

COMMUNITY BANK TAX REPORT



CLAIMS COURT EXPANDS 'REPLACEMENT OF CAPITAL' DAMAGES FOR CAPITAL RAISED TO PROVIDE THRIFTS 'CAPITAL CUSHIONS'

In *American Federal Bank, FSB v. United States*, 72 Fed. Cl. 586, final judgment rendered, 2006 U.S. Claims LEXIS 335 (2006), the Court of Federal Claims continued to give favorable reception to damage claims by thrifts in *Winstar*-related litigation based upon a “replacement of capital” theory, and continued to be hospitable to claims that such awards should be “grossed up” to account for Federal income taxes that might be imposed upon the awards. The decision expands upon prior decisions by allowing costs of establishing a “capital cushion,” even where the thrift had not consistently maintained such a cushion historically.

American Federal

American Federal was a federally chartered savings and loan association in South Carolina which in 1982 acquired four troubled South Carolina thrifts. Its agreements with the Federal Home Loan Bank Board (FHLBB) which permitted American Federal to count as regulatory capital the intangible goodwill that was generated as a result of the mergers, and to amortize that goodwill over a forty-year period. In an earlier decision, the Claims Court found that these agreements resulted in the creation of implied-in-fact contracts between American Federal and the government. *American Fed. Bank, FSB v. United States*, 62 Fed. Cl. 185, 186 (2004) (“*AmFed II*”).

In January 1989, American Federal, in order to meet applicable capital requirements, executed a modified conversion from mutual to stock form. In connection with the conversion, the amortization period for the supervisory goodwill was shortened to 29.5 years, and the thrift issued three new series of securities – common stock, and two classes of subordinated debentures (Series A and Series B). The thrift issued two million shares of common stock, which were sold at a purchase price of \$5 per share. The Series A subordinated debentures bore stated aggregate principal amount of \$100,000, due January 15, 2004. They were issued for \$12.5 million, and could be converted into common stock at a conversion ratio that took account of the full price of \$12.5 million; but they were accompanied by a mandatory purchase contract (MPC), which required the converting holders to acquire common stock at a price of \$5.75 per share, in exchange for an aggregate purchase price of \$12.65 million. These shares were acquired by institutional investors, including Travelers Insurance Company and the General Electric Pension Trust.

The Series B subordinated debentures were issued for an aggregate purchase price of \$15 million, allocated \$1.361 million to detachable warrants, which enabled holders to purchase 600,000 shares of common stock, and

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PREPARED BY
STANLEY I. LANGBEIN

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TAX RELIEF AND HEALTH CARE ACT EXTENDS TAX BENEFITS AND LIBERALIZES RESEARCH CREDIT

On December 20, President Bush signed into law the Tax Relief and Health Care Act of 2006, P.L. 109-432. The principal effect of the bill is to extend expiring tax relief provisions. The bill also includes revisions of energy tax legislation and of the medical and health savings account provisions, as well as a number of tariff provisions.

Tuition Expenses, New Markets Credit and Sales Taxes of Individuals

Section 222 provides a tax deduction for qualified tuition and related expenses of \$4,000 for taxpayers whose gross income does not exceed \$65,000, and \$2,000 for taxpayers with gross income between \$65,000 and \$80,000. The credit was to expire at the end of 2005. The TRHCA makes the deduction permanent.

Section 45D(f)(1) imposed maximum limitations on the amount of new markets tax credits allowable annually. The amount was \$3.5 million for 2006 and 2007, and no amount was specified for years beyond 2007. The TRHCA creates a limitation (authorization) of \$3.5 million for 2008. The law also authorizes Treasury regulations under the NMTC that “ensure that non-metropolitan counties receive a proportional allocation of qualified equity investments.” IRC § 45D(i)(6).

The American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, provided an election to individual taxpayers either to deduct state and local income taxes or state sales taxes. The election applied only to taxable years beginning in 2004 and 2005. The TRHCA extends the provision to taxable years beginning in 2006 and 2007.

Research Credit

The TRHCA extends the research credit, which expired in 2005, for two more years, to apply to expenditures in 2006 and 2007. The statute also makes certain changes in the way the credit may be computed. Under the statute, an alternative incremental credit computes the limitation on the amounts creditable as a series of increasing percentages of the amount of the average gross receipts for the four-year period immediately preceding the year. Under current law, the amount is 2.65% of the amount between 1% and 1.5% of the average for the four-year period; 3.25% of the amount between 1.5% and 2% of that average; and 3.75% of the amount by which the year’s expenses exceed 2% of that average. These percentages are raised to 3, 4, and 5%, respectively. This change is effective for taxable years ending after 2006.

