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November 30, 2006

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Proposed Regulations under Section 1363(b) Concerning S Corporation Banks

Dear Commissioner Everson:

Enclosed are comments on proposed regulations under section 1363(b), regarding the application of certain banking provisions to S corporations and qualified subchapter S subsidiaries, as prepared by members of the Committees on S Corporations and Banking and Savings Institutions. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Clarissa C. Potter, Deputy Chief Counsel (Technical), Internal Revenue Service
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**COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 1363(b)
CONCERNING S CORPORATION BANKS**

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These comments were prepared by members of the Committee on S Corporations of the Section of Taxation, with substantial assistance from members of the Committee on Banking and Savings Institutions. Principal responsibility was exercised by Kevin D. Anderson. Significant contributions were made by John Ensminger. Substantive comments were made by Paul Kugler, Thomas Nichols, Mark Baran, Ronald Blasi, Andrew Immerman, and Charles Wheeler. The Comments were reviewed by Carol Kulish Harvey, Chair of the Committee on S Corporations, and John Ensminger, Chair of the Committee on Banking and Savings Institutions. The Comments were further reviewed by: Charles Egerton of the Section's Committee on Government Submissions; Barbara Spudis de Marigny, Council Director for the Committee on S Corporations; and Peter J. Connors, Council Director for the Committee on Banking and Savings Institutions.

Although some of the members of the Tax Section who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on applications of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: November 30, 2006

EXECUTIVE SUMMARY

The Internal Revenue Service (the "Service") has proposed to amend the section 1363 regulations with respect to the application of certain banking provisions to banks that are either S corporations or qualified subchapter S subsidiaries.[1] The Proposed Regulations would apply the 20-percent proportionate disallowance provisions of section 291(a)(3) and (e)(1)(B) relating to financial institution preference items to a bank that is an S corporation. These Proposed Regulations would apply to an S corporation that has never been a C corporation, as well as to an S corporation that has passed the three-year period specified in section 1363(b)(4). They would presumably also apply to determine the income of a bank that is a qualified subchapter S subsidiary.

We respectfully submit that the Proposed Regulations are inconsistent with the relevant provisions of the statute. The application of the section 291 tax-preference provisions to an S corporation is governed by section 1363(b)(4). Section 1363(b)(4) states that section 291 applies to an S corporation if the corporation has been a C corporation during any of the preceding three taxable years. The meaning of this provision is clear and unambiguous. Under the statutory provision, after the expiration of the three-year period for an S corporation, that corporation is no longer subject to any of the provisions of section 291, including the provision that reduces the allowable deduction for interest expense incurred by a bank.

We find no other relevant statutory provision that either conflicts with the application of section 1363(b)(4) to an S corporation bank or creates an ambiguity in the application of this rule to such banks. We believe that, if the Service seeks to attain the result provided by the Proposed Regulations, Congress would need to amend section 1363(b)(4). We take no position in these Comments regarding the policy arguments in support of or against such a legislative modification.

[1] Except to the extent specified otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder, as applicable.

DETAILED COMMENTS

I. INTRODUCTION

On August 23, 2006, the Service issued a Notice of Proposed Rulemaking (REG-158677-05)[2] proposing to amend the regulations under section 1363 of the Internal Revenue Code of 1986, as amended (the "Code"). Prop. Reg. § 1.1363-1 provides that section 1363(b) does not affect an S corporation's status as a bank, and does not prevent the application to an S corporation of special rules applicable to banks under the Code, such as sections 582(c) and 291(a)(3) and (e)(1)(B). The Proposed Regulations provide, *inter alia*, that the 20-percent reduction under section 291 of the amount otherwise allowable as a deduction for interest on indebtedness incurred to carry certain tax-exempt obligations, which applies to C corporations for three years after their conversion to S corporation status under section 1363(b)(4), would continue to apply to S corporations after that three-year period (and would also apply to S corporation banks that were never C corporations).

