No. 09-36109

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

WASHINGTON MUTUAL, INC.,
AS SUCCESSOR IN INTEREST TO
H.F. AHMANSON & CO. AND SUBSIDIARIES,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court
for the Western District of Washington

BRIEF FOR PLAINTIFF-APPELLANT

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CORPORATE DISCLOSURE STATEMENT

Plaintiff-Appellant, Washington Mutual, Inc., states that it has no parent company and that no publicly held corporation owns 10% or more of its stock.

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JURISDICTIONAL STATEMENT

This is an appeal from a final judgment of the district court disposing of all of the parties' claims. The judgment of the district court was entered on November 5, 2009. A timely notice of appeal was filed on December 15, 2009. The jurisdiction of the trial court rested on 28 U.S.C. § 1346(a)(1), and this Court's jurisdiction rests on 28 U.S.C. § 1291.

ISSUE PRESENTED

Whether appellant's predecessors had a tax basis in intangible assets received from the Federal Savings and Loan Corporation (FSLIC) in exchange for an agreement to acquire three insolvent thrifts.

STATEMENT OF THE CASE

This is a federal tax refund suit seeking recovery of taxes paid by Plaintiff-Appellant's predecessor in interest, H.F. Ahmanson & Co., and Ahmanson's wholly owned subsidiary Home Savings of America ("Home"), for the 1990, 1992, and 1993 tax years. Plaintiff Washington Mutual, Inc. ("Plaintiff" or "WMI") acquired Ahmanson in 1998 and is the successor in interest to these refund claims. The issue arises as a result of an extraordinary intervention by the federal government to save the savings and loan (or thrift) industry. In the late 1970s and early 1980s, many U.S. thrifts became insolvent as interest rates skyrocketed. The rising rates increased the thrifts' interest costs but failed to increase interest income

commensurately because thrifts typically held a portfolio of long-term fixed-interest-rate mortgage loans. The fair market value of those fixed-rate mortgage loans also declined because of the rising rates.

The resulting thrift insolvencies created massive exposure for the deposit insurance program of the Federal Savings and Loan Insurance Corporation ("FSLIC"). To reduce that exposure, the federal government actively sought to broker deals in which relatively healthy thrifts would acquire unhealthy thrifts and thereby relieve FSLIC of its impending deposit insurance liability, thus reducing the ultimate cost to FSLIC. To induce the healthy thrifts to acquire insolvent thrifts, which would have otherwise been a bad business decision, the government sweetened the deal for potential acquirers by providing them favorable regulatory rights. In some instances – as in this case – the government offered special regulatory rights that had enormous value to large acquirers like Home.

In the transaction at issue in this case, Home agreed to acquire three failed thrifts in exchange for FSLIC providing Home with "branching rights" for Missouri and Florida, that is, a limited waiver of restrictions on Home having branches outside its home state of California. Home also obtained from FSLIC the right to special regulatory accounting treatment for the transaction (the "RAP Right"). The issue in this case concerns the proper tax treatment of these two

acquired rights ("the Rights") – specifically, whether Home has a tax basis in the Rights.

The parties filed cross-motions for partial summary judgment, and the district court granted the government's motion, holding that Home did not have tax basis in the Rights. After the parties agreed to a resolution of the remaining issues, the district court entered final judgment.

STATEMENT OF FACTS

1. The Savings and Loan Crisis of the 1980s. The travails of the thrift industry in the late 1970s and early 1980s, and the efforts of FSLIC to arrange acquisitions that would relieve it of its deposit insurance liability, are generally described in the Supreme Court's decision in *United States v. Winstar Corp.*, 518 U.S. 839 (1996). Thrifts historically borrowed money in the form of passbook savings accounts and certificates of deposit and loaned money in the form of long-term fixed-rate mortgages. *Id*. at 845. When interest rates rose sharply in the late 1970s, the spread between what thrifts paid depositors and what they earned on their fixed-rate mortgage loans turned negative. The resulting losses pushed thinly capitalized thrifts toward insolvency, and hundreds of them failed in the early 1980s. *Id*.

FSLIC, in its capacity as regulator and insurer of thrift deposits, was obligated to take over and liquidate insured thrifts once their book liabilities

exceeded the book value of their assets. Because the fair market value of the assets was considerably lower than their book value, those takeovers were prohibitively expensive for FSLIC, which was liable to make the depositors whole for the amount by which the thrift's insured deposits exceeded the proceeds FSLIC received from selling the failed thrift's assets. *Id*. at 846-47. By 1985, the General Accounting Office estimated that it would cost $15.8 billion to close all the insolvent thrifts, more than triple the amount of FSLIC's reserves. *Id*. at 847.

In order to alleviate the government's financial burden, FSLIC and its operating head, the Federal Home Loan Bank Board ("FHLBB"), "chose to avoid the insurance liability by encouraging healthy thrifts and outside investors to take over ailing institutions" in transactions known as "supervisory mergers." *Id*. These transactions "were not intrinsically attractive to healthy institutions" because they required the assumption of "liabilities that far outstripped [the failing thrifts'] assets." *Id*. at 848. FSLIC had to offer inducements like cash or other assets to the acquiring thrifts to make the transactions economically desirable. *Id*.

2. <u>Home's Deal with FSLIC to Take Over the Insolvent Thrifts</u>. The specific factual background of this case is described in prior litigation between the parties concerning the government's breach of certain regulatory accounting promises it made to induce Home to consummate the merger. *See especially Home*

Sav. of America v. United States ("*Home III*"), 57 Fed. Cl. 694, 695-706 (2003), *aff'd*, 399 F.3d 1341 (Fed. Cir. 2005).

Before 1981, FHLBB regulations prohibited thrifts from opening branches outside of the state in which they had their home office. Large thrifts like Home wanted to expand nationally, especially into growing states like Florida and Texas. ER105. The federal regulators realized that this desire gave them a valuable regulatory asset that they could use to induce healthy thrifts to merge with insolvent thrifts. Accordingly, the FHLBB issued regulations in September 1981 that allowed a thrift to operate branches in a state other than its home state, but only if the first branch in the non-home state was acquired in a supervisory merger. Specifically, the regulations made branching rights available only if: "(1) the establishment of the branch office will be achieved by acquiring assets of another institution, by merger or otherwise, pursuant to an action by [FSLIC] to prevent the failure of the other institution [and] (2) the Board determines that the insurance liability or risk of [FSLIC] will be reduced as a result of maintaining the branch office. . . ." 12 C.F.R. § 556.5(a)(3)(ii)(a) (1982); *see Statement of Policy Regarding Supervisory Mergers and Acquisitions*, 46 Fed. Reg. 45120, 45120 (Sept. 10, 1981); *Home III*, 57 Fed. Cl. at 699.

Home wanted to solidify its status as one of the Nation's leading thrifts by branching outside of California, and it was highly motivated to take advantage of

the opportunity to get into other states. In late 1981, Home and FSLIC negotiated a supervisory transaction involving three failed thrifts in Missouri and Florida: Hamiltonian Federal Savings and Loan Association of Ladue, Missouri; Security Federal Savings and Loan Association of Sikeston, Missouri; and Southern Federal Savings and Loan Association of Broward County, Pompano Beach, Florida. Hamiltonian and Security were first merged into Southern. ER106-26. Then the "new Southern" was merged into Home in a transaction that qualified as a tax-free "G" reorganization under the Code. *Id*. at 698-700; *see* I.R.C. § 368(a)(1)(G) (1982); ER127-73.

As required under the regulations, the FHLBB found that "(1) maintenance of branch offices by Home in Florida and Missouri as a result of the proposed acquisition will be achieved by a merger pursuant to an action by the FSLIC to prevent the failure of [the new] Southern" and "(2) the insurance liability or risk of the FSLIC will be reduced as a result of the maintenance of such branch offices by Home." ER211. Mr. H. Brent Beesley, the Director of FSLIC at the time, explained that FSLIC's insurance liability was reduced in a supervisory merger "[b]ecause when the institution fails, the FSLIC as an insurer has an obligation to go in and pay those off. . . . [A]t the time that we did these [supervisory] transactions, we were transferring what could be construed as our immediate obligation to pay those depositors off, but we were not forsaking our long-term

obligation as an insurer for all deposits in the nation up to the insured amount." ER28.

FSLIC and Home entered into an Assistance Agreement that set forth the terms of this supervisory transaction. ER174-206. The Assistance Agreement gave Home the right to operate the existing branches, and to open new branches, in Missouri and Florida (the "Branching Rights"). *Home Sav. of Am. v. United States* ("*Home I*"), 50 Fed. Cl. 427, 430-31 (2001); ER204; ER207-214; ER215. As required under the regulations, the Board issued a resolution finding that the merger was "pursuant to an action by the FSLIC to prevent the failure of [the new] Southern" and "the insurance liability or risk of the FSLIC will be reduced as a result of the maintenance of such branch offices by Home." ER211. The resolution was integrated into the Assistance Agreement. ER204.