For taxable years ending after 2006 that include December 31, 2006, the percentages used are prorated according to the number of days in the year during 2006

and the number during 2007. Thus, for instance, assume a taxpayer with a March taxable year with \$65,000 in research expenses for its year ending March 31, 2007, with a four-year average gross receipts for its years ending March 31, 2003, through March 31, 2006 of \$1 million. Under the alternative incremental method, the taxpayer receives no credit for the first \$10,000 of expenses (1% of the four-year average). Its credit for the first “tranche” of \$5000 (between 1% and 1.5% of the average) is determined by multiplying \$5000 by $[(275/365) \times .0265] + (90/365) \times .03$, which computes to 2.73% and yields a credit of \$136.81. Its credit for the second “tranche” of \$5000 (between 1.5% and 2% of the average) is determined by multiplying \$5000 by $[(275/365) \times .0325] + (90/365) \times .04$, which computes to 3.43% and yields a credit of \$171.75. Its credit for the third “tranche” of \$45,000 (over 2% of the average) is determined by multiplying \$45,000 by $[(275/365) \times .0375] + (90/365) \times .05$, which computes to 4.06% and yields a credit of \$1,826.20. The total credit would thus be \$2,134.76.

Third Alternative for Computing Research Credit

In addition for taxable years ending after 2006, the law provides a third alternative for computing the credit, which is simpler and will generally be more generous than the two applicable under current law. This method computes the credit as 12% of the excess of the expenses for the year over 50 percent of the average expenditures for the preceding three years. If one assumes, in the preceding example, that the three-year average of qualified gross receipts is \$50,000. This would yield a credit on the facts stated above of \$4800 – more than seven times that allowable under AIC computation. If a taxpayer has no expenses during the three-year period, the credit is 6% of the amount of the expenditures. This method, once elected, is irrevocable except with consent. The statute provides that for years including December 31, 2006, a taxpayer electing the credit is deemed to have revoked any election to use the alternative incremental method with consent, beginning with the first year after the year including December 31, 2006.

For taxable years ending after December 31, 2006, that include that date, the new method may be elected, but the credit is computed by multiplying the amount determined under whatever old method applied by the ratio of the number of days in 2006 to the number in the taxable year; and the amount under the newly elected by a the ratio of the number of days in 2007 to the number in the taxable year. To use our above example, one would multiply \$2,134.76 by $(275/365)$ (to yield \$1608.36), and add \$4800 multiplied by $(90/365)$ (yielding \$1183.56), to get a total credit of \$2791.92. And it is the case that, if

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PROPOSED REGULATIONS ON SUBCHAPTER S BANKS, RECEIVABLES, AND CAPITALIZATION DRAW SERIOUS CRITICISM

Three sets of proposed regulations published by the Treasury and Service in the late summer have drawn emphatic protest from affected taxpayers and professional and industry groups.

Section 291 and Subchapter S Banks

On August 24, the Service published in the Federal Register REG-158677-05, 71 *Fed. Reg.* 51,007 (Aug. 24, 2006), providing that 1363(b), which states that the “taxable income of an S corporation shall be computed in the same manner as in the case of an individual,” does not affect an S corporation’s status as a bank within the meaning of section 581, and does not “prevent the application to such an S corporation bank of any special rule applicable to banks under the Internal Revenue Code.” Prop. Reg. § 1.1363-1(b)(2). The “special rules” of greatest concern are those of Sections 291(a)(3) and (e)(1)(B), which disallow 20% of the interest expense of a financial institution, when the interest is allocable to certain “qualified tax-exempt obligations” (QTEOs). Section 1363(b)(4), provides that “section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years.” The Treasury and Service make clear, in the examples to the regulations and in the preamble to the proposal, that the general rule of the Proposed Regulations, making special bank rules applicable to Subchapter S banks, would override Section 1363(b)(4), and subject Subchapter S banks to the 20% disallowance beyond the third year of the S corporation election. See “IRS Issues Proposed Regulations Subjecting Subchapter S Banks to Section 291 Interest Disallowance,” *CBTR*, Sept. 2006, p. 1.

Comments on the proposal were due November 22, and critical comments were filed by the American Bankers Association (ABA), America’s Community Bankers (ACB), Subchapter S Bank Association (SSBA), and the Tax Section of the American Bar Association (Tax Section).

American Bankers Association Comments

The ABA (bankers) comment asserts that in the past year, the Service has initiated audit activities with respect to the Section 291 issue, and it suggests that at least one taxpayer has “decided to challenge the Service’s position in court.” The ABA comment suggests that the Service has “made it clear on many occasions” that while the issue was still on audit or in litigation, the National office would not take any position until resolution.” It therefore suggests that it is not appropriate for the Service to finalize the regulations prior to final decision by the courts; and that the issuance of the proposed regulations was “a

way for the Service to boost its position unfairly in the upcoming litigation on the issue.”

The core of the ABA comment is twofold: a first argument going to substance; the second to effective dates. The Service’s position, expressed in the preamble, is that, because Congress included a special rule stating that the bad debt reserve method would not be available to Subchapter S banks, it must have intended that, in the absence of an express provision otherwise, all “special” bank rules apply to Subchapter S banks. The ABA characterizes this argument as “quite difficult to follow,” and insists that the *inference* drawn from the Section 585 provision should not mean that the *express* provision of Section 1363(b)(4) should be overridden by the general rule inferred from the statute.