The Proposed Regulations further provide that the rules would apply to taxable years of corporations beginning on or after August 24, 2006.

II. ANALYSIS AND COMMENT

These Comments are focused entirely on the conclusions regarding the application of section 291(a)(3) and (e)(1)(B) to banks that are either S corporations or qualified subchapter S subsidiaries. We do not question the Service's authority to apply section 582(c) to such banks.

A. The Preamble to the Proposed Regulations

The Preamble to the Proposed Regulations makes several observations as either background or explanation, including the following:

1. The Service noted that questions have arisen concerning whether section 1363(b) may prevent S corporation banks from being subject to the special bank rules. Section 1363(b) provides, with certain exceptions, that "[t]he taxable income of an S corporation shall be computed in the same manner as in the case of an individual." The Preamble then observes that "[t]he special bank rules, however, apply only to corporations, because section 581 banks must be corporations for Federal tax purposes."

2. The Preamble then implies that Congress did not specifically address the relationship between the special bank provisions and the scope of section 1363(b). It asserts that "Congress . . . did not intend to deny [S corporation banks] the benefits, or shield them from the burdens, ordinarily applicable to banks." Such intent was said to be reflected in the

[2] This Notice was published in the *Federal Register* at 71 Fed. Reg. 50,007 (Aug. 24, 2006).

existing regulations applicable to banks that are qualified subchapter S subsidiaries.

3. Finally, the Preamble states that the only special bank rule that Congress made inapplicable to S corporation banks was the section 585 reserve method for bad debts. Thus, the Preamble indicates that, in amending section 1361(b)(2)(A), "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."

B. Historical Development of Relevant Provisions

We believe that a brief review of the relevant provisions of the Code and regulations would be useful to illustrate the purpose for their enactment or promulgation, as the case may be. Because the chronological order of these developments is relevant to the issue presented in the Proposed Regulations, this discussion will also be presented in chronological order.

In 1982, Congress scaled back certain perceived corporate tax preferences as part of the Tax Equity and Fiscal Responsibility Act of 1982.[3] At that time, banks were not subject to a proportionate disallowance of their interest expense, a result that is currently required by section 265(b). However, section 291(a)(3) reduced the otherwise allowable interest expense for banks (as defined therein) by 20 percent, to the extent that the indebtedness giving rise to the interest expense was proportionately allocated to investments in tax-exempt obligations.[4] This 20-percent "haircut" applied to interest allocable to tax-exempt obligations acquired after December 31, 1982. Because of its historical origin, this provision is sometimes referred to as the "TEFRA disallowance," and we will use this term from time to time in these Comments.

Also in 1982, the provisions of subchapter S were substantially revised by the Subchapter S Revision Act of 1982.[5] Section 1363(b) was enacted to more closely follow the format of the comparable partnership rules by providing that, with certain exceptions, the taxable income of an S corporation is to be computed in the same manner as in the case of an individual.[6] As originally enacted, section 1363(b) had three exceptions, which have remained largely unchanged since enactment. However, in the Deficit Reduction Act of 1984,[7] Congress added section 1363(b)(4) to provide that "section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years." Congress provided that this rule was to become effective as if enacted as part of the Subchapter S Revision Act of 1982.[8]

[3] Pub. L. No. 97-248, § 204(a).
[4] This result was accomplished by reducing the deduction for any "financial institution preference item" by 20 percent in section 291(a)(3), and by defining this term in section 291(e)(1).
[5] Pub. L. No. 97-354.
[6] *See* section 703(a).
[7] Pub. L. No. 98-369.
[8] Pub. L. No. 98-369, § 721(p).

As part of the Subchapter S Revision Act of 1982, Congress made another change to section 291. As originally enacted, section 291(a) was to apply only to "an applicable corporation." Former section 291(e)(2) (as in effect before its repeal by the Subchapter S Revision Act) defined this term to mean "any corporation other than an electing small business corporation (as defined in section 1371(b))."[9] After its amendment, section 291(a) now applies to "a corporation."

