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■ Appeals Court Reverses Tax Court Decision in *Vainisi v. Commissioner*

Last week, the 7th Circuit Court of Appeals rendered its decision in favor of the Sub S taxpayer in the case of *Vainisi v. Commissioner* (the TEFRA interest disallowance case for S corporation and QSub banks). After oral arguments last month before Judges Posner, Sykes and Bauer, the Court decided that the clear language of the statute should apply in this case, which is that a sub S bank (regardless of whether it is a parent or subsidiary of another S corp and therefore, a QSub) is not subject to the application of IRC section 291 20% interest disallowance rule on its qualified tax-exempt obligations (QTEOs) after three years of S status.

This issue, which has been the subject of IRS audits, proposed regulation and litigation over the last few years, has been focused on the question of whether or not Congress intended the application of the TEFRA interest disallowance rules as interpreted by the IRS. According to the IRS, even though Section 1363(b)(4) clearly states that the interest disallowance provision of Section 291 (the "TEFRA haircut") should not apply to an S corporation with a C history after three years, Congress did not intend that S corporation banks be excluded from the TEFRA haircut after three years of S status. The judges gave very little deference to the Tax Court's reasoning and pretty much dismissed the IRS's proposed regulation as an attempt to reflect Congress' intent or to "correct" the anomalous result created with respect to S banks by the language of Section 1363(b)(4).

Since this issue first came up on audit several years ago, the ABA has advocated the position reflected in the Appeals Court's decision at conferences and through the media, and closely monitored the issue. We were on hand to provide amicus briefs, if needed at any stage of the litigation process. The ABA is very pleased with the outcome of the appeal and expects that, while the government is weighing its options, including whether or not to seek a legislative "fix" to this issue, it will withdraw its 2006 proposed regulation as even the Court questioned the validity of its interpretation of the Code. Furthermore, we hope that the IRS will issue guidance as quickly as possible outlining steps that taxpayers who have been taking the TEFRA haircut should follow in order to receive their refunds. We will continue to closely monitor the government's activities in this area and keep our members updated. Click [here](#) to view the Appeals Court decision.



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