As to effective dates, the ABA notes that the regulations are effective with respect to taxable years beginning after August 24, 2006, but that the preamble states that no inference should be drawn respecting prior taxable years. The ABA suggests it is “impossible” not to draw an inference, and suggests that the regulations should be prospective from the date of final resolution of the issue in litigation. The ABA also suggests that obligations acquired before the effective date should be grandfathered, because institutions “priced” obligations they acquired on the assumption that the bonds would not be subject to Section 291.

Other Comments

ACB similarly contested the Service and Treasury reading of the statute, and requested a grandfathering of existing obligations, and a prospective effective date. ACB also argued that the rule would depress the market price of existing obligations held by the banks, with potential regulatory consequences.

The SSBA states that its members have consistently assumed that the Section 291 disallowance would not apply to Subchapter S banks after three years (or to new Subchapter S banks at all), and that tax and accounting professionals had reported at the SSBA’s annual conferences and otherwise that the position had been confirmed by the IRS Chief Counsel. It says that it was at the 2005 conference that the IRS first stated its position challenging the industry. It states that its members had thought “the informal direction from the Chief Counsel’s office which had been communicated by subchapter S technical advisors from the IRS was all the clarification that was necessary,” and that the recent audit positions that the Service has taken in Wisconsin and Illinois (and perhaps elsewhere) were “particularly alarming.”

The Tax Section’s comment was prepared by its Committees on S Corporations and Banking and Savings

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\$13.639 million to debentures, which were to mature on January 15, 1999. These were also purchased by sophisticated institutional investors, including Travelers and the GE Pension Trust. The Series B debentures had an interest rate of 11.25%, paid on a semiannual basis.

FIRREA

The Financial Institutions Reform Recovery and Enforcement Act, Pub. L. No. 101-73, 103 Stat. 183 (FIRREA), was enacted in August 1989, and abrogated American Federal's right to count supervisory goodwill as capital and its subordinated debentures as core capital. Pursuant to a capital plan submitted in January 1990, and approved by the Office of Thrift Supervision (OTS) the following May, American Federal executed a series of transactions to bring it into compliance with the new standards by December 31, 1994, the date when those standards were to be fully phased in.

First, in April 1990, the holders of Series B subordinated debentures exchanged the debentures for noncumulative, nonvoting Series I preferred stock. The holders received 15,000 shares, at a nominal value of \$1,000 per share. The Series I preferred permitted American Federal to pay no dividends for a period of time, but gave the holders priority of payment should the bank be sold, merged, or begin to pay dividends on its common stock, in an amount determined by the dividends that would have been paid. The Series I preferred had priority over the common stock in payment of dividends, priority in payment of proceeds in the event of a liquidation of the bank, and priority in the allocation of proceeds in the event of a business combination involving the bank. The non-cumulative dividend on the Series I preferred was at a rate equal to the interest that was payable on the Series B subordinated debt, adjusted for the tax consequences to the bank of the obligation to pay preferred dividends as contrasted to interest. Most of the holders were corporations which would qualify for a dividends received deduction on payment of the dividends, but would be taxable on the interest paid, so the adjustment did not affect the after tax amount earned by the recipients.

Second, between 1990 and 1993, American Federal

undertook a program of converting residential mortgage loans in its portfolio to mortgage-backed securities. This conversion process, along with the retention of earnings, improved American Federal's capital position to the point where by the end of 1992, it was in compliance with its three capital standards (tangible capital, risk-based capital, and core capital) as of that time, although it did not yet meet the standards that would apply when the standards were to be fully phased in, as of the end of 1994.

Exchange and Secondary Offering

Third, in March 1993, American Federal executed an exchange and secondary stock offering, which had three steps. The first two involved exchanges of the Series I preferred and Series A debentures for common stock. The Series A holders converted their subordinated debentures into 2,173,912 shares of common stock, and, as

required by the MPCs, purchased an additional 2,195,650 shares of common stock for \$12.625 million. Both reflected a price of \$5.75 per share, determined by the terms of the debentures. The Series I preferred stockholders received 2,340,768 shares of common stock for their 15,000 preferred shares. Of these shares, 1,714,286 common shares were attributable to the paid-in preferred shares themselves, and 626,482 were attributable to the compounded dividend entitlement (which amounted to \$5,481,918 at the time of the exchange). The shares received by the Series I holders reflected a face amount of \$15 million for the debentures, plus the entitlement, at \$8.75 per share.

The third step was the secondary offering of stock. American Federal sold 2,083,955 shares of common stock. The former holders of Series A and Series I instruments sold 4,126,045 shares; many of these needed to sell the shares to avoid becoming holding companies of American Federal under applicable OTS regulations. The 6.21 million shares were sold in the public offering at a price of \$8.75 per share.

