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November 21, 2006

Laura Fields  
CC: PA: LPD: PR: (Reg – 158677 – 05)  
Room 5203  
Internal Revenue Service  
PO Box 7604  
Ben Franklin Station  
Washington, DC 20044

Re: *IRS Proposed Regulations (REG – 158677 – 05) Clarifying Applicability of Code’s  
Special Rules for Banks to S Corporations*

Dear Ms. Fields

The American Bankers Associations (ABA) is pleased to submit comments on the *IRS Proposed Regulations Clarifying Applicability of the Code’s Special Rules for Banks to S Corporations* (the “Proposed Regulations”). The ABA brings together all categories of banking institutions to best represent the interests of a rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies as well as savings associations, trust companies and savings banks – makes ABA the largest banking association in the country.

### **ABA Position**

The ABA strongly urges that the Service withdraw the Proposed Regulations for the following reasons:

- The Service has made it clear on many occasions that while the issue was still on audit or in litigation, the National office would not take any position until resolution. Because the issue is currently under litigation, it is not appropriate for the Service to finalize any regulations prior to resolution by the courts.
- The Service’s issuance of these Proposed Regulations indicates that the issue is not as clear as the Service had indicated in its audit report. Therefore, legislative clarification is required.
- Some view the issuance of the Proposed Regulations as a way for the Service to boost its position unfairly in the upcoming litigation on the issue.
- As discussed below, the dispute is not whether special bank rules apply to sub S banks, but whether the language of section 1363(b)(4) makes section 291 inapplicable after the first three years of S conversion. The Service

argues that if the special bank rules did not apply to sub S banks because of section 1363(b), it would have been unnecessary for Congress to make the section 585 rule inapplicable to S corporation banks – “thereby making it superfluous.” This argument is quite difficult to follow. Simply put, Congress intended that sub S banks be excluded from using the reserve method and included such language in the Code when it allowed banks elect sub S in section 1361(b)(2)(A). The fact that Congress was aware of the language of 1363(b)(4), which provides an exception for sub S banks with respect to the application of section 291, and did not do anything about it at that time, clearly shows that it intended to leave it that way.

- The Service’s conclusion that, “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)” is flawed. It is the existence of section 1363(b)(4) that makes section 291 (i.e., section 291(a)(3) and (e)(1)(B)) specifically applicable to a sub S bank, and it is the same section 1364(b)(4) that makes section 291 applicable only for the first three years of conversion. Thus, section 1363(b)(4) provides both the application and the limitation of the application of section 291 to sub S banks. In the absence of section 1363(b)(4), a sub S bank would compute its taxable income in the same manner as an individual under section 1363(b) – without the application of section 291 – because section 291 does not apply to individuals. What section 1363(b)(4) does is simply to clarify when section 291 applies to a sub S corporation.
- The Service’s continued reference to existing regulations does not support its position in anyway. First, the referenced regulations do not provide that the special bank rules in the Code override or supersede the application of section 1363(b) and section 1363(b)(4) to sub S banks. By providing that special bank rules apply to a parent S corporation bank or a bank that has made a QSub election, the regulations simply factor in the application of bank specific rules that would have been inoperative because of the deemed liquidation resulting from the QSub election. Indeed, there is no disagreement on the question of whether section 291 applies to QSubs. The fact is that there is nothing in the referenced regulations that negate the application of the 3-year rule that is specifically stated in section 1363(b). Therefore, reference to these regulations in support of its position shows a misreading by the Service.
- Even if the Proposed Regulations are left to stand, they should apply prospectively, after the outcome of ongoing litigation, and only if such outcome is favorable to the Service.
- The Service states that the Proposed Regulations would apply to taxable years of corporations beginning on or after August 24, 2006. They caution that no inference should be drawn from this effective date regarding prior taxable years. However, it is impossible not draw an inference from the effective date of the Proposed Regulations. The obvious implication is that no published guidance previously existed to specifically apply section 291 to S corporations after the first three years of S conversion (as provided in the referenced regulations), so the Service cannot justify the position taken before the effective date of the any final regulations. If, as the Service claims, Congress did not intend to exclude sub S banks from the application of