The Assistance Agreement also promised Home the RAP Right, which was the regulatory accounting treatment designed to keep successor thrifts from needing to acquire additional capital to meet minimum regulatory requirements. *See generally Home I*, 50 Fed. Cl. at 437-38. Thrifts were required to report newly acquired assets and liabilities to regulators at fair market value. In Home's case, the fair market value of the acquired thrifts' liabilities (principally deposits) exceeded the fair market value of their assets (principally loans) by more than $260 million. ER246. For financial accounting purposes, Home treated that excess as

an intangible asset representing the cost of the Branching Rights. *Id*. The RAP Right was a promise from the regulators that Home could also treat this excess (known as "supervisory goodwill") as an asset that could be counted for purposes of meeting regulatory capital requirements. *Home III*, 57 Fed. Cl. at 695-96. As the Supreme Court explained in *Winstar*, this regulatory action was essential to convincing healthy thrifts to participate in supervisory mergers. *See generally* 518 U.S. at 848-55. For Home, "[t]he provision of supervisory goodwill as regulatory capital . . . allowed Home Savings to take-over a failing thrift while minimizing the infusion of additional capital." *Home III*, 57 Fed. Cl. at 699.

3. The District Court Litigation. In the early 1990s, Home made a business decision to exit the Missouri market. In 1992 and 1993, Home sold its remaining Missouri branches and abandoned its Branching Rights for Missouri. For the 1993 tax year, Home claimed a deduction for the abandonment of those rights. For tax years 1990, 1992, and 1993, Home also claimed amortization deductions with respect to the RAP Right. The IRS disallowed those deductions and denied the administrative tax refund claims based on those deductions. Plaintiff then brought this district court suit seeking a tax refund.

The amount of any allowable amortization or abandonment deduction related to the RAP Right or Branching Rights depends on Home's tax basis in those assets. (Tax basis is the starting point for computing a taxpayer's annual

amortization deduction for a depreciating asset and the measure of a taxpayer's loss upon abandonment of an asset.) WMI filed a motion for partial summary judgment asking the district court to determine the correct method for calculating Home's tax basis in the Rights.

WMI suggested two possibilities for determining the tax basis that flowed from the transaction. First, because Home incurred a cost by taking over thrifts with liabilities that exceeded the fair market value of their assets, Home had a "cost basis" in the Rights. Cost basis is the most common method for assigning basis to an asset. *See* I.R.C. § 1012 ("The basis of property shall be the cost of such property, except as otherwise provided in the [Code]"); 2 Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, ¶ 41.2.1, at 41-8 (3d ed. 2000) ("Although there are many important exceptions . . ., the basis of property in the overwhelming number of cases is its cost.").[1] Alternatively, WMI asserted that, because the Rights are "money or other property" under former Code section 597, the Rights should have a basis equal to their fair market value. *See id.* ¶ 41.2.5, at 41-24. The government responded with a motion for partial summary judgment arguing that the Rights should not have any tax basis at all.

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1986 (26 U.S.C.), as in effect for the tax years at issue ("the Code" or "I.R.C.").

The district court granted the government's motion, finding fault with both of the basis calculation methods advanced by WMI. The court acknowledged at the outset that Home acquired "enforceable" contract rights from FSLIC (ER9), noting that "Home was owed the Rights by the government as a result of the Assistance Agreement with the FSLIC." ER10. But the court then stated that this did not mean that "Home received the Rights from FSLIC," which it conceded would imply that the Rights should receive a cost basis. ER9-10. Rather, the court concluded that treating the Rights as having been provided by FSLIC in exchange for Home's assumption of FSLIC's liability would be an impermissible form of "double-counting." ER11.

The court based its holding on an analysis of what it recognized was a "bargain" struck between Home and FSLIC. ER12. The district court made clear that it was not suggesting that FSLIC "conveyed the Rights for nothing," but it stated that it could not assign a cost basis because, in the court's view, "Home did not acquire the Rights in exchange for the FSLIC's liabilities as a separate matter from the supervisory merger itself." ER11. Rather, the court decided to treat the entire three-party transaction as a two-party tax-free "G" reorganization under the Code and assumed that there could not be any tax consequences resulting from the transaction other than those prescribed by the "G" reorganization rules. *See* I.R.C. § 368(a)(1)(G) (1982). The court asserted that "Plaintiff's position has to be that

along with the considerable tax benefits of the 'G' reorganization, it bargained for the right to assign a basis to the Rights as well." ER12. Finding no evidence that Home specifically bargained for a right to basis, the court concluded that there was no justification for assigning a cost basis to the Rights. *Id*.

The district court also rejected WMI's alternative suggestion that, as inducements from FSLIC to get Home to participate in the transaction, Home obtained a fair market value basis in the Rights. ER13-17. In 12 U.S.C. § 1729(f), Congress authorized FSLIC to provide assistance to acquiring thrifts "[i]n order to facilitate a merger or consolidation of an insured institution." Former section 597, in turn, provided special tax treatment to facilitate such transactions by excluding from gross income and insulating from basis-reduction consequences "any amount of money or other property received from the [FSLIC] pursuant to" 12 U.S.C. § 1729(f). I.R.C. § 597(a)(1) (1982).

The court agreed with WMI that the Supreme Court had held in *Winstar* that FSLIC conveyed the RAP Right pursuant to its section 1729(f) authority. It concluded, however, that the phrase "money or other property" in section 597, even though "it has to include non-cash assistance," did not encompass the Rights. ER14. The court relied primarily on the fact that the legislative history of section 597 refers to "financial" forms of assistance and makes no specific reference to inclusion of regulatory rights. ER14. For this and other reasons, the court

surmised that Home "had no expectation [at the time of the transaction] that the Rights (or at least Branching Rights) were FSLIC-assistance for the purpose of Section 597." ER14-15. Acknowledging that there is no "obvious answer" to how section 597 should be interpreted, the court concluded that the legislative history, the principle that exemptions from taxation should not be implied, and the relative difficulty in valuing non-financial assets pointed to construing the statute as not covering the Rights. ER15-16.

Having found flaws in both of WMI's suggested methods for calculating the basis of the Rights, the court granted the government's motion for partial summary judgment. The court did not discuss what is the proper tax treatment of the Rights, evidently concluding that they should be ignored for tax purposes.

Subsequently, the parties resolved the remaining outstanding issues, and the district court entered final judgment. ER1-2.

SUMMARY OF ARGUMENT

There are two reasonable ways to characterize the transaction in which Home received the Rights. First, the economic reality of the transaction was that Home purchased the Rights from FSLIC in exchange for relieving FSLIC of an impending insurance liability. Alternatively, if not treated as a purchase, the Rights are reasonably treated as assistance provided by FSLIC to facilitate a supervisory merger. Depending on the characterization, the Code and settled tax

principles established different methods for computing Home's tax basis in the Rights – cost basis and fair market value basis respectively. The district court, however, departed from those principles and the Code by embracing a legally indefensible third alternative – namely, simply ignoring the Home-FSLIC transaction for tax purposes and assigning no basis to the Rights at all.

A. Home acquired the Rights from FSLIC as part of a three-party transaction in which Home agreed to acquire insolvent thrifts and thereby relieve FSLIC of its impending liability to the depositors of those thrifts. FSLIC provided the Rights to Home in exchange for its agreement to engage in that merger. The cost to Home to obtain the Rights was the amount by which the thrifts' liabilities exceeded the value of their assets. The record shows that both Home and FSLIC understood that, in essence, the deal between Home and FSLIC was a purchase of the Rights by Home from FSLIC. Therefore, under Code section 1012, Home took a tax basis in the Rights in the amount of its cost.

The district court's reasons for failing to apply section 1012 are without merit. The court asserted that WMI failed to show that "assigning a separate tax basis to the Rights was also part of the bargain" (ER12), but tax basis flows from the operation of the tax law. FSLIC had no power to award or withhold tax basis from Home, and there was no occasion for the parties to bargain over it.

The court also stated that assigning a cost basis to the Rights would be "double-counting." ER11. But that is not so. The cost incurred to obtain multiple assets in a transaction should be allocated across those assets. Home took a carryover basis in the mortgages acquired by merger pursuant to the "G" reorganization rules, which Congress deliberately expanded to cover acquisitions of failing thrifts. It also took a cost basis in the Rights pursuant to I.R.C. § 1012 in the amount of the consideration it paid for the Rights – namely the excess of the liabilities assumed over the value of the assets acquired in the merger. Nothing in the "G" reorganization rules prevents Home from obtaining a cost basis in the assets acquired from FSLIC outside the merger.

B. Alternatively, if Home is not given a cost basis in the Rights, then it should be given a fair market value basis in them under the only other reasonable characterization of the transaction. If Home did not receive the Rights in an exchange, then the tax law would ordinarily view the transaction as providing an inducement that constitutes income to Home, and Home would take a fair market value basis in the inducement. Code Section 597, however, established a special rule for assistance provided by FSLIC to facilitate supervisory mergers; that rule prevents such assistance from being included in gross income, and it eliminates any basis reduction in the recipient's assets. The district court erred in ruling that section 597 does not apply to the Rights.