Of the 2,083,955 shares offered and sold by American Federal, the bank allotted 810,000 shares at \$8.24 per share as an over-allotment to the underwriters; this was called the "green shoe." American Federal granted the underwriters a thirty-day option to purchase these additional shares to cover over-allotments. The bank determined the amount to be offered based on its capital needs, but if the offering proved attractive to investors, there

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would be a “green shoe.” The offering proved attractive, and the full amount of the green shoe was exercised.

Release and Takeover

Shortly after completion of the exchange and offering, the OTS released American Federal from its capital plan and attendant conditions. By the end of 1993, American Federal was well-capitalized with respect to all three of its capital ratios, even as they would stand when fully phased in; and the bank wrote off its remaining supervisory goodwill.

On August 1, 1997, American Federal was acquired by CCB Financial Corporation, of Durham, North Carolina (“CCB”) in a stock swap, as a result of which American Federal became a wholly owned subsidiary of CCB. On June 17, 2000, American Federal merged into Central Carolina Bank & Trust Company (“CCB&T”), another wholly-owned subsidiary of CCB.

On July 5, 2000, CCB merged with National Commerce Bancorporation (“NCBC”), and thus CCB&T became a wholly-owned subsidiary of NCBC. On or about April 25, 2001, NCBC changed its name to National Commerce Finance Corporation (“NCFC”). On December 31, 2001, CCB&T merged into National Bank of Commerce, another wholly-owned subsidiary of NCFC. On October 1, 2004, NCFC merged into SunTrust Banks, Inc. National Bank of Commerce remained a wholly-owned subsidiary of SunTrust Banks, Inc. until April 22, 2005, when that bank merged into SunTrust Bank, the principal wholly-owned banking subsidiary of SunTrust Banks, Inc.

Winstar and Expectancy Damages

In *Winstar Corp. v. United States*, 518 U.S. 839 (1996), as is well known, the Supreme Court ruled that the adoption of capital standards by FIRREA, abrogating the right of thrifts to use “supervisory goodwill,” constituted a breach by the government of contracts by which the thrifts involved had previously acquired other thrifts; and that the plaintiff thrifts could recover damages for the breach. In the years since, the Federal Circuit and Claims Court have struggled to determine the quantum of damages in *Winstar*-related cases. The courts recognize that there are three general theories for granting damages for breach of contract – expectancy damages, reliance, and restitution – and that expectancy damages are the primary

form of damages that should be awarded. See *Glendale Federal Bank FSB v. United States*, 245 F.3d 1342 (Fed. Cir. 2001). But the courts have found “lost profits” difficult if not impossible to measure. In some early cases, the courts measured damages as the amount an acquiring party had advanced to acquire a thrift, under a “reliance” theory, although most of these cases involved acquisition targets that became insolvent when the use of supervisory goodwill was disallowed. *Landmark Land Co. v. United States*, 256 F.3d 1365, 1370 (Fed. Cir. 2001); *Far West Federal Bank v. OTS*, 119 F.3d 1358, 1367 (9th Cir. 1997); *Hansen Bancorp, Inc., v. United States*, 53 Fed. Cl. 92, 104 (2002). See *Franklin Federal Savings Bank v. United States*, 55 Fed.Cl. 108, 121 (2003). The Federal Circuit and Claims Court have uniformly rejected measuring damages by the amount of a target’s book deficit, under a restitution or “benefit” to the government theory.

California Fed. Bank, FSB v. United States, 245 F.3d 1342 (Fed. Cir. 2001).

In these cases, the thrifts “replaced” supervisory goodwill ordinarily through some sort of capital transaction, either a securities offering or an infusion of capital by an acquiring party.

Cost of Replacement Capital

In response to these difficulties, the courts have upheld awarding damages based on the “cost of replacement” capital, on the theory that those costs represent an appropriate measure of “expectancy” damages, by analogy to provisions of the Uniform Commercial Code permitting recovery of damages based on the cost of “cover.” *Home Savings of America v. United States*, 399 F.3d 1341 (2005); *LaSalle Talman Bank, FSB v. United States*, 462 F.3d 1331 (Fed. Cir. 2006); *Citizens Federal*

Bank v. United States, 66 Fed. Cl. 179, 185 (2005); see *UNIFORM COMMERCIAL CODE* §§2-703(d), 2-706. In these cases, the thrifts “replaced” supervisory goodwill ordinarily through some sort of capital transaction, either a securities offering or an infusion of capital by an acquiring party. The cost of replacement capital is generally measured by the return the thrift has paid on the securities so offered or the capital so supplied, over the time when it would have been allowed to use supervisory goodwill. This is reduced by the “benefit” of having tangible capital. That benefit is usually measured by multiplying the amount of capital involved by some “safe” rate of return.

