying to make it on their own, the companies could have both. Their NOLs would shelter future profits in spite of the Treasury's purchase and subsequent sale of controlling stakes in each company. The company's benefit was the public fisc's detriment. As a longtime tax practitioner explained, "The government is consciously forfeiting future tax revenues. It's another form of assistance, maybe not as obvious as direct assistance but certainly another form … I've been doing taxes for almost 40 years, and I've never seen anything like this, where the IRS and Treasury acted unilaterally on so many fronts."[31]

This prediction has proved true. In fiscal year 2011, for example, GM reported net income of almost $10 billion. It paid only $199 million in global income taxes, for an average income tax rate of slightly over 2%. (The statutory rate in the US is 35%.) In 2012-2104, GM reported an average tax rate of around 14%.

1. Evaluating Notice 2010-2

Notice 2010-2 and Notice 2008-83 share many obvious similarities. Both notices concern the tax value of transferred losses that are ordinarily restricted under Section 382. One of the arguments in

---

acquisition of GM stock did not triggers 382(g) because, among other reasons, it was exempted by Section 382(n). In all three cases, at least one of the pattern of transactions by Treasury triggered 382(g).

[28] Although the Treasury never owned more than 50% of Citigroup, Citigroup issued a great deal of equity to private shareholders during the period. As a result, more than 50% of ownership changed hands from one set of large shareholders to another, trigerring Section 382(g).

[29] Most of the Treasury's initial investments came in the form of debt, preferred stock, and/or warrants (company issued stock options). Sections A and B of Notice 2010-2 explained that such investments did not count as stock ownership for purposes of Section 382. . Many of these investments were later converted to common stock.

[30] Notice 2010-2 Sections D and E explain that sales of stock by the Treasury, either directly to the company itself (Part D), or to other shareholders (Part E)do not trigger Section 382 change of control restrictions.

[31] http://www.washingtonpost.com/wp-dyn/content/article/2009/12/15/AR2009121504534.html.

favor of Notice 2008-83—that Section 382 is an overly broad statute and the costs of such breadth were particularly acute during the Great Recession, applies to Notice 2010-2.

But Notice 2010-2 and differ in important respects. Notice 2008-83 was issued at the heart of the financial crisis, before TARP had been passed. The alternatives to Notice 2008-83—a joint FDIC/Treasury supported takeover of Wachovia by Citigroup-- were extremely questionable and without firm legal precedent. Under the circumstances, Notice 2008-83—in spite of all of its critics—may have been the best of a bad series of options.

Notice 2010-2, by contrast, was issued under different circumstances. While the economy was moribund in 2010, it was more stable than it was in September of 2008. In addition, Treasury enjoyed obvious alternatives to Notice 2010-2. TARP retained xxx dollars in 2010. Let us assume that AIG, GM, and Citigroup needed the asset infusions provided by Notice 2010-2. Instead of providing AIG, GM, and Citigroup the necessary cash with a multi-billion dollar tax windfall, Treasury could have transferred TARP funds directly and transparently. Indeed, Treasury used TARP funds to stabilize all three companies. All Treasury had to do was more of the same with respect to TARP. A direct injection of additional TARP funds would have raised Treasury's share of each company, while the tax windfall established by Notice 2010-2 was shared with private minority shareholders in each corporation. Finally, Section 382(n) provided a near-contemporaneous Congressional indication that Section 382 was intended to apply to sales by the Treasury. For all of these reasons, Notice 2010-2 reflected a poor policy choice. Notice 2010-2 put forth a questionable legal position that put the US government in a worse financial position than a legally sound alternative.

Why was Notice 2010-2 issued? It is hard to avoid the conclusion that Notice 2010-2 was intended to minimize the headline costs of Federal bailouts. If the Treasury had injected more TARP funds into AIG, GM, or Citigroup, the direct cost of the government bailouts would have risen. Changing tax law, by contrast, helped each firm without formally increasing the government's support. As Ramseyer and Rasmussen conclude, "Only potential bad publicity would worry [a regulator with inappropriate motivations]. But publicity he can skirt by giving the funds through exemptions from the application of Sec. 382 of the tax code to limits on carryforwards of NOLs … Giving a billion dollars in cash to the UAW would be obvious. Giving it through a Sec. 382 exemption will put his critics to sleep."[32]

To prevent recurrences of Notice 2010-2, Ramseyer and Rasmussen advocate new legal rights. Whatever the merits of these rights, they fail to put Notice 2010-2 in the proper context—law and macroeconomics. Notice 2010-2 is just one of many examples of regulation changing to fit the macroeconomic and financial environment. Notice 2008-83 (which Ramseyer and Rasmussen also condemn) and the Treasury/Federal Reserve/FDIC bailouts of Bear Stearns, AIG, and Citigroup provide examples of changing regulation from a non-tax perspective.

We need a framework for evaluating law's response to the macroeconomic environment. This book sets forth several. Regulations should change to fit the macroeconomic environment when the regulations improve financial stability in a recession with interest rates at the zero lower bound. In

[32] Ramseyer and Rasmussen

addition, the change in regulations should not preempt direct mechanisms for achieiving the same macroeconomic effects. Notice 2008-83 improved financial stability by facilitating the takeover of a failing bank by a healthier one. There was no clear alternative to Notice 2008-83, only other ad hoc solutions. Contrary to conventional wisdom, I therefore conclude that Notice 2008-83 was a reasonable adjustment to law during a financial crisis.

Notice 2010-2 meets some of the conditions for macroeconomically motivated regulatory policy, but not others. The goals of Notice 2010-2 could have been accomplished by TARP, recently passed by Congress for the purpose of assisting ailing firms during the financial crisis. As a result, Notice 2010-2 presents an example of illegitimate macro-economically motivated regulation—regardless of its macroeconomic merits.

Notice 2010-2 doesn’t prove that macroeconomically oriented regulatory change is improper. Instead, Notice 2010-2 demonstrates that, as with any legal goal, macroeconomic or financial stability can be opportunistically exploited by lawmakers and regulators. In the last section of the book, I explore institutional mechanisms to limit the ability of judges and regulators to exploit macroeconomic rationales.