The plain terms of section 597 encompass the Rights. The section applies to "money or other property received from the [FSLIC] pursuant to section 406(f) of the National Housing Act (12 U.S.C. § 1729(f))." The Rights are property. And they were received from FSLIC pursuant to section 1729(f), which is the basic provision authorizing FSLIC assistance and was recognized by the Supreme Court as FSLIC's authority for conferring the RAP right. *See Winstar*, 518 U.S. at 890-91 (plurality opinion); *id*. at 919 (Scalia, J., concurring).

The district court mistakenly ruled that the Rights were not encompassed by the phrase "other property" because the legislative history of section 597 focuses on "financial" assistance. That ruling misreads the legislative history, which taken in context evinces no Congressional intent to restrict section 597 to "financial assistance," and it also erroneously disregards the plain statutory text. Moreover, the court's ruling cannot be squared with *Winstar*, where the Supreme Court construed a statute that explicitly refers to "financial assistance" to include the RAP right. Finally, the district court's construction of section 597 would undermine the statute's overriding purpose to provide favorable tax treatment for recipients of section 1729(f) assistance; no logical legislative goal is served by having the availability of that tax treatment depend on the form of the FSLIC assistance. *See Centex Corp. v. United States*, 395 F.3d 1283, 1297 (Fed. Cir. 2005).

STANDARD OF REVIEW

The district court's decision to grant the government's motion for partial summary judgment is reviewed de novo. *See White v. City of Sparks*, 500 F.3d 953, 955 (9th Cir. 2007), *cert. denied*, 128 S. Ct. 2062 (2008); *Universal Health Servs., Inc. v. Thompson*, 363 F.3d 1013, 1019 (9th Cir. 2004).

ARGUMENT

BASIC TAX LAW PRINCIPLES REQUIRE THAT A TAX BASIS BE ASSIGNED TO THE REGULATORY RIGHTS OBTAINED BY HOME IN CONNECTION WITH THE SUPERVISORY MERGER

The question in this case is the correct application of Internal Revenue Code provisions and settled tax principles to aspects of a somewhat unusual public-private transaction – namely, Home's receipt of the Rights from FSLIC in exchange for relieving FSLIC of its impending deposit insurance liability. The district court, however, strayed from the correct line of inquiry. Instead of simply applying the tax law to this transaction, the court looked for some special agreement or principle unique to this transaction. Thus, the court mistakenly asked whether Home had "bargained" for some particular basis treatment for this transaction and whether Home had a particular "expectation" of how the tax law would apply to it. ER12, ER14. These inquiries are irrelevant and led the court to the wrong outcome.

The district court recognized that FSLIC conveyed the Rights to Home in exchange for Home's agreement to participate in the supervisory merger. The court similarly recognized that FSLIC did not "convey[ ] the Rights for nothing" (ER11), but rather FSLIC reaped a direct financial benefit from Home's acquisition. In other words, the Rights were valuable intangible assets that FSLIC conveyed to Home to induce Home to consummate the supervisory merger. The tax law attaches consequences to such transactions and, in particular, provides that the acquirer has a tax basis in the acquired intangible assets. The district court gave no adequate explanation for why these particular assets should be treated differently and, indeed, made no effort to provide a tax law justification for attaching no basis to intangible assets acquired in this fashion. Apparently, the court concluded that it could simply pretend for tax purposes that the Home-FSLIC portion of the transaction never occurred. That is reversible error.

A. The District Court Erred in Failing to Assign a Cost Basis to the Rights That Home Received from the Government in Consideration for Consummating the Supervisory Merger

1. FSLIC Afforded Special Regulatory Rights to Home in Exchange for Home's Assumption Through the Supervisory Merger of Liabilities That Otherwise Would Have Been Borne by FSLIC

As discussed above, this tax issue arises out of an unusual public-private transaction brought on by the savings and loan crisis of the early 1980s. Because of FSLIC's massive impending deposit insurance liability to depositors of failing

thrifts, the government was desperate to have healthy thrifts relieve it of that liability by acquiring the unhealthy ones. But such mergers, if consummated as conventional private transactions, made no economic sense for the acquirers. The thrift liabilities being assumed greatly exceeded the value of the failing thrifts' assets. Without more, the acquisitions would have a cost to the acquirers that exceeded any potential benefit. Therefore, the government had to sweeten the pot to induce the acquiring thrifts to engage in the mergers. Because its goal was to minimize outlays of cash, the government's inducements sometimes took the form of non-financial assistance, such as relief from otherwise applicable regulations and restrictions. In this case, the government's inducement consisted primarily of providing regulatory rights that were valuable to Home – the RAP Right and the Branching Rights.

a. The Economic Reality of the Transaction Was That FSLIC Provided the Rights Directly to Home in Exchange for the Financial Benefit of Being Relieved of Its Impending Obligation to Pay the Depositors of the Failing Thrifts

Although the transaction is unusual, the basic economics are not complicated. Home's primary contribution to the deal was its assumption of the liabilities on the books of the failing thrifts as guaranteed by FSLIC. This action benefited FSLIC to the extent that the liabilities exceeded the value of the failing thrifts' assets. Because the thrifts had been declared insolvent and could not

possibly pay that excess liability amount, FSLIC would have had to pay it but for Home's assumption.

In exchange for incurring this cost, Home received three distinct benefits. First, Home received the assets of the failing thrifts, consisting mostly of the low-interest mortgages that the thrifts held. Although diminished because of the increase in market interest rates, the mortgages still had value. Second, Home obtained a tax benefit in the form of built-in tax losses on those mortgages. Because the transaction was a "G" reorganization, Home received those mortgages with a carryover basis (that is, the tax basis the mortgages had in the hands of the failed thrifts), which exceeded the current value of the mortgages. An immediate sale of the mortgages therefore would have produced a tax loss for Home to the extent that the basis was higher than the fair market value of the mortgages. But the value of this tax benefit, while significant, was not enough to make up for the difference between the liabilities assumed by Home and the diminished value of the acquired mortgages. Home considered the deal advantageous only because it also received a third benefit from FSLIC – namely, the Rights, including the Branching Rights that Home believed to be extremely valuable for growing its business.

That third benefit was part of a classic quid pro quo agreement between Home and FSLIC. Viewed from Home's perspective, Home incurred a cost to

obtain the Rights in the form of the assumption of the net of the acquired thrifts' liabilities in excess of the value of the thrifts' assets. Viewed from FSLIC's perspective, it sold the Rights to Home in order to obtain relief from its obligation to satisfy those excess liabilities. This exchange enabled FSLIC to protect the cash position of its deposit insurance fund.

The economics of the transaction can be illustrated by a simple numerical example. Suppose that an insured thrift with savings deposits of $1,000 issues a low-interest mortgage loan of $1,000. Suppose further that the fair market value of the mortgage loan falls to $750 because of rising interest rates. If the thrift were then liquidated and required to pay off its depositors, it would be able to pay only $750 of the $1,000 in savings deposits owed. The FSLIC insurance fund would be liable for the $250 excess. When a thrift like Home comes to FSLIC's rescue by acquiring the failed thrift, the acquirer incurs a $1,000 cost because it is now liable to the depositors for $1,000. The benefits it receives in return are: (1) $750 worth of thrift assets (the mortgage); (2) tax benefits with a maximum potential value of $75 (because the acquired mortgage comes with a $250 built-in tax loss, and the resulting deduction would generate a tax reduction of $75 at a 30% marginal tax rate); and (3) whatever regulatory rights are conveyed by FSLIC. For the transaction to make economic sense, the regulatory rights must be worth at least $175 to the acquirer ($1,000 cost less $750 market value and $75 maximum tax

benefit of the acquired assets). Thus, the acquirer incurs a cost of at least $175 to obtain the regulatory rights.

b. The Record Establishes That the Parties Understood the Transaction as Including a Sale by FSLIC of the Rights

In this case, the record and prior judicial rulings establish that FSLIC exchanged the Rights as a quid pro quo to obtain Home's promise to relieve FSLIC of its impending obligation to depositors in the acquired thrifts. The Court of Federal Claims found that the Assistance Agreement for this transaction constituted a binding contract that obligated the government to provide the RAP Right to Home. *Home III*, 57 Fed. Cl. at 695-96; *Home I*, 50 Fed. Cl. at 437-38. The consideration for that contractual obligation was Home's agreement to assume deposit liabilities and thereby eliminate FSLIC's impending exposure as insurer of the deposits. The Court of Federal Claims also made findings concerning the events that led to the formation of this contract. The court noted that the regulators at the time sought to convince healthy institutions to engage in supervisory mergers by "tout[ing]" various "economic inducements, including supervisory goodwill, regulatory forbearances and waivers from regulatory requirements." *Home III*, 57 Fed. Cl. at 699. In particular, Home "would not have taken over troubled thrifts absent the incentive of supervisory goodwill." *Id*. As the district

court acknowledged, the Court of Federal Claims' rulings and findings are binding in this litigation under principles of collateral estoppel. ER9.[2]

