Ninth Circuit Takes Hard Line on Built-In Deductions

by Robert W. Wood • San Francisco

In *Idaho First National Bank*, CA-9, 6/24/93, *rev'g* 95 TC 185 (1990), the Ninth Circuit reversed the Tax Court to hold that an acquiring company's deductions for losses were built-in rather than rehabilitative, and thus could not offset the taxable income of other consolidated group members. The case arose out of Moore Financial Group's acquisition program.

Moore Financial was a regional bank holding company that held Idaho First National Bank ("IFNB") as one of its subsidiaries. Moore Financial wished to acquire a bank in Oregon in order to expand throughout the Pacific Northwest, but was prohibited by regulatory constraints from buying a solvent bank.

However, under an FDIC bidding procedure, Moore acquired Oregon Mutual Savings Bank, an insolvent Portland-area institution with 13 branches. After necessary approvals, Oregon Mutual Savings Bank was converted from a mutual savings bank to a state-chartered stock bank, and renamed Oregon First Bank ("OFB"). It became a member of Moore Financial's consolidated group.

To Deduct or Not to Deduct?

OFB sold various assets to third parties, which generated losses that Moore Financial and IFNB claimed on their consolidated returns. The IRS disallowed the deductions, viewing them as built-in deductions under Reg. 1.1502-15(a)(2). In Tax Court, Moore Financial claimed that the losses were "rehabilitation losses" that, under Reg. 1.1502-15(a)(2)(i), were not subject to the limitations applied to built-in deductions.

The Tax Court interpreted the regulation literally, holding that the losses were deductible. According to the court, the losses were rehabilitation losses because the *purpose* of the disposition of the assets was rehabilitation in the normal sense of the word.

The Service appealed, arguing that for a loss to constitute a rehabilitation loss, it must meet two requirements. Not only must the realization of the loss have a rehabilitative purpose, said the IRS, but the loss must result from post-acquisition economic investment. According to the Service, Moore Financial did not meet the latter requirement.

The Ninth Circuit, in a *per curiam* opinion, has agreed with the IRS, noting that the case is one of first impression. The court held that Moore Financial's deductions were built-in losses, not rehabilitative ones. Thus, they could not be offset against other consolidated group members' taxable income.

Post-Acquisition Expenses

The Ninth Circuit noted the general rule that a built-in deduction cannot ordinarily be used to offset income of any member of a consolidated group other than that of the member generating it. The court opined that the regulations should not be read to allow the acquiring group to take advantage of losses resulting from the financial failures of the acquired corporation prior to the acquisition. It found that the language of the regulation was intended to make clear that when a parent acquiring a financially troubled subsidiary incurs additional expenditures in attempting to rehabilitate that company, additional losses resulting from these expenditures are not built-in deductions.

However, in what can only be described as a "floodgates" concern, the court agreed with the Service that the Tax Court's reading of the rehabilitation loss concept would emasculate the limitation on the use of built-in deductions or losses as offsets against the income of other members of a consolidated group. The court observed that every acquiring company could argue that its purchase of a financially troubled company was for rehabilitative purposes. This narrow reading of the rehabilitation loss concept rendered Moore Financial unable to argue that the losses it used on its post-acquisition consolidated return were rehabilitation losses. ■