Causation and Mitigation

An abiding difficulty with this approach concerns the

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link between capital transaction at issue and the breach of contract. The courts recognize four “elements” of expectancy damages – that the damage have been caused by the breach; that the damage have been foreseeable; that the injured party have taken steps to mitigate the damage; and that the damages be calculable with reasonable certainty. The linkage question arises with respect to the first and the third, causation and mitigation. The question arises because the capital transaction involved may have business motivations or effects other than or beyond “replacing” supervisory goodwill – particularly when the amount of capital raised exceeds the amount necessary to meet minimum requirements. In *Home Savings*, the plaintiff thrift was a large thrift that had always been healthy, and had historically maintained a capital “cushion” in excess of minimum requirements. The courts held that the plaintiff could recover the costs of the capital raised to

replace goodwill, even though the thrift was rebuilding its cushion, and not simply meeting regulatory requirements.

In *LaSalle Talman Bank, FSB v. United States*, 64 Fed. Cl. 90, 106 (2004), aff’d, 462 F3d 1331 (Fed. Cir. 2006), the Claims Court held that a thrift could recover costs triggered by a capital infusion if the breach involved were a “substantial factor” leading to the infusion. The Court repudiated a requirement that the breach be a “proximate cause” of the loss. Subsequent to the Claims Court’s decision, the Federal Circuit rejected the “substantial factor” test in favor of the “proximate cause” standard in *California Federal Bank v. United States*, 395 F.3d 1263 (2005). Notwithstanding this, and without discussing the issue, the Federal Circuit affirmed the *LaSalle Talman* decision, apparently finding that the damages there met the narrower standard as well as the broader one.

American Federal Litigation

As has been the case with most of the *Winstar* damages cases, the Claims Court entered a series of decisions in

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the AIC method is used, one uses the revised percentages, not the old ones, in computing the portion of the credit attributable to the “old” law: the statute expressly permits a “dual” election of the AIC and the new method for a transitional year.

Work Opportunity and Welfare-to-Work Credits

The statute extends the work opportunity and welfare-to-work credits, which expired at the end of 2005, to apply to wages paid to individuals who begin work in 2006 or 2007. The statute makes certain minor changes in the work opportunity credit, by dropping a limitation on wages paid to ex-felons to those in families with incomes less than 70% of the Bureau of Labor Statistics’ lower living standard; by increasing the age of the Food Stamp recipients who may qualify from 25 to 40; and by extending the period after the date of hire by which the employer must apply for certification of the employee from 21 to 28 days. These changes are effective for hires after 2006.

The law also consolidates the work opportunity and welfare-to-work credits. There are differences between the two credits. The work opportunity credit applies only to first-year wages, and equals 40% of only the first \$6000 in wages. The welfare-to-work credit applies to first- and second-year wages; is equal to 35% of first-year wages; and 50% of second-year wages; and applies to \$10,000 wages per year. Under the consolidation, the 40% rate

will apply to wages paid to “long-term family assistance recipients”; second-year wages will continue to qualify, but only up to 50% of the wages paid. The increased limitation (to \$10,000 per year) will continue to apply. These rules apply to employees hired after 2006.

Qualified Zone Academy Bonds

The statute provides a \$400 million limitation on qualified zone academy bonds (QZABs) for 2006 and 2007; the limitation had been zero after 2005. The new law imposes on QZABs issued pursuant to post-2005 allocations the arbitrage and reporting requirements imposed on private activity bonds by private law. In addition, it imposes upon such bonds requirements concerning the application of the proceeds of the bonds. The issuer must reasonably expect, on the date of issuance, that at least 95 percent of the proceeds from the sale of the issue will be spent for 1 or more qualified purposes with respect to qualified zone academies within the 5-year period beginning on the date of issuance of the qualified zone academy bond. It must also expect, as of that date, that a binding commitment with a third party to spend at least 10 percent of the proceeds from the sale of the issue will be incurred within the 6-month period beginning on the date of issuance; and that those purposes will be completed with due diligence and the proceeds from the sale of the issue will be spent with due diligence. The Treasury is permitted, on request prior to the expiration of the 5-year period, to extend the period if failure to satisfy the 5-year requirement is due to reasonable cause and the related purposes will continue to proceed with due diligence. To the extent that less than

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the American Federal litigation. The Court denied cross-motions for summary judgment on liability in *American Fed. Bank, FSB v. United States*, 58 Fed. Cl. 429 (2003) (“*AmFed I*”), and established liability after nine-day trial in *American Fed. Bank, FSB v. United States*, 62 Fed. Cl. 185, 186 (2004) (“*AmFed II*”). In a third decision in the American Federal litigation, the Claims Court rejected other measures of damages, but upheld recovery based on cost of replacement capital. *American Fed. Bank, FSB v. United States*, 68 Fed. Cl. 346, 349 (2005) (“*AmFed III*”). In the fourth decision, rendered in September, the Court addressed issues raised by the Government with respect to the four principal elements of expectancy damages – causation, foreseeability, mitigation, and reasonable certainty of measurement.

