

We are seeking your reaction to newly proposed IRS regulations relating to subchapter S banks. At issue is whether the "special bank rules" in the Internal Revenue Code (the Code) apply to Sub S banks regardless of language contained in Subchapter S of the Code. (The proposal is attached.) This is important because it is a tax issue that concerns all sub S banks that carry qualified tax exempt obligations. I need to receive your comments no later than October 3, 2006, in order to determine whether the ABA should submit written comments and/or participate in the public hearing.

Written comments and requests for public hearing are due to the IRS on November 2, 2006.

### **The View of IRS**

The proposed regulations are intended to clarify that banks that are Subchapter S corporations are subject to specific banking rules included in the Code, without regard to other rules applicable to sub S entities contained in the Code. According to the IRS, there is no evidence that Congress intended that a bank that makes an S election be denied the benefits, or be shielded from the burdens, ordinarily applicable to all banks. Therefore, the IRS believes the sub S provisions in the Code do not operate to prevent the application of banking rules to a bank that has made the S election. The proposed regulations refer to Treasury Regulations (Section 1.1361-4(a)(3)), which state that if a bank or its parent is an S corporation, any rules applicable to banks under the Code "continue to apply separately to the bank parent or bank subsidiary."

The IRS noted that the proposed regulations were prompted by taxpayer questions. While the proposed regulations would apply to tax years beginning on August 24, 2006, the IRS specifically states that "[n]o inference should be drawn from this effective date regarding prior taxable years."

### **Background**

As many of you are aware, the subject of the proposed regulations has been a topic of IRS audit in the past few months – specifically, the question of whether the 20% TEFRA disallowance of bond interest applies to sub S banks three years after the sub S election in made. The disagreement is essentially over whether under an exception provided in SubChapter S of the Code (Section 1363(b)(4)), if a bank makes an S election, it is subject to the TEFRA disallowance rule for only the first three years of the election (this is known as the three-year rule). Accordingly, once the three years have elapsed, the sub S bank would no longer be subject to any interest disallowance rules on its qualified tax-exempt obligations (i.e., 100% of its interest expense relating to the tax-exempt obligations will be deductible).

However, the IRS has argued (and is reiterating through these regulations) that the banking section in the Code (Section 291(e)), which require 20% interest disallowance on qualified tax-exempt obligations for banks, applies to all banks at all times, including sub

S banks. (Please see the attached article that was included in our Summer 2005 Sub S Newsletter for more details on the TEFRA audit.)

One bank has recently been issued a 90-day letter and has decided to litigate the issue. The general opinion is that the IRS issued the proposed regulations in an attempt to beef up support for its position that the 20% TEFRA disallowance continues to apply even after a bank has had S corporation status for three years. Further, the fact that the IRS felt it was necessary to issue new regulations on this issue indicates that they were concerned that the current guidance did not adequately support their position. The preamble to the regulations clearly sets out the IRS' rationale for its position.

We contacted the IRS to discuss this issue prior to issuance of the proposed regulations; however, the IRS indicated that it could not discuss the issue because it is under audit.

Some have indicated that this proposal will be extremely problematic for sub S state banks, because they had planned for the TEFRA disallowance to be eliminated after three years (clearly, the litigating bank is in this position and we have heard this from other banks). However, other banks may have different views. For example, we have heard that the IRS's position is quite valid. According to this school of thought, the TEFRA disallowance rules applicable to banks were already in existence before banks were allowed to elect sub S status. If Congress had wanted to exempt sub S banks from its application, it would have made that clear when it passed the law allowing banks to elect sub S status.

*We are very interested in learning your perspective about the following:*

- ***Is this proposal problematic for sub S banks? If so, why. If not, why not?***
- ***Do you believe it was intended that sub S banks be treated differently from non-sub S banks with respect to the TEFRA disallowance?***
- ***Is there any concern that the proposed regulations create new requirements or impose problematic burdens on banks?***
- ***Are there other scenarios (other than the TEFRA disallowance example described above) that this might impact?***
- ***Any other thoughts?***

Please send your comments or questions to me at [fmordi@aba.com](mailto:fmordi@aba.com) or call 202.663.5317.

Thank You,

Fran Mordi

# **IRS Proposed Regulations (REG-158677-05) Clarifying Applicability of Code's Special Rules for Banks to S Corporations**

The proposed regulations are in the August 24, 2006 *Federal Register*

## **DEPARTMENT OF THE TREASURY**

### **Internal Revenue Service**

#### **26 CFR Part 1**

#### **[REG-158677-05]**

#### **Effect of Election on Corporation**

**ACTION:** Proposed regulations and notice of public hearing.

**SUMMARY:** These proposed regulations clarify that if a bank is an S corporation within the meaning of section 1361(a)(1), its status as an S corporation does not affect the applicability of the special rules for banks under the Internal Revenue Code.