provisions in the Code that apply to all banks, then Congress, not the Service, should be the one to solve the problem. Regulations cannot override the statute, which is clear on its face – it provides that a sub S corporation (bank or not) shall compute its tax like an individual (section 291 does not apply to individuals), but if the S corporation was a C corporation in any of the preceding 3 years, it will be subject to section 291. In its fourth year of being a sub S corporation, the entity will no longer be subject to section 291 because it was not a C corporation in any of the preceding 3 years.

- The Service claims that when banks were allowed to elect sub S status in 1996, nothing in the rules stated that the general rule of section 1363(b) prevented special bank rules from applying to sub S banks. While this is true, it is also true that nothing in the rules stated that the application of section 1363(b) and section 1363(b)(4) did not apply, nor could be superseded by any other rules in the Code.
- Notwithstanding the above, any new law or change in current law should provide grandfathering for sub S banks that own QTEOs that were purchased before the date of enactment. Such banks entered into the transaction based on current law, which provides that Section 291 would apply to such banks' tax computation for only the first three years of S conversion. As a result, these banks priced the QTEOs to reflect the 20% interest disallowance for three years and 100% deduction for years after that. A change in the law without a grandfathering provision would put these banks at a huge disadvantage, resulting in significant losses.

### **The Proposed Regulations**

In general, the Proposed Regulations provide that an S Corporation bank is subject to all special rules applicable to banks in the Internal Revenue Code (the "Code") regardless of the provisions that apply to sub S corporations under Subchapter S of the Code. In effect, the Proposed Regulations provide that, although the general rule of section 1363(b) and the exception provided in section 1363(b)(4) apply to sub S corporations (bank or not), their application to sub S banks are superseded or overridden by the applicability of special bank rules contained in other sections of the Code. The Proposed Regulations note that, "[w]hen 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." Furthermore, according to the Proposed Regulations, the fact that Congress explicitly, and therefore, intentionally made only the section 585 reserve method for bad debts inapplicable to S corporation banks provides support for the assertion that Congress did not intend to exclude sub S banks from the applicability of the special bank rules contained in the Code.<sup>1</sup>

According to the Proposed Regulations, if the Code's special bank rules were rendered inapplicable by section 1363(b), the restriction contained in 1361(b) regarding the use of section 585 reserve method would be superfluous. That is, since

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<sup>1</sup> The section 585 reserve method for bad debt is a special bank rule. Section 1361(b)(2)(A) provides that a bank that uses the section 585 reserve method for bad debts is ineligible to make the S election.

section 585 reserve method is a special bank rule, if the special bank rules did not apply to S corporation banks because of section 1363(b), it would have been unnecessary for Congress to make that rule inapplicable to S corporation in section 1361(b).

To support its position, the Proposed Regulations refer to existing regulations under section 1361, which provide that, "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 as if the deemed liquidation of any QSub under paragraph (a)(20) of this section had not occurred (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 ...)."2

The Proposed Regulations conclude that, "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)."

### **Background**

Subchapter S of the Code (sections 1361 through 1379) provide tax rules governing entities that are referred to as sub S corporations. In 1996, Congress passed legislation allowing banks to operate as sub S corporations and as a result sub S banks are governed by the rules of Subchapter S. Section 1363(b), which has been in the Code since 1984, provides the general rule on how a sub S corporation computes its tax. It provides that "[t]he taxable income of an S corporation shall be computed in the same manner as in the case of an individual..." Section 1363(b)(4) provides an exception to this general by stating that section 291 shall apply to the S corporation's computation of tax if such corporation (or any predecessors) was a C corporation for any of the three preceding tax years. (Section 291 has been in the Code since 1982.) Section 291 (i.e., 291(a)(3) and 291(e)(1)(B)) is a special rule that applies to financial institutions that are corporations. Specifically, under the section 291 special rule, the amount allowed as a deduction for tax-exempt interest expense for a financial institution under section 265(b) is subject to a 20% disallowance.