Capital Cushion Immediately Before the Breach

With respect to causation, American Federal argued that it took five sets of actions to mitigate the consequences of the breach – the 1990 exchange of Series B subordinated debt for Series I preferred, the three elements of the 1993 secondary offering (the stock offering; the exchange with the Series A subordinated debt holders; and the exchange with the Series I preferred stockholders), and the 1997 merger with CCB. The government contested whether all

but the first of these was caused by the breach. The government noted that as a consequence of the 1993 offerings, American Federal’s capital levels exceeded regulatory minima. The government distinguished the case from prior decisions, especially *Home Savings*, in which the thrift had regularly maintained a capital “cushion,” prior to FIRREA; American Federal, by contrast, had annually failed its capital requirements. The government argued that the 1993 exchange and offering had been motivated by business reasons independent of the breach, and that the plaintiff was seeking to apply a “substantial factor” standard of causation, rejected by the Federal Circuit in favor of a “proximate cause” standard in *Calfed*.

The Court held that the reasons American Federal had for the 1993 offering, apart from the breach, involved a “desire to be an attractive candidate for acquisition,” but found this to be a “secondary objective,” noting that *Calfed* “elaborated on its direct-causation test by stating that the breach need *not* be ‘the sole factor or sole cause’ of damages.” 72 Fed. Cl. at 601 (emphasis in original). The Court rejected alternative arguments by the government that portions of the 1993 offering and exchange were not caused by the breach. With respect to the capital cushion, and the distinction from *Home Savings*, the Court held that “in actuality, contrary to the government’s contention, prior to FIRREA, the bank had started to develop a capital cushion beginning with the modified stock conversion in January 1989.” It noted that American Federal had

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95 percent of the proceeds of such issue are expended by the close of the 5-year period or any longer extended period, the issuer is required to redeem all of the nonqualified bonds within 90 days after the end of the period.

The TRHCA extends the designation of census tracts in the District of Columbia as enterprise communities, which expired at the end of 2005, is revived for 2006 and 2007. The authorization for tax exempt economic development bonds for the District is renewed for 2006 and 2007. The zero capital gains rate applicable to “DC Zone” assets applies to property acquired in 2006 or 2007, and the period over which the gain accrue is extended to the end of 2012; under prior law, qualification for the rate applied only to property acquired before 2006, and to gain accrued by the end of 2010. The first-time homebuyer credit for the District of Columbia is extended to property acquired in 2006 and 2007.

The treatment of certain “qualified leasehold improvement” property and certain “qualified restaurant property” as 15-year property for purposes of the modified

accelerated cost recovery system is extended to property acquired in 2006 and 2007. Under section 170(e)(1), the amount of charitable contributions of inventory and other “ordinary income” property are reduced by the amount that would constitute ordinary income if the property were sold. Under Section 170(e)(6), the reduction is limited in the case of contributions of computer technology and equipment for educational purposes. This limitation expired at the end of 2005. The TRHCA revives it for contributions during 2006 and 2007.

The law extends the period during which property placed in service in the “Gulf Opportunity zone” will qualify for the special 50 per cent bonus depreciation enacted by the GO Zone Act of 2005. Under the original enactment, the bonus applied only to property placed in service before 2008, or, in the case of real property, before 2009. The new law extends the period until the end of 2010 for real property in a county or parish identified by the Treasury as one in which the 2005 hurricanes damages, in the aggregate, more than 60% of the occupied housing units. The extension also applies to personalty substantially all of the use of which is in such a building and which is placed in service within 90 days of the date the building is placed in service. ■

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Institutions, but had not been officially approved by the Bar Association's House of Delegates, and thus was not an official American Bar Association position. The Tax Section's comment emphasized the "plain language" argument advanced by the Bankers Association.

Accounts and Notes Receivable

On August 7, the Treasury and IRS proposed regulations to define when accounts and notes receivables do not constitute capital assets under Section 1221(a)(4). 71 Fed. Reg. 44,600 (Aug. 7, 2006). See "Proposed Regulations Define When Accounts and Notes Receivables Constitute Capital Assets," CBTR, Oct. 2006, p. 2.

The regulations were intended to overturn decisions *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), aff'd. in part and rev'd. in part on other grounds, 335 F.2d 125 (9th Cir. 1964), acq. sub nom. *United Assocs., Inc.*, 1965-1 CB 3, and *Federal National Mortgage Association v. Commissioner*, 100 T.C. 541 (1993), which expanded the circumstances in which such receivables are treated as giving rise to ordinary gain or loss.

The proposed regulation provides that an account or note receivable is not described in Section 1221(a)(4) (and thus not excluded from capital asset treatment) if either "[i]n acquiring the account or note receivable, the taxpayer provides more than de minimis consideration other than services or property described in section 1221(a)(1),"

COMMUNITY BANK TAX REPORT

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or "[t]he obligor under the account or note receivable is a person other than the person acquiring the services or property described in section 1221(a)(1)." Prop. Reg. § 1.1221-1(e)(1)(i)-(ii). The proposed regulation has limited application to banks, Section 582(c) provides that evidences of indebtedness are not treated as capital assets in the hands of such institutions in any event.