At the time section 1363(b)(4) was enacted, banks were not permitted to be S corporations. However, the provision would have applied to other tax preferences subject to the 20-percent reduction of section 291, such as the recapture of depreciation on real estate[10] and the allowable deduction for percentage depletion.[11] Outside of the banking area, this provision reflects the clear intention of Congress that certain disadvantageous provisions applicable to the determination of the taxable income of C corporations should apply to S corporations only for a three-year period following their conversion to S corporation status.

In the Tax Reform Act of 1986,[12] Congress decided to apply the proportionate disallowance rule so as to disallow *all* of the interest expense allocable to tax-exempt obligations of financial institutions.[13] This rule, contained in the current version of section 265(b), applies to tax-exempt obligations acquired after August 7, 1986.[14] Putting these provisions together, a 20-percent disallowance applies to obligations acquired after December 31, 1982, and on or before August 7, 1986. A full disallowance of allocable interest expense applies to obligations acquired after August 7, 1986.

At the same time, Congress created an exception to the application of section 265(b) for "qualified tax-exempt obligations" ("QTEOs").[15] If a bank acquired such obligations, the interest expense allocable to the obligations would be subject to the more favorable 20-percent rule of section 291(a)(3) rather than the full disallowance provided by section 265(b). This effect was technically achieved by treating all QTEOs as if they were acquired on August 7, 1986, for purposes of both sections 265(b)(2) and 291(e)(1)(B). As a result, for a QTEO that was acquired after December 31, 1982, the 20-percent disallowance applied to such obligations regardless of whether they were actually acquired before or after the 1986 date. Thus, banks viewed tax-exempt obligations subject to section 291(a)(3) as preferred investments for their portfolios when compared with obligations subject to the proportionate disallowance rules of section 265(b).

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[9] This defined term has been replaced by the term "S corporation" as defined in section 1361(a).
[10] Section 291(a)(1).
[11] Section 291(a)(2).
[12] Pub. L. No. 99-514.
[13] The term "financial institution," as used in section 265(b), generally encompasses more entities than the defined term "bank," to which the provisions of section 291(b)(3) apply. However, for purposes of the Proposed Regulations and these Comments, the relevant term is "bank" as defined in section 585(a)(2). Pursuant to this provision, the term "bank" generally means any bank as defined in section 581.
[14] *See* section 265(b)(2)(A).
[15] Section 265(b)(3).

The Small Business Job Protection Act of 1996 made several important changes to the provisions of subchapter S.[16] Two such changes are relevant to this issue.[17] First, section 1361(b)(2) was amended to narrow the scope of a provision that had previously precluded all financial institutions from being "small business corporations." As amended, a financial institution was an "ineligible corporation" only if it used the reserve method of accounting for its bad debts described in section 585. In other words, a financial institution had to make a choice between the continued use of the reserve method and an S corporation election.

Second, section 1361(b)(3) was enacted to permit an S corporation to own stock of another corporation, and to make a "qualified subchapter S subsidiary" ("QSub") election for an otherwise eligible wholly-owned subsidiary. If a QSub election is made for a subsidiary, the subsidiary is disregarded "for purposes of this title [26—the entire Internal Revenue Code]" except as provided in regulations prescribed by the Service.[18] Section 1363(b)(3) and the regulations promulgated thereunder provide that disregarded entity status is accomplished in the following manner: (1) the QSub is not treated as a separate corporation; and (2) all assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and such items of the S corporation.

The Service did not originally have the authority to prescribe exceptions to the requirement to disregard a QSub for all purposes of the Code. However, such authority was granted pursuant to a technical correction made to section 1361(b)(3)(A) by the Taxpayer Relief Act of 1997.[19] As a technical correction, the amendment had the same effective date as if it had been enacted as part of the 1996 legislation.