With respect to the Branching Rights, former FSLIC Director Beesley testified in this litigation that "in effect we were selling interstate merger rights." ER27; *see also* ER248 ("In effect, the agency [FSLIC] is selling market entry rights for its own benefit, says Beesley . . . ."). That characterization reflects the way that the government contemporaneously viewed the use of branching rights to induce supervisory mergers. Brookings Institution economist Andrew Carron testified before Congress about his ideas for addressing the savings and loan crisis, including the use of branching rights to facilitate mergers:

> Approval of an interstate or cross-industry merger may be likened to a license that can be offered for sale. In effect, the FSLIC is selling

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[2] These findings of a contractual arrangement in which FSLIC exchanged regulatory rights for relief from its impending financial obligations to depositors accord with the conclusions of other courts that have adjudicated issues arising out of other supervisory mergers arranged by FSLIC in the 1980s. *See*, *e.g.*, *Winstar*, 518 U.S. at 843 (1996) (plurality opinion) (case involves "contracts between the Government and participants in a regulated industry, to accord them particular regulatory treatment in exchange for their assumption of liabilities"); *id.* at 919 (Scalia, J., concurring); *Admiral Fin. Corp. v. United States*, 54 Fed. Cl. 247, 259 (2002) ("The consideration supporting the Government's promises was the prospective savings in liquidation costs"); *Cal. Fed. Bank v. United States*, 39 Fed. Cl. 753, 775 (1997) ("consideration was exchanged" and "[t]he government was given the benefit of being relieved of the obligation to liquidate a failing bank"), *aff'd*, 245 F.3d 1342, 1347 (Fed. Cir. 2001) ("both the government and Cal Fed provided consideration for the agreements. . . . Cal Fed was reciprocally bound to assume the net liabilities of the acquired thrifts").

> market entry rights for its own benefit. The price of the license is the excess of liabilities over assets for a failing thrift, a price that would have to be paid by the insurance agency if the license is not sold.

Hearings Before the Committee on Banking, Housing and Urban Affairs on S. 2531 and S. 2532, 97th Cong., at 396 (1982). When the FHLBB amended its policy statement on branching rights to address the use of those rights to facilitate mergers, it explained that "interstate branching in supervisory cases is warranted to accommodate the present needs of the thrift industry and the protection of the insurance fund," citing Mr. Carron's analysis as authority. *Amendments to Policy Statement Concerning Branching in Supervisory and Non-Supervisory Acquisitions*, 47 Fed. Reg. 34125, 34126 and n.1 (Aug. 6, 1982) (*citing* Andrew S. Carron, *The Plight of the Thrift Institutions* 51-82 (1982)); *see id*. at 70-71.

The Assistance Agreement confirms in FSLIC's own words that FSLIC made this sale of regulatory rights in order to avoid "losses" arising from its deposit insurance obligations. FSLIC "determined . . . that the amount of [its] assistance would be less than the losses [FSLIC] would sustain upon the liquidation of each such MERGING ASSOCIATION through a receivership accompanied by the payment of insurance of accounts." ER175. FHLBB Resolution 81-803, which guaranteed the Branching Rights and was incorporated into the Assistance Agreement, explicitly linked the Branching Rights with the

benefit to FSLIC: "the insurance liability or risk of the FSLIC will be reduced as a result of the maintenance of such branch offices by Home." ER211.

Home also expressed its view of the transaction as essentially a purchase of regulatory rights. In its formal SEC filings, Home explained that the "excess cost" it incurred by assuming liabilities in excess of the value of the acquired thrifts "represents the cost of obtaining the opportunity to conduct business . . . in the new market areas served by the acquired associations and branches." ER243; *see also* ER61. In its public comments on the acquisition, Home similarly described the purchase as primarily motivated by the desire to obtain Branching Rights. ER218 ("Home . . . entered into its merger with Southern Federal . . . of Fla., and with two Missouri associations because it wanted to expand its market, says Executive Vice President Mario J. Antoci.").

In sum, FSLIC and Home made a deal for the Rights, with FSLIC getting Home's agreement to the supervisory merger that would get FSLIC off the hook for its impending deposit insurance liabilities. The cost to Home of that deal for the Rights was the excess liability that it assumed.

2. General Tax Principles Assign a Cost Basis to Purchased Assets

The bottom line of the district court's opinion is to ignore for tax purposes the existence of the exchange between FSLIC and Home. But the tax law does not permit that option; that aspect of the transaction must be recognized and given the appropriate tax treatment. With respect to basis, Code section 1012 establishes the general rule that the basis of property is its cost, unless otherwise provided. Although there are a variety of exceptions to that rule, "the basis of property in the overwhelming number of cases is its cost." 2 Bittker and Lokken, ¶ 41.2.1, at 41-8; *see also id*. ¶ 41.1, at 41-3 (basis is "ordinarily the cost of the property").

An assumption of liabilities is a "cost" for tax purposes; a taxpayer that assumes a liability to obtain an asset has a cost basis in the asset under section 1012. *See, e.g.*, *Crane v. Comm'r*, 331 U.S. 1 (1947). And the cost-basis rules apply equally without regard to whether the property is tangible or intangible. *See*, *e.g.*, *Tenneco, Inc. v. United States*, 433 F.2d 1345, 1346 (5th Cir. 1970) ("costs . . . represented the cost basis of intangible assets (the easements)"); *John Town, Inc. v. Comm'r*, 46 T.C. 107 (1966) (assigning cost basis to license to use perfume and trade name), *aff'd*, 19 A.F.T.R. 2d (RIA) 1389 (7th Cir. 1967).

The same principles apply when a taxpayer obtains intangible assets from government regulators. For example, an FCC license confers upon a TV or radio station a regulatory right to broadcast over a designated segment of the spectrum.

The taxpayer capitalizes the cost of obtaining such a license and treats that cost as its basis, which cost basis the taxpayer can depreciate over the useful life of the license (if one can be determined) or recover upon the sale or disposition of the license. *See, e.g.*, *Radio Station WBIR, Inc. v. Comm'r*, 31 T.C. 803, 811 n.4, 815-16 (1959); Rev. Rul. 56-520, 1956-2 C.B. 170. *See also Nachman v. Comm'r*, 191 F.2d 934 (5th Cir. 1951) (cost of obtaining liquor license); *Uecker v. Comm'r*, 81 T.C. 983, 993 (1983), *aff'd*, 766 F.2d 909 (5th Cir. 1985) (grazing privileges); *Nicolazzi v. Comm'r*, 79 T.C. 109, 123-26 (1982) (fees paid in connection with acquisition of oil and gas leases are capitalized into the asset's basis), *aff'd*, 722 F.2d 324 (6th Cir. 1983); *Smith v. Comm'r*, 55 T.C. 133, 136-37 (1970) (upland cotton acreage allotment); Rev. Rul. 92-16, 1992-1 C.B. 15 (taxpayers take cost basis under section 1012 for sulfur dioxide emission allowances permitted by Clean Air Act).

Applying these principles here, Home's basis in the Rights is the cost Home incurred to acquire them. As discussed above, in order to obtain the Rights, the government required Home to absorb the insolvent thrifts, and thereby assume liabilities that were greater than the fair market value of the assets acquired from the thrifts. In exchange for incurring that significant cost, Home received the Rights and the assets of the insolvent thrifts (including the associated built-in tax losses). *See supra* pp. 18-20. A portion of Home's cost is properly allocated to the

thrifts' assets. But to the extent that the cost incurred by Home exceeded the value of the thrifts' assets, which it unquestionably did, that excess cost must be viewed as the cost paid by Home to acquire the Rights. Accordingly, the Rights had an original cost basis equal to that portion of Home's cost.

The district court's rejection of that outcome simply denies the economic reality of the transaction, even though the basis rules generally seek to reflect economic reality in the absence of some special provision. *See, e.g.*, *Gladden v. Comm'r*, 262 F.3d 851, 854 (9th Cir. 2001) (rejecting IRS refusal to allocate any basis to water rights as a departure from "economic reality"); *Kraft, Inc. v. United States*, 30 Fed. Cl. 739, 766 (Ct. Cl. 1994) ("the tax consequences of any particular transaction must be based upon economic realities"); 2 Bittker and Lokken, ¶ 41.6.9, at 41-72 (noting primacy of "economic reality test" in resolving basis allocation disputes). The district court's failure to recognize a tax consequence for Home's expenditure to obtain the Rights is reversible error.

3. The District Court Erred in Denying a Tax Basis for the Rights on the Ground That Home Never "Bargained" for Any Special Basis Treatment

The district court did not disagree with the general tax principles discussed above. The court refused to recognize a cost basis in the Rights, however, because it addressed the wrong question. Instead of asking how the tax law applies to the facts of this case, the court asserted that "[t]he question raised here is whether the

right to assign a tax basis to the Rights came as part of the package [acquired by Home from FSLIC].” ER12. That misguided approach led the court down a completely irrelevant path to the wrong answer.