Nonbank Credit Card Issuers

It does, however, affect nonbank credit card issuers. American Express Co. filed a comment on the proposal and appeared at a November 7 hearing on it, emphasizing that there are differing approaches to whether income from credit card transactions of the issuer constitute income from services or from financing. Amex factors credit card receivables at a discount; the loss is generally treated as ordinary under *Burbank Liquidating*, but would probably be treated as capital under the proposed regulation. Some of Amex' subsidiaries constitute financial institutions subject to Section 582(c); others do not. Critical comments were also filed by the National Association of Home Builders and the Association of International Automobile Manufacturers, citing potential adverse effect on home lending and automobile lending, respectively. Validity

Robert Rudnick of Shearman & Sterling LLP filed a comment questioning the validity of the proposed regulation; the comment predicted there would be litigation over it that might last ten years, and that in the interim would be extremely costly to a wide range of lenders in contemporary financial markets. Rudnick argues that the regulation overturns 40 years of settled law, and ignores congressional re-enactment in the face of settled interpretation, and violates principles of administrative consistency. Rudnick also suggested that the proposed regulation was one involving significant regulatory action because of "the number of taxpayers whose market behavior would be affected by the Proposed Regulation and the enormous volume of ordinary business transactions affected."

Costs Associated with Tangible Property

On August 21, the Treasury and Service in August proposed regulations governing the deduction of amounts incurred to acquire, construct, or improve tangible property. REG-168745-03, 71 Fed. Reg. 48590-48623 (August 21, 2006). See "Service and Treasury Issue Proposed Regulations Governing Capitalization of Costs of Tangible Property," CBTR, Oct. 2006, p. 1. The regulations revised existing Treas. Reg. §§ 1.263(a)-1 – 1.263(a)-3. At a December 19 hearing on these regulations, industry and professional representatives complained about the lack of clarity in the proposed regulations, and their poor coordination with rules in other area, particularly the regulations under Section 162 governing deductions for repairs and supplies, and those in the depreciation area concerning what constitutes a unit of property. These experts predicted that the proposed rules would give rise to years of litigation. ■

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undertaken not to pay dividends until it built up its capital position, and quoted the FDIC as well as minutes of the bank's executive committee on the need to build capital beyond regulatory minima. It concluded that "American Federal could reasonably take steps to restore its capital position *as it existed immediately prior to the breach*, and that capital position involved some cushion over minimal capital requirements, although not as much as American Federal wanted to have for its business purposes." 72 Fed. Cl. at 601 (emphasis added). The Court was clearly going somewhat beyond *Home Savings* in finding causation in these circumstances.

Remote Connections

The Court held, however, that with respect to the 1997 acquisition by CCB, that "the only 'direct connection' between the government's breach and the merger with CCB was that without the breach American Federal would have been larger in size and a candidate to acquire banks rather than to be acquired," and thus that "American Federal has failed to satisfy its burden of proof that the implementation of FIRREA caused the bank's merger with CCB in 1997." It found that "merger and all subsequent mergers are remote from the government's breach." It also held that the issuance of the "green shoe" allotment was not replacing supervisory goodwill: "[t]hat the overallotment was realized stemmed entirely from favorable market conditions and demand for American Federal's offering"; thus "the breach did not cause the sale of the bank's common shares attributable to the green shoe."

Mitigation and Capital Structure

The Court summarily rejected the government's argument that the type and scope of mitigation were not foreseeable. With regard to mitigation, the Court conceded that the considerations involved overlapped to a considerable extent with those involved with respect to the question of causation. The Court addressed the three steps of the 1993 transaction separately. With respect to the transaction as a whole, however, the Court's essential position was that American Federal needed to simplify the complex capital structure that resulted from the 1989 conversion, in order to begin paying dividends and to raise

additional capital in the equity markets.

With respect to the exchange with the Series A debenture holders, the Court held that the exchange "made sense" for three reasons. First, American Federal intended to begin paying dividends (5 cents per share, to rise to 20 cents). The exchange permitted the debenture holders to begin earning a current return. Second, the Court found American Federal needed the additional capital it would raise upon exercise of the MPCs. Third, the Court found that some of the debenture holders would be required to sell some of the stock they received in order to avoid holding company status; this would be facilitated by coupling the exchange with the secondary offering.

With respect to the exchange of the Series I preferred, the government argued that it did not constitute mitigation, because it did not add to American Federal's regulatory capital – the Series I constituted capital to the same extent as the common stock. The Court responded that the exchange was nevertheless reasonable in relation to building capital, because the superpriority of the Series I would have constituted an obstacle to the payment of dividends on common stock: it was a "2000 pound gorilla . . . sitting over the top"; thus, this exchange was "reasonable and necessary to mitigate the harm caused by the breach." 72 Fed.Cl. at 607. Later American Federal would come to regret leading the Court to this conclusion.