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

Section 1361(b)(2) describes corporations that are ineligible to be S corporations (ineligible corporations). Until 1996, section 1361(b)(2)(A) treated as ineligible corporations financial institutions to which section 585 applied (without regard to section 585(c)), which included primarily all banks within the meaning of section 581 (section 581 banks). In 1996, Congress revised section 1361(b)(2)(A) to allow certain banks to be S corporations. Under current section 1361(b)(2)(A), a section 581 bank is eligible to be an S corporation only if it does not use the reserve method of accounting for bad debts described in section 585, which is otherwise available to certain banks.

The proposed regulations address issues regarding the application, to S corporation banks, of the special rules applicable to banks under the Internal Revenue Code (Code) (the special bank rules).

First, questions have arisen regarding whether certain language in section 1363(b), enacted in 1982, may prevent S corporation banks from being subject to the special bank rules. Subject to certain exceptions, the general rule of section 1363(b) requires that "[t]he taxable income of an S corporation shall be computed in the same manner as in the case of an individual ...." The special bank rules, however, apply only to corporations, because section 581 banks must be corporations for Federal tax purposes.

Second, questions have also arisen regarding the impact of section 1363(b)(4), which also pre-dates the 1996 legislation allowing banks to be S corporations. Section 1363(b)(4) applies section 291 to certain S corporations even if they would not otherwise be subject to it. Specifically, section 1363(b)(4) provides, "Section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years." Section 291(a)(3) and

(e)(1)(B) is a special bank rule that reduces by 20 percent the amount allowable as a deduction with respect to the portion of a bank's interest expense that is allocable to qualified tax-exempt obligations as defined in section 265(b)(3)(B). This portion of a bank's interest expense is the amount that bears the same ratio to the taxpayer's interest expense as the taxpayer's average adjusted bases of those tax-exempt obligations bears to the taxpayer's average adjusted bases of all its assets.

### **Explanation of Provisions**

The proposed regulations clarify that neither the general rule of section 1363(b), nor paragraph (4) of that section, prevents the special bank rules from applying to banks that are S corporations. When Congress allowed banks to become S corporations, it did not intend to deny them the benefits, or shield them from the burdens, ordinarily applicable to banks. This is reflected in the existing regulations under section 1361. See §1.1361-4(a)(3) ("If an S corporation is a bank, or if an S corporation makes a valid QSub election for a subsidiary that is a bank, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to the bank parent or bank subsidiary ... (except as other published guidance may apply section 265(b) and section 291(a)(3) and (e)(1)(B) not only to the bank parent or bank subsidiary but also to any QSub ...).").

The only special bank rule that Congress made inapplicable to S corporation banks was the section 585 reserve method for bad debts. The restriction in section 1361(b)(2)(A) regarding use of that method would be superfluous if the special bank rules were rendered inapplicable by section 1363(b). The section 585 reserve method is available only to banks, and those banks must be corporations. In amending section 1361(b)(2)(A), therefore, Congress did not expect the pre-existing general rule of section 1363(b) to prevent the special bank rules from applying to S corporation banks. The section 585 reserve method is a special bank rule, and it would have been unnecessary for Congress to make that rule inapplicable to S corporation banks if the special bank rules did not apply to them generally because of section 1363(b).

Section 1363(b)(4) historically subjected certain nonbank S corporations to section 291 if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years, even if section 291 would not otherwise apply. Section 1363(b)(4) does not provide that section 291 shall not apply in any other circumstance. When Congress enacted section 1363(b)(4) in 1984, banks could not yet be S corporations, and thus section 1363(b)(4) had no applicability to section 291(a)(3) and (e)(1)(B) (which applies only to banks). After the 1996 amendments to subchapter S, the general rule of section 1363(b) does not prevent the special bank rules from applying to S corporations. Thus, if section 291(a)(3) and (e)(1)(B) applies to an S corporation bank in the absence of section 1363(b)(4), section 1363(b)(4) does not affect the continuing application to that bank of section 291(a)(3) and (e)(1)(B).

### **Effective Date**

These regulations are proposed to apply to taxable years of corporations beginning on or after August 24, 2006. No inference should be drawn from this effective date regarding prior taxable years.

### **Drafting Information**

The principal author of these proposed regulations is Laura Fields, Office of the Associate Chief Counsel (Passsthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Paragraph (b) of §1.1363-1 is amended as follows:

1. Paragraph (b) is revised.
2. Paragraph (d) is amended by removing the language "This section applies" and adding the language "This section (except for paragraph (b)(2) of this section) applies" in its place.
3. The paragraph heading for (d) is revised.
4. A sentence is added at the end of paragraph (d).