The district court began this analysis by stating that, in exchange for acquiring the failing thrifts, Home received a “package of regulatory ‘carrots’ contained in the Assistance Agreement,” which included “the right to structure the merger transaction as a tax-free ‘G’ reorganization.” ER11-12. The court then asserted that “Plaintiff’s position has to be that along with the considerable tax benefits of the ‘G’ reorganization, it bargained for the right to assign a basis to the Rights as well.” ER12. Because Plaintiff did not show that “assigning a separate tax basis to the Rights was also part of the bargain” (*id.*), the district court concluded that the Rights had no basis.

The court’s reasoning is flawed. FSLIC has no power to award tax basis. Tax basis in an asset is a function of tax law and not something that one party to a transaction awards the other party, so it cannot have been the subject of bargaining between Home and FSLIC. Thus, even the starting point of the district court’s analysis is mistaken because the “G” reorganization was not “part of the aid package” (*id.*) and Home did not “bargain” with FSLIC for the tax benefits associated with “G” reorganization treatment. Those benefits flowed inexorably from the operation of section 368(a)(1)(G) of the Code, which generally provides

non-recognition treatment for acquisitions of insolvent institutions – namely, transactions involving a "transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case" – subject to certain conditions.

Congress specifically determined that supervisory mergers like the one in this case should qualify for tax-free "G" reorganization treatment, and it passed legislation in 1981 to implement that determination. In offering that legislation, Senator Boschwitz explained that it "would facilitate . . . the merger of a savings and loan with another financial institution by clarifying that [this] transaction[] [is a] nontaxable event." *See* 127 Cong. Rec. at 17,128 (July 23, 1981). That legislation, addressed to "Reorganizations Involving Financially Troubled Thrift Institutions," exempted such thrift acquisitions from the generally applicable "continuity of interest" requirement for reorganizations. 127 Cong. Rec. S8287 (daily ed. July 23, 1981). The new statute also provided that the required showing that the reorganization qualified as an acquisition of an insolvent institution (that is, as a "title 11 or similar case") should be made through a certification of insolvency by the appropriate banking agency (either FSLIC or the FHLBB). *See* Pub. L. No. 97-34, § 241, 95 Stat. 172, 254 (1981); I.R.C. § 368(a)(3)(D) (1982).[3]

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[3] Congress later repealed the special provisions affording "G" reorganization treatment to supervisory mergers, effective for acquisitions after December 31, 1988. *See* Pub. L. No. 99-514, § 904(a), 100 Stat. 2085, 2385 (1986).

Thus, there was no need for Home to "bargain" with FSLIC to have the merger portion of the transaction treated as a "G" reorganization. The Internal Revenue Code imposed that tax treatment based upon the facts of the transaction. Home acquired the assets of an insolvent corporation (I.R.C. § 368(a)(1)(G) (1982)) in a transaction that satisfied the other conditions applicable to financial institutions set forth in section 368(a)(3)(D). To be sure, the statute required that FSLIC or the FHLBB certify that the acquired thrifts were insolvent (§ 368(a)(3)(D)(ii)(III)), but that certification was not a subject of bargaining. That certification was necessary to give FSLIC the right to arrange a supervisory merger, and it merely reflected the actual facts.

In any event, there is no conceivable justification for the court's conclusion that Home was required to "bargain for" a tax basis in the Rights. The existence of that basis is determined entirely by operation of the Code. FSLIC had no power either to create tax basis or to prevent its creation. There was no reason for the subject ever to be raised in the discussions between Home and FSLIC. There is accordingly no foundation whatsoever for the district court's conclusion that Home should be denied a cost basis in the Rights, notwithstanding the provisions of Code section 1012, simply because "assigning a separate tax basis to the Rights was" not "part of the bargain." ER12.

4. Recognizing Cost Basis for the Rights Does Not Impermissibly "Double Count" the Liabilities Assumed in the "G" Reorganization

The district court also stated that assigning a cost basis to the Rights would be "double-counting." ER11. The court then made a series of observations designed to elaborate on this conclusion. The court first emphasized that, even though "both the institutions and the government may be said to have liabilities, . . . those liabilities are one and the same." *Id*. As a result, the court stated, "Home did not acquire the Rights in exchange for FSLIC's liabilities as a separate matter from the supervisory merger itself." *Id*. Rather, in the court's view, "[t]here was one transaction that created contractual obligations between Home and FSLIC: Home agreed to acquire the failing thrifts . . . and to assume their duties and obligations. In exchange, it received the package of regulatory 'carrots' contained in the Assistance Agreement." *Id*. The court's analysis is faulty – both because some of these observations are incorrect and because, in any event, they do not add up to the conclusion that it would be impermissible "double counting" to afford a cost basis to the Rights.

At the outset, the court's insistence that Home did not acquire the Rights "as a separate matter from the supervisory merger itself" cannot be sustained. In the merger Home acquired New Southern (the combination of the three failed thrifts) and its assets. The Rights were not among Southern's assets. The government

banking agencies encouraged and sought to facilitate the merger between Home and Southern, but they were not parties to it. Yet those regulatory agencies were the only entities that could, and did, provide the Rights to Home. The transaction providing the Rights to Home necessarily occurred outside the framework of the merger. Indeed, the RAP Right did not even exist until after the merger was consummated because the RAP Right addressed the regulatory accounting treatment of an asset that appeared on Home's books only as a result of the merger.

Moreover, the district court missed the point when it made the technically correct statement that FSLIC was not "relieved of its insurance obligations as a result of the transaction" because it continued to insure the thrift deposits after the merger. What is significant is that, as the government has conceded, "the FSLIC insurance fund was undeniably the better off for the transaction" with respect to its insurance obligations. ER11 (internal quotations omitted). That is because FSLIC's imminent obligation to make cash payments to cover the deposit liabilities of insolvent thrifts had been replaced by an insurance obligation to depositors of a solvent institution that was unlikely ever to require any payments from FSLIC. The court acknowledged that FSLIC did not "convey[ ] the Rights for nothing" (*id.*); rather, it conveyed the Rights in exchange for Home taking steps to relieve FSLIC of an impending liability. That action cost Home a lot of money

(because Home ultimately paid the deposit liabilities) and benefited FSLIC immensely. A portion of that cost represents Home's tax basis in the Rights.

In emphasizing that the thrift institution's liabilities and the government's liabilities are "one and the same," the court appears to have endorsed the government's argument that Home cannot receive a tax basis because one of the conditions for a supervisory "G" reorganization is that the acquirer assume substantially all of the liabilities of the acquired thrift. *See* I.R.C. § 368(a)(3)(D)(ii) (1982); ER12; ER38-44; ER98-101. But there is no inconsistency between "G" reorganization treatment for the assets obtained in the merger and assigning a cost basis to the Rights obtained from the government outside the merger. The fact that, under the reorganization rules, the assets acquired in the merger are given a carryover basis does not negate the economics and other tax consequences of the overall transaction, namely, that Home incurred a cost to acquire the Rights from FSLIC and therefore has a cost basis in those Rights. To the contrary, Congress extended "G" reorganization treatment to acquisitions of failing thrifts in order to facilitate supervisory mergers, so it would be perverse to regard that treatment as creating the *adverse* tax consequence of preventing the acquisition of a cost basis in other assets. *See supra* p. 29.

The government argued below that Home could have tax basis in the Rights only by "recycling its assumption of the thrifts' debt" in the reorganization because

it had to assume New Southern's liabilities to obtain the carryover basis in New Southern's assets. ER42. But Home did not "recycle" anything. The reorganization rules are not concerned with the amount of the acquirer's costs. Indeed, that is the defining feature of a reorganization – the acquirer's basis in the assets is carried over from the transferor and not established by the acquirer's cost. Home's cost is determined by the economics of the merger, and, as discussed above, Home incurred the cost of assuming the full amount of Southern's liabilities only because it was acquiring more than Southern's assets. Part of that cost – that is, the assumption of the net liability for which FSLIC had responsibility – was incurred to obtain the Rights from FSLIC.

Splitting costs for tax purposes between assets acquired from two parties is not unique to this transaction. For example, suppose there are two joint tortfeasors who incur joint and several liability towards an injured party. Then a third party comes along and assumes the obligation to the injured party in exchange for property from each of the tortfeasors. In that case, the third party would have an allocated cost basis in each piece of property, with the total cost basis equal to the total cost of the assumption of liability. This case is the same. Home incurred some of the cost in exchange for the assets received from Southern (that is, the mortgages and associated built-in tax losses), but some of the cost must be allocated to the Rights, which Home undeniably received in exchange for agreeing

to assume the net liability through its agreement to merge new Southern into Home. The "G" reorganization treatment of the merger poses no obstacle to that tax treatment.

Indeed, the IRS has recognized in other settings that tax-free reorganization treatment of a transaction does not preclude tax recognition of aspects of the transaction that are outside the reorganization. For example, in Rev. Rul. 73-233, 1973-1 C.B. 179, the IRS addressed another tax-free reorganization involving a separate inducement to persuade someone to engage in the transaction. There, the majority 60 percent shareholder of a corporation wanted to make a tax-free acquisition of the assets of another company. But he needed the consent of at least one of the two minority 20 percent shareholders. Neither of the minority shareholders was willing to vote for the deal unless he ended up with a larger (25 percent) stake in the company. The majority shareholder agreed and sought to effectuate the transaction by first contributing some of his shares to the corporation, creating a 50-25-25 split, and then proceeding with a pro rata tax-free reorganization.

