beginning of the assistance year (representing losses already recognized), plus loss in the current year (disregarding FFA). The proposed formula generally allowed the Institution the benefit of any prior losses of its owners' equity, but offset any losses of creditors' capital by the inclusion of FFA. However, with respect to losses during the year FFA is received, the proposed formula did not distinguish between losses of owners' equity and losses of creditors' capital and, therefore, offset losses of owners' equity by inclusion of FFA. The formula (together with related recapture rules) in the final regulations has been changed to reflect that the owners' equity is the first capital lost and, in a transaction without Continuing Equity, is not offset by inclusion of FFA.

Deferral formula with Continuing Equity. The proposed regulations allowed deferral under different conditions where Continuing Equity is present. In that case, the Institution must include currently, in addition to the normal formula amount, income equal to all net operating loss carryovers available to it. Also, an Institution with Continuing Equity must recapture deferred FFA at least as quickly as pro rata over a maximum of six years, regardless of whether it recognizes all of its built-in losses during that time.

Commentators suggested that the proposed regulations unfairly limited deferral for Institutions with Continuing Equity and recommended the same deferral formula apply in all cases. They criticized the Continuing Equity concept because it focused on the identity of the Institution's shareholders after the assistance transaction.

Under the definition of Continuing Equity in the proposed regulations, an Institution generally would have Continuing Equity if five percent or more of its stock at the end of a taxable year was owned by shareholders who owned stock before the Institution was placed in receivership by a supervisory agency (Agency) or first received FFA. The five percent reference was misleading because, under § 1.597–5, a 50 percent change in ownership generally results in a deemed Taxable Transfer (now defined in § 1.597–5(a)(1)) in which the failed Institution is treated as a New Entity. The deferral rules do not apply after a deemed Taxable Transfer. The final regulations thus clarify that Continuing Equity exists only if the Institution is not (i) a Bridge Bank, (ii) in Agency receivership, or (iii) treated as a New Entity. The modification to the definition of Continuing Equity is not intended as a substantive change. The Continuing Equity deferral provisions apply only to the limited number of ''open bank'' resolutions not subject to the deemed Taxable Transfer rules. (As discussed below, the Taxable Transfer definitions have also been modified to clarify that most ''open bank'' assisted transactions are treated as Taxable Transfers.)

The final regulations do not eliminate the special treatment of Institutions with Continuing Equity. The regulations provide deferral rules to ameliorate a timing mismatch between FFA income and related losses. Deferral is not designed to allow built-in losses to offset operating income instead of FFA or to permit the permanent elimination of any subsidy provided by Agency. The requirement that Institutions with Continuing Equity recapture their deferred FFA within six years is a reasonable safeguard against indefinite deferral of FFA income. The results under these rules are comparable in effect to those applicable to acquirors in Taxable Transfers.

The final regulations do, however, modify the Continuing Equity formula, which, in the proposed regulations, counted some losses twice. Recognized losses represented in the first prong of the formula (liabilities minus asset bases) may comprise part of the third prong (net operating losses available to the Institution or its consolidated group). The final regulations correct this double counting of losses.

Transfers of money and property to Agency. The proposed regulations contained rules for taxing FFA if money or property is also transferred to Agency. These rules, together with rules for the treatment of FFA received pursuant to a Loss Guarantee, have been clarified, reorganized, and restated in § 1.597–2(d).

The proposed regulations provided an offset or deduction for payments by an Institution to Agency to the extent of previously received FFA. The rule as proposed provided limited relief for payments made to Agency by a New Entity or Acquiring, because they receive little or no FFA. However, an assisted acquisition can result in income to a New Entity or Acquiring in the form of built-in gain. Under section 597(c) and § 1.597–3(b), an instrument issued to Agency by a New Entity or Acquiring is, in effect, disregarded. If a New Entity or Acquiring issues its instrument to Agency in connection with the acquisition of an Institution, the value of the instrument is not included in the purchase price. Consequently, a New Entity or Acquiring may have a basis shortfall in the assets acquired (or deemed acquired) from the failed Institution. The final regulations provide a New Entity or Acquiring a purchase price adjustment upon any transfer to Agency (e.g., in satisfaction of the disregarded instrument).

In response to comments, the final regulations also specifically provide for repayments to Agency by Institution affiliates. Moreover, the final regulations provide that if Agency sells an Institution's instrument to a third party, the sales price is treated as a repayment to Agency by the issuer. Furthermore, the instrument is treated as having been newly issued by the issuer to the holder at that time. The IRS and Treasury believe that this is an appropriate time for the issuer to offset FFA or increase its basis, because the sales price reasonably fixes the value of the instrument, and any subsequent cost associated with the instrument should be accounted for in accordance with the nature of the instrument.

Section 1.597–4(g) Elective Disaffiliation

The proposed regulations would allow a consolidated group to elect (after the regulations became final) to exclude an Institution in receivership from its group. The election potentially requires the inclusion of a ''toll charge'' in the income of those members owning the common stock of the Institution (the member shareholders). The amount of the toll charge is the excess of the disaffiliated Institution's liabilities over the adjusted basis of its assets. The toll charge is intended to reflect the amount that would be included in income if Agency were to provide the entire amount of FFA necessary to restore the Institution's solvency at the time of the event permitting disaffiliation. Commentators suggested that the final regulations should include the toll charge in the income of the disaffiliated Institution (rather than its member shareholders), provide the group with a ''toll charge deduction,'' and clarify the ability of the member shareholders to take a worthless stock deduction.

Toll charge. Commentators suggested that the final regulations include the toll charge in the income of the failed Institution rather than its member shareholders. According to the commentators, including the toll charge in the income of the member shareholders may result in disadvantageous state tax consequences in those states where banking corporations are not permitted to file consolidated returns with nonbanking corporations. Under the proposed regulations, a bank holding corporation (the disaffiliated Institution's shareholder) would have to include in income the toll charge without the