

Update on Subchapter S TEFRA Issue

The question of whether a sub s bank is subject to the 20% interest expense disallowance rule of section 291 after its third year of being sub S is still very contentious. IRS and taxpayers have taken opposing positions on the issue, which is now the subject of Tax Court litigation. Both IRS and taxpayer briefs have been filed in the case (the Vainisi case), and we expect the Tax Court to issue its decision any time soon.

As you may recall, the IRS issued a proposed regulation in August 2006 on the issue, taking the position (as it is doing on taxpayer audits and in the court case) that the section 291 interest disallowance rule continues to apply to S corporation banks after the third year of S status. The IRS received many comments in response to the proposed regulation. In the ABA comment letter to the IRS, we specifically requested that the IRS withdraw the proposed regulation because it is in conflict with the Internal Revenue Code (the "Code"), which clearly states that section 291 does not apply to an S corporation after its third year of S status. The letter noted that the IRS has no authority to change the provisions of the Code through regulations. Any such change should be done by Congress through legislation, not by the IRS through regulation. While the IRS has not responded publicly to any comments, it is our understanding that it intends to go ahead and issue the proposed regulation as final without any changes. It had been expected that the IRS would wait until the Tax Court decision in the pending case before moving forward on the proposed regulations.

We will continue to provide updates on this issue as they become available.

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