The IRS ruled that having the tax-free reorganization rules govern the *entire* transaction failed to attach the proper tax consequences to the side deal in which the majority shareholder increased the minority shareholders' stakes to induce them to agree to the merger. The IRS explained that this side deal should be

accounted for outside the reorganization. The IRS ruled that the transaction should be treated as if the tax-free merger was consummated under the original 60-20-20 split, and then the majority shareholder transferred five percent of its holdings to each of the minority shareholders in consideration for their having agreed to the merger. The transfer of those holdings was treated as a sale with the majority shareholder recognizing gain or loss and the minority shareholders taking a fair market value basis in the acquired shares, even through the overall transaction included a tax-free reorganization.

The lesson of this Revenue Ruling for present purposes is that, when two parties strike a quid pro quo bargain in order to induce one of those parties to engage in a tax-free reorganization, the tax effects of the bargained-for exchange are not subsumed in the reorganization. Rather, the exchange is treated separately and carries the same tax effects that it would in the absence of a tax-free reorganization. *See also* Rev. Rul. 70-140, 1970-1 C.B. 73 (where a corporation received assets in exchange for stock just before it was acquired in a tax-free reorganization, a portion of the acquirer's stock received in the reorganization is carved out of the tax-free transaction and treated as an amount received for the sale of those assets).

Finally, the flawed nature of the district court's "double counting" objection is further revealed by examining a slightly different scenario for the transaction.

Suppose that FSLIC had offered a different inducement to Home to enter into the merger – namely, a cash payment instead of the Rights. In that case, there would be no question that Home would have a tax basis in the cash received from FSLIC. And if Home were to use that cash to purchase assets, like computers or a building, Home would have a cost basis in the assets and would be entitled to the associated amortization or loss deductions (depending on what Home did with the assets). The "G" reorganization tax treatment of the thrift acquisition, however, would still be precisely the same as occurred here. Thus, it is apparent that there is no impermissible "double counting" in both having "G" reorganization treatment for the acquisition and attaching a tax basis to the consideration supplied by FSLIC to induce Home to enter into the transaction.

To be sure, in actuality FSLIC did not give Home any significant amount of cash; instead, the primary consideration consisted of the Rights. Structuring the deal in that way was critically important to FSLIC since its overriding goal in inducing supervisory mergers was to reduce its cash obligations. But there is no reason why that difference in the form of the consideration provided by FSLIC should have an adverse tax effect on Home. Intangible assets like the Rights take a cost basis just like cash or other tangible assets. The district court provided no cogent basis for denying that cost basis to Home in this case.

B. If the Rights Are Not Afforded a Cost Basis, the Rights Had a Fair Market Value Basis Pursuant to Code Section 597

If this Court agrees with the district court that the Rights should not have been assigned a cost basis because the "G" reorganization precludes treating Home's acquisition of the Rights consistent with the economics of the acquisition, the district court's decision still must be reversed because the Rights should then have a fair market value basis. As noted above, the transfer of the Rights to Home cannot be ignored for tax purposes; rather, the tax law provides for tax consequences of that transfer according to the nature of the transaction. If Code section 1012 is inapplicable, the operation of standard tax rules, coupled with the special treatment afforded by Code section 597 to FSLIC assistance designed to facilitate supervisory thrift mergers, results in Home having a fair market value basis in the Rights.

1. Home Took a Fair Market Value Basis in the Rights Pursuant to Code Section 597

Generally, a taxpayer receives property in one of three ways: 1) through an exchange for other property, such as a cash purchase; 2) in exchange for services, which yields income; or 3) as a gift or bequest. The Rights were not a gift or bequest. The district court recognized that they were not "conveyed . . . for nothing" (ER11); the Court of Federal Claims has already held that the government received consideration in exchange for the RAP Right (*see supra* pp. 21-22); and,

of course, FSLIC was not in the business of giving gifts to the entities that it regulated.[4]

If the district court is correct that Home did not purchase the Rights, the only possible tax characterization remaining is that FSLIC provided the Rights to Home in exchange for Home's performance of services, which would ordinarily produce income to Home and give Home a fair market value basis in the Rights. That characterization fits comfortably within established tax law.

There is no question that FSLIC provided the Rights to Home as an inducement for Home to take action; the district court acknowledged that FSLIC "had an undeniable interest in Home's acquisition of the failing thrifts." ER11.

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[4] The Code specifically addresses the concept of a gift to a corporate entity in I.R.C. § 118. Well-settled principles govern when a particular transaction can be classified as a non-shareholder contribution to capital under that section, and FSLIC's provision of the Rights to Home does not qualify. Interpreting a predecessor Code section in the context of government expenditures on railroad facilities, the Supreme Court identified five characteristics of a non-shareholder contribution to capital, including that "[i]t may not be compensation." *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401, 413 (1973). Accordingly, government inducements to encourage taxpayers to perform a service for the government are not classified as non-shareholder contributions to capital under section 118. *See G.M. Trading Corp. v. Comm'r*, 121 F.3d 977, 981 (5th Cir. 1997); *Deason v. Comm'r*, 35 T.C.M. (CCH) 978, 984 (1976), *aff'd*, 590 F.2d 1377 (5th Cir. 1979). The government's provision of the Rights in this case falls into this category; the Rights cannot be regarded as a non-shareholder contribution to capital in view of the holding in *Home I* that the Rights were enforceable contract rights furnished for consideration – namely, Home's agreement to participate in the supervisory merger.

Property received as an inducement to engage in desired behavior is income to the recipient in the amount of the fair market value of the property. *See Comm'r v. Duberstein*, 363 U.S. 278, 291-92 (1960) (a car received by taxpayer was income rather than a gift because "it was at bottom a recompense for [taxpayer's] past services, or an inducement for him to be of further service in the future"). This principle also applies in the corporate context. *See* Rev. Rul. 73-233, 1973-1 C.B. 179 (income assigned to minority shareholders who received additional shares as an inducement to agree to a merger); *supra* pp. 35-36.

A taxpayer that receives property as income takes a fair market value basis in that property. *See* 2 Bittker and Lokken, ¶ 41.2.5, at 41-24; *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 188 (Ct. Cl. 1954); *Williams v. Comm'r*, 37 T.C. 1099, 1106 (1962); Rev. Rul. 73-233, *supra*. Section 597 provided, however, that "money or other property" received from FSLIC to facilitate supervisory mergers does not result in taxable income to the recipient, and the recipient's basis is not adjusted by the amount of untaxed income.[5]

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[5] Section 118 provides that in the case of non-shareholder contributions, a taxpayer recognizes no income but must adjust the basis of its assets downward by the amount of untaxed income. Section 597 was enacted to maximize the benefit of FSLIC assistance received by, among other things, ensuring that the recipient would not be required to reduce the basis of its other assets.

Accordingly, if the Rights were covered by section 597, Home had a fair market value basis in the Rights.

The district court recognized that, given this basic framework, the existence of a fair market value basis in the Rights "depends on the breadth assigned to" section 597. ER13. The court erroneously determined that the Rights were not covered by section 597, however, and therefore that Home did not have basis in the Rights.

2. Congress Created a Statutory Framework for Facilitating Supervisory Mergers in Which Section 597 Was Designed to Minimize FSLIC's Financial Obligations by Providing Favorable Tax Treatment for Recipients of FSLIC Assistance

The primary source of FSLIC's authority to render assistance to facilitate acquisitions of failing thrifts in the 1980s was section 406(f) of the National Housing Act, 12 U.S.C. § 1729(f) (1982). Congress enacted this statute in 1978 to give FSLIC broad authority and discretion to provide "assistance to thrift institutions . . . upon such terms and conditions as the Corporation may prescribe." This authority included steps to strengthen troubled institutions in order to help them survive or "to lessen the risk to [FSLIC] posed by such insured institution under such threat of instability." 12 U.S.C. § 1729(f)(1)(c) (1982). The statute also authorized FSLIC to render assistance "in order to facilitate a merger" of a troubled thrift or the "assumption of [its] liabilities" by a healthier institution. 12

U.S.C. § 1729(f)(2)(A) (1982). And the statute made clear that FSLIC could render such assistance not only to the troubled institution but also to "any person acquiring control of, merging with, consolidating with or acquiring the assets of an insured institution." 12 U.S.C. § 1729(f)(3) (1982). *See generally Winstar*, 518 U.S. at 890-91 (plurality opinion) (*citing* 12 U.S.C. § 1729(f)(2) as authority for FSLIC and the FHLBB to contract to permit the acquirer in a supervisory thrift merger to count supervisory goodwill toward regulatory capital); *Centex Corp. v. United States*, 395 F.3d 1283, 1292 (Fed. Cir. 2005).