Section 265(b)(1) provides the general rule for interest expense deduction applicable to financial institutions that invest in tax-exempt obligations. Under the general rule, there is a 100% deduction disallowance for interest expense allocable to such exempt obligations. Section 265(b)(2) provides the method for determining the amount of the bank's total interest expense that is allocable to tax-exempt obligations, and therefore subject to the 100% disallowance. Section 265(b)(3) provides an exception from the 100% disallowance rule for tax-exempt obligations that qualify as QTEOs. For these QTEOs, the general rule of 100% disallowance does not apply. However, for a financial institution that is a corporation, Section 291 provides a 20% interest disallowance for such QTEOs.

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<sup>2</sup> Treas. Reg. §1.1361-4(a)(3).

Based on the language of section 1363(b)(4), sub S banks have determined that: (1) after the first 3 years of sub S election (conversion from C corporation to S corporation) the S corporation bank is no longer subject to the section 291 20% disallowance for QTEOs, and (2) a sub S bank with no C corporation history is not subject to the section 291 20% disallowance at any time. In other words, the sub S bank with a C corporation history would start to compute its taxable income in the same manner as an individual after the first three years of S election and the sub S bank without a C corporation history would do the same from day one – without the application of the 20% disallowance contained in section 291.

In the past year, the Internal Revenue Service (the “Service”) started audit activities with respect to this issue, claiming that section 291 is a special bank rule that applies to banks, including sub S banks, regardless of the provisions of section 1363(b) and section 1363(b)(4), which state that a sub S corporation shall compute its taxable income in the same manner as an individual, except that “... section 291 shall apply to the S corporation’s computation of tax if such corporation (or any predecessors) was a C corporation for any of the three preceding tax years”.

In the audit reports generated by the Service, the Service referenced the same regulations referred to in the Proposed Regulations to support its claim that the special bank rule contained in section 291 applies to sub S banks at all times (not just in the first three years of S conversion). The taxpayer on audit responded to the Service’s claim by pointing out that the referenced regulations do not in any way support the Service’s position that the exception provided in section 1363(b)(4) does not prevent the application of section 291 to a sub S bank after the first 3 years of S conversion. In fact, according to the taxpayer, the referenced regulations explicitly provide that other published guidance will be needed to specifically apply section 265(b) and section 291 (i.e., 291(a)(3) and 291(e)(1)) to the sub S bank – meaning that these sections do not apply unless such guidance is published. No guidance was published until the taxpayer decided to challenge the Service’s position in court.

### **Conclusion**

The ABA urges that the Service withdraw the Proposed Regulations, because they are in direct conflict with the clear language of the statute applicable to sub S corporations. The tax laws state that the 20% interest disallowance rule will only apply to an S corporation (holding “qualified tax exempt obligations” (QTEOs)) if such S corporation was a C corporation in any of the three preceding years. In effect, after its first three years of S election, the S corporation shall compute its taxable income in the same manner as an individual – without applying the disallowance rule. The language of the statute applies to all S corporations – whether or not they are banks. Thus, the Proposed Regulations improperly apply the interest disallowance rule to sub S banks holding QTEOs, thereby establishing a rule that is in direct conflict with the statute. Furthermore, the Proposed Regulations would not only remove one of the benefits of making the S election (the TEFRA disallowance relief enjoyed only by sub S corporations), they would greatly impact the purchase of QTEOs by sub S banks in a manner that would jeopardize the ability of municipalities to obtain financing for important projects through tax-exempt bonds.

Again, we appreciate the opportunity to submit this comment letter, and hope that the Service will give due consideration to the concerns raised here. Please feel free to contact me if you have any questions or if you would like to discuss this further.

Sincerely,

A handwritten signature in black ink that reads "Fran Mordi". The signature is written in a cursive style with a large, stylized initial "F".

Francisca N. Mordi