The revision and additions read as follows:

*§1.1363-1 Effect of election on corporation.*

\* \* \* \* \*

(b) Computation of corporate taxable income--(1) In general. The taxable income of an S corporation is computed as described in section 1363(b).

(2) Treatment of banks. Section 1363(b) (concerning computation of an S corporation's taxable income) does not affect an S corporation's status as a bank within the meaning of section 581, and it does not prevent the application to such an S corporation bank of any special rule applicable to banks under the Internal Revenue Code, such as sections 582(c) and 291(a)(3) and (e)(1)(B). See §1.1361-4(a)(3) regarding application under subchapter S of the special rules applicable to banks. Further, section 1363(b)(4) causes section 291 to apply to an S corporation if the S corporation (or any predecessor) was a C corporation for any of the three immediately preceding taxable years, but section 1363(b)(4) does not prevent section 291 from applying to an S corporation to which section 291 otherwise applies.

(3) Example. The following example illustrates the application of this paragraph (b)(2):

Example. (i) Facts. X is described in section 581 and is an S corporation. Neither X nor any of X's predecessors was a C corporation for any of the three immediately preceding taxable years. During the current taxable year, X sold debt instrument DI at a loss. At the time of the sale, X's holding period in DI was more than one year and, but for section 582(c), the loss on the sale of DI would be capital. During the same taxable year, X held debt instrument QD, which it acquired after August 7, 1986. QD is a qualified tax-exempt obligation within the meaning of section 265(b)(3)(B).

(ii) X is described in section 581, and section 1363(b) does not affect X's status under section 581. Accordingly, X qualifies as a bank within the meaning of section 581. Also, section 1363(b) does not prevent any special rule applicable to banks under the Internal Revenue Code from applying to X. Thus, section 582(c), which is a special rule applicable to banks, imposes ordinary character on the loss that X recognized from the sale of debt instrument DI.

(iii) Because QD is a qualified tax-exempt obligation that was acquired after August 7, 1986, section 265(b)(3)(A) causes QD to be treated for purposes of section 291(e)(1)(B) as having been acquired on that date. For that reason, if section 291(e)(1)(B) applies to X, a portion of the interest expense that X incurs during the taxable year is interest on indebtedness incurred or continued to purchase or carry qualified tax-exempt obligations and thus is a financial institution preference item. Section 291(a)(3) and (e)(1)(B) is a special rule applicable to banks, and thus section 1363(b) does not prevent section 291(a)(3) and (e)(1)(B) from applying to X unless some other authority prevents that result.

(iv) Section 1363(b)(4) does not prevent section 291 from applying in situations in which section 291 otherwise applies. Therefore, section 1363(b)(4) does not prevent section 291(a)(3) and (e)(1)(B) from applying to X. It is irrelevant that neither X nor any predecessor of X was a C corporation for any of the three immediately preceding taxable years. X's status as a bank under section 581 causes section 291(a)(3) and (e)(1)(B) to apply.

\* \* \* \* \*

(d) Effective dates. \* \* \* Paragraph (b)(2) of this section applies to taxable years of corporations beginning on or after August 24, 2006.

## SUMMER 2006

## NEWS/LEGISLATIVE DEVELOPMENTS

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## IRS DEVELOPMENTS

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## ECONOMIC PERFORMANCE

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## News

**Investment Requirements for National Bank Directors**

Directors of National Banks are required to own a specified amount of stock in the bank or in the holding company that owns the bank. (See 12 U.S.C. § 21) This requirement, which was enacted before banks were able to elect sub S status, has been the subject of much concern for banks that have made or intend to make the sub S election. First, it raises the question about whether these director shares represent a second class of stock outstanding; second, it raises the question about whether a qualified subchapter S subsidiary ("QSub") meets the 100 percent stock ownership requirement of the Internal Revenue Code ("IRC"); and third, it creates other complications relating to income distributions and taxation of the directors. While the Office of the Comptroller of Currency ("OCC") has approved certain arrangements designed to comply with the requirement, the only IRS material that addresses the issue has held one such arrangement to be in violation of the one class of stock requirement of the Code. In a 2002 private letter ruling (PLR 200217048), the IRS ruled that a bank's sub S election was inadvertently invalid as a result of the arrangement which created a second class of stock.