As the thrift crisis deepened in the early 1980s, Congress realized that providing assistance to facilitate supervisory mergers was placing an enormous financial strain on FSLIC. It determined that tax law changes could provide additional benefits for acquirers of failing thrifts, which would correspondingly reduce the level of FSLIC assistance necessary to induce healthy thrifts to participate in these mergers. That determination led to the enactment in 1981 of several changes to the Code, including amending the tax-free reorganization rules to enable acquirers to obtain the tax benefit of built-in losses in the failing thrifts' devalued assets. *See generally id.*; I.R.C. §§ 368(a)(3)(D), 381 (1982).

The enactment of Code section 597 was directed specifically at FSLIC's actions taken under the authority of section 1729(f). That section provided as follows:

Sec. 597 FSLIC FINANCIAL ASSISTANCE

> **(a) Exclusion From Gross Income.** – Gross income of a domestic building and loan association does not include any amount of money or other property received from the Federal Savings and Loan Insurance Corporation pursuant to section 406(f) of the National Housing Act (12 U.S.C. § 1729(f)), regardless of whether any note or other instrument is issued in exchange therefor.
>
> **(b) No Reduction in Basis of Assets.** – No reduction in the basis of assets of a domestic building and loan association shall be made on account of money or other property received under the circumstances referred to in subsection (a).

The statute thus addressed two different kinds of tax consequences that could result from the receipt of FSLIC assistance. First, recognizing that such assistance could be regarded as income to the recipient, section 597(a) provided that the assistance should be excluded from gross income, thereby preventing any increase in the recipient's income tax obligation in the year of receipt. Second, section 597(b) forestalled the possibility that the tax law might treat receipt of the assistance as having the effect of reducing the recipient's basis in its assets. Overall, section 597 "had the effect of ensuring that FSLIC assistance payments would never be taxed, either immediately or subsequently." *Centex*, 395 F.3d at 1293.

The history of section 597 illuminates Congress's intent that the statute would operate to reduce the financial burden on FSLIC by providing tax benefits as an additional inducement to acquirers. Richard Pratt, Chairman of the FHLBB, urged Congress to pass the legislation because standard application of the tax law

otherwise "could significantly increase the cost of supervisory activities to the FSLIC." 127 Cong. Rec. 17,128 (July 23, 1981). Senator Boschwitz echoed this concern. He explained that deeming FSLIC's provision of assistance in a supervisory transaction "to be a taxable event will deny possible benefits to a financial institution taking over a troubled savings and loan and would trigger additional tax liability of a savings and loan which received additional capital." *Id*. Thus, as the Federal Circuit concluded, Congress intended "to provide tax benefits for institutions engaging in FSLIC-sponsored mergers and consolidations, thereby assisting the federal regulatory agencies in their efforts to address the savings and loan crisis." *Centex*, 395 F.3d at 1292.

3. The Rights Fall Within the Plain Terms of Section 597

The plain terms of section 597 encompass the Rights. Those terms restrict the tax benefits of that section to "money or other property received from the Federal Savings and Loan Insurance Corporation pursuant to section 406(f) of the National Housing Act (12 U.S.C. § 1729(f))." I.R.C. § 597(a) (1982). The Rights satisfy the plain meaning of the first part of that definition because they are "property" for tax purposes. *See supra* pp. 25-26.

And the Rights were received from FSLIC "pursuant to section . . . 1729(f)." Home received the Rights through the Assistance Agreement, which was its contract with FSLIC. *See Home I*, 50 Fed. Cl. at 435. Specifically, the Rights

were embodied in FHLBB Resolution 81-803, as well as in a contemporaneous letter from the FHLBB's Office of Industry and Development allowing branching in Missouri and Florida. Those documents were integrated into the Assistance Agreement between Home and FSLIC. *See generally Home I*, 50 Fed. Cl. at 430-31; ER204; ER207-14; ER215.

In *Winstar*, the Supreme Court considered a virtually identical contract structure, with the acquiring thrifts entering into Assistance Agreements with FSLIC. The Assistance Agreements contained integration clauses that integrated FHLBB resolutions providing a RAP right. *See* 518 U.S. at 861-62, 864-65 (plurality opinion). The Court ruled that these agreements were binding as a valid exercise of FSLIC's authority to provide assistance under section 1729(f). *Id*. at 890. Citing to section 1729(f)(2), the plurality opinion stated that "[t]here is no question . . . that the Bank Board and FSLIC had ample statutory authority to . . . promise to permit respondents to count supervisory goodwill and capital credits toward regulatory capital." *Id*. The plurality further explained that there is no "reason to suppose that the breadth of this authority was not meant to extend to contracts governing treatment of regulatory capital" (*id*.) and that this conclusion was buttressed by Congress's specific recognition of "FSLIC's authority to permit thrifts to count goodwill toward capital requirements

when it modified the National Housing Act in 1987." *Id*. at 891. *See also id*. at 919 (Scalia, J., concurring) ("I agree with the principal opinion that the contracts at issue in this case gave rise to an obligation on the part of the Government to afford respondents favorable accounting treatment").

Although *Winstar* did not involve branching rights, section 1729(f) surely applies to those rights as well. Branching rights were similarly provided by the banking agencies in order to make acquisitions of failing thrifts more financially attractive to the acquirers. In particular, the FHLBB has identified section 1729 as the source of FSLIC's authority to provide branching rights to assist supervisory mergers. When the FHLBB announced in 1981 that it was amending its regulations to allow interstate branching for institutions engaging in supervisory mergers, it included section 1729 in its citation of statutory authority. *See Statement of Policy Amendment Regarding Supervisory Mergers and Acquisitions*, 46 Fed. Reg. 19221, 19222 (Mar. 30, 1981). Thus, the FHLBB understood that section 1729 was the statutory authority for FSLIC's provision of assistance in the form of branching rights to facilitate these mergers.

The same is true of Congress. In 1987, Congress made a statutory change that expanded the circumstances under which interstate branching was permissible. The Conference Report noted that interstate branching was then permitted in only one situation under existing law – namely, "the FSLIC may approve such an

interstate acquisition under 406(f) or 408(m) of the National Housing Act [12 U.S.C. § § 1729(f), 1730(m)]." H.R. Rep. No. 100-261, at 139 (1987) (Conf. Rep.). Thus, Congress in 1987 recognized that FSLIC assistance both in the form of the RAP right (*see Winstar*, 518 U.S. at 890-91) and branching rights was provided pursuant to section 1729(f).

The Rights received by Home as FSLIC assistance to facilitate the supervisory merger involved here therefore qualify for the special tax benefits afforded by section 597 under the plain terms of that statute.

4. The District Court's Reasoning for Excluding the Rights from Section 597 Is Fallacious

Despite the plain terms of the statute, the district court determined that the Rights are not encompassed within section 597. ER13-17. The court relied for its conclusion primarily on some snippets of legislative history, along with a couple of questionable observations about the text of the statute and its background. But the court's reasoning is flawed. It ignores the context and evident purpose of section 597 and provides no justification for its artificially restrictive reading of the statute's plain terms.

At the outset, we note that the district court did not disagree that a straightforward reading of section 597 encompasses the Rights. The court acknowledged that "[t]here is some appeal to Plaintiff's interpretation of the Code." ER14. In particular, the court recognized that "the phrase 'money or other

property' in section 597 suggests a broad swath of possible FSLIC assistance." *Id.* As discussed above, that observation is correct because by its terms the phrase encompasses all property provided by FSLIC pursuant to section 1729(f). In addition, the statute uses broadly sweeping terminology elsewhere in applying the favorable tax provisions of sections 597 to "any" amount of property. *See generally United States v. Clintwood Elkhorn Mining Co.*, 552 U.S. 214, 219-21 (2008) (by using the word "any," "Congress meant the statute to have expansive reach"); *Ali v. Fed. Bureau of Prisons*, 128 S. Ct. 831, 835-37 (2008) (statutory use of the word "any" is "expansive" and "all-encompassing").

The primary reason given by the district court for resisting this straightforward reading was that "the legislative history consistently describes 'money or other property' in Section 597 in terms suggesting it must be uniquely *financial* forms of assistance." ER14.[6] The court's objection, however, is completely misguided. To be sure, the legislative history of section 597 contains references to specific kinds of FSLIC assistance that are "financial," and the relevant Conference Report states that section 597 was to apply to property

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[6] The court correctly observed that no weight should attach to the fact that section 597 is titled "FSLIC Financial Assistance." *See* ER14 n.2; I.R.C. § 7806(b); *Greene v. United States*, 62 Fed. Cl. 418, 433 (2004) (section 7806 "requires the courts not to infer any intentions or meaning from the title of particular sections"), *rev'd on other grounds*, 440 F.3d 1304 (Fed. Cir. 2006).

"contributed to the thrift institution by [FSLIC] under its financial assistance program." *See* H.R. Rep. No. 97-215, at 284 (1981) (Conf. Rep.). But these references, taken in context, lend no support at all to the district court's conclusion. *See generally King v. St. Vincent's Hosp.*, 502 U.S. 215, 221 (1991) ("the meaning of statutory language, plain or not, depends on context").