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Mitigation and Minimum Requirements

With respect to the stock offering, the question on mitigation recapitulated the problem with respect to causation – the government argued the size of the offering was unreasonable because American Federal prior to the offering satisfied its minimum capital requirements. The Court again responded that American Federal needed a capital cushion for its business operations, and held that the government had failed to sustain its burden of proving the bank acted unreasonably "by raising enough capital . . . to create a moderate capital cushion that essentially matched what it had immediately prior to the breach." 72 Fed. Cl. at 608. The Court concluded that the size of the capital cushion that American Federal developed was reasonable.

Plaintiff's Damages Model

In addressing the damages question, the Court rejected

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three models proffered by the plaintiff's expert. In the first model, the expert calculated the costs of the stock by using the actual dividend rates paid by American Federal, and its successors; the successors' rates were computed with respect to the dividends paid by the holding companies to their shareholders. The expert also did not take into account costs and benefits with respect to the conversion of the Series A debentures and the attendant exercise of the MPCs. In a revision of this model, the expert used the dividend rates paid by the successor banks to their holdings companies. Costs were computed through 2011, when the last supervisory goodwill would have been amortized. The third model included the costs and benefits associated with the Series A debentures; and calculated costs and benefits based upon a spread between a synthetic dividend rate and the yield on certain government-backed securities.

The Court rejected all three models, the first two because they excluded the stock issued with respect to the Series A debentures, and because they included the stock issued in the "green shoe"; and because it used the dividend rates paid by the institutions that acquired American Federal, when the Court had held those acquisitions were too remote from the breach to have been caused by the breach. It rejected the third model for including the green shoe shares and reflecting the acquisitions, and because it found the use of a synthetic spread unsupported by the facts of the case.

Claims Court Methodology

Nevertheless, the Court found that the record provided a basis for determining damages with reasonable certainty. The first step was to determine a schedule of the regulatory capital eliminated by FIRREA, including both subordinated debt and goodwill: the Court cited *Home Savings and Old Stone Corp. v. United States*, 450 F.3d 1360, 1370 (Fed. Cir. 2006), for the proposition that the Federal Circuit had recognized that "a plaintiff-thrift may raise more capital than is necessary to achieve minimum regulatory capital compliance, but no greater than the amount of regulatory capital that was eliminated as a result of the government's breach." 72 Fed. Cl. at 613.

The second was to identify the four "tranches" of shares of common stock which were sources of replacement capital – the shares into which the Series A subordinated were converted; the shares acquired under the MPCs; the shares exchanged for the Series I preferred; and the shares issued in the secondary offering. The last category of shares was to be reduced for the excess of the capital raised over the amount of regulatory capital

eliminated by FIRREA. The cost for the shares through the third quarter of 1997 (when the acquisition occurred) was to be computed on the basis of the actual dividends paid; for periods after that, the cost was to be American Federal's actual average earnings per share for the first two quarters of 1997 times a dividend payout ratio of 34 percent. The resulting amount was to be reduced by the interest that would have been paid on the Series B subordinated debentures during the period from 1993 to 1999. The benefit of the replacement capital through the second quarter of 1997 was computed by the average yield on American Federal's assets in each quarter times the amount of replacement capital for the period; the benefit for subsequent periods was to be the 5.67 percent after-tax yield on 10-year Treasury notes issued in 1990 times the amount of goodwill replacement capital for each quarter. A discount rate of 8% was to be applied to the net costs occurring after November 1, 2006, the date of the expected final judgment in the case. The overall result was to be grossed up at a marginal rate of tax of 37.35%.

Incidental Losses

The Court awarded \$3.6 million for incidental losses, comprising: (1) \$1.6 million in transaction costs arising in connection with the 1993 transaction; (2) \$406,000 for increased risk-based premiums for deposit insurance assessed on account of the breach; (3) \$52,000 in increased OTS assessment costs in 1992; (4) an additional \$1.54 million in costs of securitizing residential loans, a program American Federal initiated in response to the breach. The Court denied the plaintiff's claim for about \$220,000 in lost management time spent on devising the capital plan in response to the breach.

Gross-up for Taxes

With respect to the gross-up for taxes, the Court relied on its and the Federal Circuit's prior "replacement of capital" decisions in concluding that the likelihood that the award would not be included in taxable income was "not high." It relied on the testimony of SunTrust's director of tax planning concerning SunTrust's tax rates for 2003 and 2004, and its projected combined federal and state tax rates for 2005, 2006, and 2007, to conclude that a gross-up rate of 37.35% was appropriate.

The Court directed American Federal to provide a calculation of damages using the Court's methodology within several weeks of the decision in *American Federal IV*. In *American Federal Bank, FSB v. United States*, 2006 U.S. Claims LEXIS 335 (2006) ("*AmFed V*"), the Court awarded American Federal \$27.1 million in cost of replacement capital damages. It rejected motions for reconsideration by both parties. ■