Over the past several years, the ABA has played a very active role in attempting to include a provision in leg-

islation (including the American Jobs Creation Act ("AJCA") of 2004 that would clarify that (i) director shares held solely for the purpose of satisfying the National Banking Act requirement would not be treated as a second class of stock; (ii) directors holding such shares would not be treated as shareholders of the sub S bank; (iii) such stock ownership would not affect the 100 percent ownership stock requirement for a QSub; and (iv) distributions on such shares would be treated as ordinary income and deductible by the bank. So far, no final legislation has addressed this issue. In 2004, the Tax Section of the American Bar Association requested that the IRS issue a Revenue Ruling that would use a "benefits-and-burdens" approach in analyzing whether the transferor (the sub S bank) rather than the director is the actual owner of the shares for purposes of determining whether that arrangement creates a second class of stock. The Tax Section noted that such guidance would not only provide much needed clarification on the issue, but also eliminate the continuous advocacy for a legislative solution.

As previously stated, this stock requirement raises complications relating to income distribution and taxation that affects sub S banks in a way that does not affect C corp banks. The C corp director/shareholder is subject to tax only on dividends actually paid on the shares. Therefore, if dividends are not paid, no tax would

be due. On the other hand, the sub S director/shareholder is subject to tax on his/her share of the bank's income whether or not income is actually distributed. This undesirable result, for this purpose, makes it difficult for some sub S banks to find and convince people to participate as directors of the bank. Another undesirable effect of the stock requirement is that the owners of the sub S bank are pressured into making their directors shareholders of the entity -- whether or not they want to -- in order to satisfy the requirement. The fact that neither the regulators for thrifts nor state banks have this director stock ownership requirement adds to the frustration for sub S national banks.

The OCC is aware of this frustration and has made efforts to address the issue. The most recent effort involves a provision included in the House-passed H.R. 3505 (*Financial Services Regulatory Relief Act of 2005*)<sup>1</sup> that would allow sub S banks to satisfy the requirement by issuing a specified amount of subordinated debt to the directors rather than stock. This provision would effectively eliminate all the concerns raised by the requirement and therefore relieve the resulting frustration for sub S national banks. The problem is that the Senate version of the bill does not contain this provision. While the Senate writing staff does not make the argument that directors must have shares in the bank (as it has continuously done in the past), it is of the opinion that recent legislation (the AJCA of 2004), which granted sufficient relief for sub S banks, contains provisions that greatly reduce the problems associated with the director stock requirement - for instance, the provisions that increased the limit on sub S shareholders from 75 to 100 and permits a family of shareholders to be counted as one shareholder for purposes of determining number of shareholders. As a result, the House provision was not included in the Senate bill. Based on the Senate's reasoning, because the entity is allowed up to 100 shareholders and the fact that family members may be collapsed into one shareholder, there is more than enough room for outsiders to participate as director/shareholders without violating the rules. This reasoning does not in any way take into consideration the fact that the directors, as shareholders, are subject to tax on the entity's income whether or not they receive income. Furthermore, it does not address the fact that the concern is not only whether the maximum number of shareholder

rule is violated, but also whether the attempt to satisfy the stock ownership requirement by making directors shareholders may create other complications that may result in inadvertent termination of the entity's S status.

ABA is continuing its education efforts on this, and we will keep you informed.

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<sup>1</sup>H.R.3505 (Financial Services Regulatory Relief Act of 2005)  
SEC. 101. NATIONAL BANK DIRECTORS.

(a) ...  
SEC. 5146. REQUIREMENTS FOR BANK DIRECTORS.

(a) ...

(b) Investment Requirement-

(1) IN GENERAL- Every director of a national bank shall own, in his or her own right, and

(3) by adding at the end the following new paragraph:

(2) EXCEPTION FOR SUBORDINATED DEBT IN CERTAIN CASES- In lieu of the requirements of paragraph (1) relating to the ownership of capital stock in the national bank, the Comptroller of the Currency may, by regulation or order, permit an individual to serve as a director of a national bank that has elected, or notifies the Comptroller of the bank's intention to elect, to operate as a S corporation pursuant to section 1362(a) of the Internal Revenue Code of 1986, if that individual holds debt of at least \$1,000 issued by the national bank that is subordinated to the interests of depositors and other general creditors of the national bank.'

### **Small Business Subcommittee Hearing on Sub S Corporations**

On June 27, 2006, the Small Business Committee's Subcommittee on Regulatory Reform and Oversight held a hearing entitled "S Corporations - Their History and Challenges." At the hearing, the Subcommittee heard testimony from four witnesses on the role of sub S corporations in the U.S. economy and the challenges they face with respect to the current rules governing them. All four witnesses testified that since its inception by Congress and President Eisenhower in 1958, the sub S corporation has played a significant role in encouraging the rise of small and closely-held businesses in the U.S. However, because of the significant restrictions placed on these entities (e.g., limitation on shareholder eligibility and stock restriction), the sub S structure is no longer the structure of choice for many small businesses. The preferred structure is now mostly the LLC, and in a small number of cases, the partnership (subchapter K). These enti-