Section 597 had one overriding purpose – to provide more favorable tax treatment for recipients of FSLIC assistance under section 1729(f) than would otherwise be provided. Both in this purpose and in the statutory text itself, section 597 is inextricably linked to section 1729(f). The legislative history of section 597 quite naturally talks in the same terms as section 1729(f), that is, in the terms of financial forms of assistance that were prevalent in the deals that FSLIC was brokering at the time. Using branching rights to facilitate mergers was not even permitted when section 597 was enacted, and therefore the legislative history understandably does not focus upon those Rights. But that in no way suggests that the broad language used by Congress in section 597 does not encompass those rights once FSLIC began to use them to facilitate supervisory mergers. *See*, *e.g.*, *Talley v. United States Dep't of Agric.*, No. 09-2123, 2010 U.S. App. LEXIS 2480, at *12 (7th Cir. Feb. 12, 2010) ("the meaning of a statute depends on what it says, not on what lawmakers foresaw").

That this is the proper interpretation of section 597 is evident from the way that the courts, Congress, and the FHLBB have broadly interpreted section 1729(f) – even though the detailed provisions of that statute focus on financial forms of assistance. Section 1729(f)(1) authorizes FSLIC to provide assistance to failing thrifts as follows: FSLIC is empowered "to make loans to, to make deposits in, to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured institution" if certain conditions are met. All of the specified forms of assistance are "financial" in the sense used by the district court. Section 1729(f)(2)(A) then authorizes FSLIC to take steps to facilitate mergers and assumptions of liabilities of failing thrifts as follows:

> (i) to purchase any such assets or assume any such liabilities;
> (ii) to make loans or contributions to, or deposits in, or purchase the securities of, such other insured institution . . .;
> (iii) to guarantee such other insured institution . . . against loss by reason of such other insured institution's merging or consolidating with or assuming the liabilities and purchasing the assets of such insured institution; or
> (iv) to take any combination of the actions referred to in clauses (i) through (iii).

Again, the statute specifically lists only "financial" forms of assistance. Finally, section 1729(f)(3) gives FSLIC the authority to provide any person acquiring control of a failing thrift "with such *financial assistance* as it could provide an insured institution under this subsection" (emphasis added).

Despite the particular references in section 1729(f) to "financial" assistance, there is no question that its terms extend to non-financial forms of assistance like regulatory rights granted by FSLIC or the FHLBB. As discussed above (*supra* pp. 45-46), the Supreme Court addressed this question in *Winstar*, holding that the RAP right at issue there was granted under the authority of section 1729(f). *See Winstar*, 518 U.S. at 890-91. And Congress and the FHLBB have acknowledged section 1729 as the authority for FSLIC assistance in the form of both the RAP right and branching rights. *See supra* pp. 46-47. Indeed, section 1729(f) is the fundamental source of authority for FSLIC to provide assistance to acquiring institutions to facilitate supervisory mergers. If statutory authority were not found in that section, that would suggest that much of FSLIC's activity to ameliorate the savings and loan crisis in the mid-1980s was unlawful – an untenable conclusion.

It follows from the settled interpretation of section 1729(f) that the Rights are also encompassed under section 597. As noted, the text of section 597 is expansive. By its terms, it covers any property received from FSLIC pursuant to section 1729(f). Section 1729(f), by contrast, is more detailed and precise, with a listing of particular kinds of FSLIC assistance with no broad reference to "other property."

Moreover, the limitation that the district court read into section 597 is based entirely on snippets of *legislative history*. The same pieces of evidence that the

district court found persuasive for section 597 – a invocation of the term "financial" assistance and reference to particular forms of assistance that are reasonably classified as "financial" – are equally present for section 1729(f), except that in the latter case those references are found *in the statute itself*. Sections 1729(f)(1) and (2) specifically list various kinds of financial assistance and do not refer to non-financial assistance like the Rights. And section 1729(f)(3) uses the term "financial assistance" in referring back to the assistance authorized elsewhere in the statute. If these statutory references posed no impediment to reading section 1729(f) broadly to encompass the Rights (and the Supreme Court plurality in *Winstar* said that there was "no serious question" about this point, characterizing the statute as "ample statutory authority," 518 U.S. at 891, 890), then surely similar references in the legislative history of section 597 pose no impediment.

Indeed, the item of legislative history primarily relied upon by the district court is the Conference Report's statement that section 597 would apply to property "contributed to the thrift institution by [FSLIC] under its financial assistance program." H.R. Rep. No. 97-215, at 284 (1981) (Conf. Rep.). But that reference to the FSLIC "assistance program" is just a less formal way of referring to assistance authorized by section 1729(f) – which, in fact, is the formulation used in the actual statute. The Conference Report's description does not suggest any

intent by Congress to exclude assistance that is permitted under the FSLIC "assistance program" – that is, it was not intended to limit the scope of section 597 to something narrower than the FSLIC assistance authorized by section 1729(f). Since the latter statute includes assistance in the form of regulatory relief like the Rights, so does the former statute, regardless of the shorthand description used in the Conference Report.[7]

In addition, the district court's restrictive reading of section 597 is at odds with its evident policy rationale. Congress wanted to change the tax law for supervisory mergers in order to ameliorate the financial burden on FSLIC. Every dollar of tax benefit that would accrue to a potential acquirer was one dollar less that would have to be spent by FSLIC as an inducement to facilitate those mergers. Thus, it would have been counterproductive for Congress to exclude certain kinds of FSLIC assistance from the tax benefits afforded by section 597; such an

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[7] In addition to its reliance on the legislative history, the district court briefly argued that its decision is supported by the statute's reference to any "amount" of money or other property. The court reasoned that this word "suggests that in order to qualify, the FSLIC assistance must be financial in nature." ER15. The court did not further elaborate on its reasoning, but it is hardly surprising that a rule governing adjustments to income would use the term "amount," since income ultimately is reflected in an "amount." To the extent the court was suggesting that the word "amount" excludes property whose value is not easily quantified, its suggestion sweeps too broadly. The Rights are no different from many forms of financial assistance, such as loan guarantees or favorable financing, in this respect; they have a quantifiable value, though the valuation process may require some degree of expert analysis.

exclusion would only force FSLIC to make up the shortfall in other ways that Congress deemed less desirable from a policy standpoint. Thus, as the Federal Circuit observed, Congress "did not intend that the extent of the tax benefits would depend – and potentially be substantially reduced – by the particular form in which the assistance payments were made." *Centex*, 395 F.3d at 1297.

There is no doubt what tax treatment Home would have received under section 597 if it had received FSLIC assistance in the form of cash rather than the Rights. The assistance would not have been treated as income, and Home would have had tax basis in the cash. When it disposed of the cash, it would have retained the tax benefit of that basis. For example, if Home had received cash and then purchased the Rights or other assets and later abandoned them, it would have a basis in the purchased assets under Code section 1012 and would have been entitled to a tax loss upon the abandonment. There is no reason, logically or under the tax law, why it should receive less favorable tax treatment here where it received the Rights directly from FSLIC rather than receiving cash directly and then using that cash to purchase the Rights. *See supra* pp. 36-37.

Finally, the district court pointed to the fact that interstate branching rights were prohibited in 1978 when section 1729(f) was enacted. Accordingly, the district court reasoned, "the parties involved in the 1981 transaction had no expectation that the Rights (or at least branching rights) were FSLIC-assistance for

the purpose of Section 597." ER14-15. The district court's observation is a non sequitur. First, and most fundamentally, the terms of the relevant tax provisions are what is controlling, and any "expectation" the parties might have had of how they would apply is entirely irrelevant. *See supra* pp. 28-30.

Second, the court's suggestion that the parties' expectations would logically be based on the regulatory landscape in 1978, rather than at the time of the transaction, is nonsensical. At the time of the transaction, federal restrictions on interstate branching had recently been relaxed to allow branching rights, but only for one specific purpose – namely, so FSLIC could use them as an inducement to facilitate supervisory mergers. And FSLIC did in fact use them as an inducement in its negotiations with Home. *See supra* pp. 5-7, 22-24. Those developments certainly would have suggested that the Branching Rights were "FSLIC-assistance" for all purposes, including section 597, and the fact that interstate branching had previously been prohibited would in no way negate that conclusion.

CONCLUSION

The judgment of the district court should be reversed.

Respectfully submitted,

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STATEMENT OF RELATED CASES

Pursuant to Rule 28-2.6, Plaintiff-Appellant states that it is not aware of any related cases pending in this Court.

CERTIFICATE OF COMPLIANCE

Pursuant to FRAP 32(a)(7)(C), the undersigned certifies that this brief complies with the type-volume limitations of FRAP 32(a)(7)(B). Exclusive of the exempted portions identified in FRAP 32(a)(7)(B), the brief contains 13,399 words, as calculated by the word-processing system used to prepare the brief. The brief has been prepared in a proportionally spaced typeface using Microsoft Word version 2003, using 14-point Times New Roman font.

April 1, 2010

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on April 1, 2010.

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