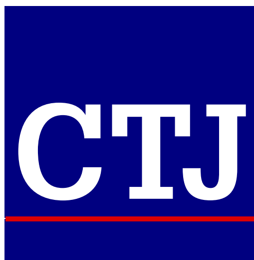

Citizens for Tax Justice

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New IRS Ruling on Bank Acquisitions Imposes Major Federal Corporate Tax Cuts—And Will Hurt States Too

In late September, while the major presidential candidates debated solutions for reforming the federal corporate income tax, a little-noticed ruling by the Internal Revenue Service (IRS) opened the door for widespread corporate tax avoidance by a few of the biggest, most profitable financial institutions in the country. The IRS ruling, which took Congressional tax writers by surprise, will almost certainly push the federal government—and many states—further into the red at a time when they can least afford it.

What the Ruling Says

Generally, corporations that report tax losses in a given year are allowed to apply these losses against profits in future years. But this ability to "carry over" losses from one year to reduce taxes in future years has limits. For example, when one company buys another company that has tax losses, the law prevents the acquiring company from using the purchased company's tax losses. There's a very sensible reason for this rule: to ensure that companies don't purchase other companies simply as a tax dodge.

But a little-noticed September IRS administrative ruling creates a specific, temporary exemption from this rule for banks acquiring other banks whose tax losses are attributable to bad loans. The rule is apparently retroactive.

Why the Ruling is Wrong

The new IRS ruling on bank acquisitions is regrettable for several reasons. First, the IRS has apparently usurped the legislative role of Congressional tax writers. It's not at all clear why IRS officials believe it's in their power to make substantive changes to this important tax law. Understandably, some members of Congress are upset by this move: Iowa Senator Charles Grassley has expressed his surprise at what he called Treasury's "astonishing action."

Second, the new rules give an artificial competitive advantage to banks that can afford to expand now by effectively offering a tax break for acquiring other banks. The single most prominent beneficiary of the new rules is Wells Fargo, which by one estimate will see a federal tax cut of $19 billion from its purchase of Wachovia. But the IRS ruling allowing this tax giveaway was made just one day after a Wells Fargo competitor, Citigroup, had made a much lower, unsuccessful bid for Wachovia. It seems likely that Citigroup's bid would have been much more generous if it had known that the tax benefits from a Wachovia would offset most or all of its acquisition costs.

Third, the change could be incredibly costly to federal taxpayers. A widely-cited analysis from the law firm Jones Day concludes that the ruling could eventually cost as much as $140 billion

in federal revenue. That's a huge cost for a change that was never considered by Congress or debated publicly, and adds another twenty percent to the cost of the much-lamented $700 billion bailout Congress has already enacted.

Fourth, the new rules present an unnecessary and harmful challenge to already-stressed state governments. Because states with corporate income taxes almost universally base their corporate taxes on federal rules, federal tax cuts for corporations generally result in state tax cuts as well. When affected states have rules making it difficult to enact tax increases (as is true of California, whose budget deficit is already in the billions of dollars), state governments find themselves practically unable to avoid costly corporate tax cuts they never wanted. As the following table shows, at least eighteen states that tax corporate profits will likely take a hit from the new IRS ruling—and any state that taxes the profits of financial companies is at risk of helping to fund the next bank that chooses to purchase another financial company.

Almost Every State Could See Tax Losses From the Latest Corporate Giveaway

Wells Fargo's $19 billion federal tax cut will be felt at the state level too. Any state in which Wells Fargo has banking locations (and therefore has nexus for corporate tax purposes) will likely feel the pinch from the new bank giveaway. Wells Fargo's 2007 annual report lists the following corporate income tax states in which they have banking locations:

Alaska	**Idaho**	**Michigan**	**New Mexico**	**Utah**
Arizona	**Illinois**	**Minnesota**	**North Dakota**	**Wisconsin**
California	**Indiana**	**Montana**	**Ohio**	
Colorado	**Iowa**	**Nebraska**	**Oregon**	

Each of these states' corporate taxes are at least potentially threatened by the new IRS rule; but they aren't the only ones. PNC, another bank identified as a beneficiary of the ruling, has presence in several other states, and the ruling's application to future acquisitions of loss-ridden banks could hit virtually every state in its pocket book.

"Congress should take steps to ensure the viability of our financial sector," said CTJ Director Robert S. McIntyre. "But huge and probably illegal tax cuts for the most profitable banks hardly seem like the smartest way of achieving this goal."