Even before this technical correction was enacted, the Service and Treasury recognized that special provisions were necessary for banks. In a typical structure, a bank holding company (generally organized as a state-law business corporation rather than as a bank) would own all of the stock of a bank. The holding company would make an S corporation election for itself and a QSub election for the bank.[20] If the bank were to be disregarded for all purposes of the Code, it was likely that certain special provisions applicable to banks might not apply to the bank. The Service quickly released Notice 97-5[21] to address this issue. The initial focus of such guidance was on the provisions of

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[16] Pub. L. No. 104-188.

[17] A third change is peripherally related to the issues presented in the Proposed Regulations. The 1996 legislation repealed former section 1371(a)(2) and redesignated former section 1371(a)(1) as section 1371(a). Former section 1371(a)(2) provided that, for purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual. The provision was thought to create confusion regarding the extent to which the provisions of subchapter C were to apply to an S corporation. Moreover, there was no need to have such a provision in order to deny the dividends received deduction of section 243 to S corporations, given the language of section 1363(b).

[18] The Code subsequently has been amended to treat a QSub as a "regarded" entity for certain information return purposes, except to the extent otherwise provided by the Secretary.

[19] Pub. L. No. 105-34, § 1601(c)(3).

[20] In a less typical structure, the entities might be reversed. The parent entity might be a bank, while a subsidiary is a state-law business corporation not authorized to conduct banking activities.

[21] 1997-1 C.B. 352.

sections 265(b) and 582(c), the latter of which provides ordinary gain and loss treatment for transactions involving the sale or exchange of debt instruments.

These provisions were reflected in the final QSub regulations, issued in January 2000.[22] Treas. Reg. § 1.1361-4(a)(3)(i) provides, in pertinent part, as follows:

> 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)(2) 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 deemed to have liquidated under paragraph (a)(2) of this section).

The examples provided in Treas. Reg. § 1.1361-4(a)(3)(ii) apply this rule to sections 265(b) and 582(c).[23]

C. Detailed Analysis

We believe that the conclusions set forth in the Proposed Regulations conflict with the plain meaning of section 1363(b), which provides that the taxable income of an S corporation shall be computed in the same manner as in the case of an individual, with four exceptions. One of those four exceptions is that "section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years." After that three-year period, the exception as stated no longer applies (nor would it apply to an S corporation bank that was never a C corporation).

We respectfully submit that the Proposed Regulations relating to the application of section 291(a)(3) and (e)(1)(B) are inconsistent with the Code. We find no conflict or ambiguity among any of the relevant statutory provisions that requires clarification through regulations. There are several components of our analysis.

1. Plain Language of the Code. It is well established that the language of the Code should be respected when it is clear and unambiguous and that the language of the Code is the best evidence of Congressional intent.[24] Here, the statutory language of section 1363(b) clearly provides that the income of an S corporation is determined in the same manner as in the case of an individual, except as specifically provided. One of the specific exceptions is that section 291 applies to an S corporation, but only during the three years following its conversion from C corporation status. Absent this exception,

[22] T.D. 8869 (Jan. 20, 2000).
[23] *See* Treas. Reg. § 1.1361-4(a)(3)(ii).
[24] See *Caminetti v. United States*, 242 U.S. 470 (1917); *BedRoc Ltd. v. United States*, 541 U.S. 176, 187 (2004); *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992); and *Gitlitz v. Comm'r*, 531 U.S. 206 (2001).

section 291 would not apply to an S corporation at any time given that section 291 relates to the computation of income of a corporation (not an individual).

2. Prior Applications of Section 1363(b). The Service has issued two revenue rulings on the application of section 1363(b) to other provisions of the Code. In Rev. Rul. 93-36, the Service ruled that the nonbusiness bad debt provisions of section 166(d) applied to S corporations.[25] Section 166(d) applies to a "taxpayer other than a corporation." In Rev. Rul. 2000-43, the Service ruled that an S corporation could not use the provisions of section 170(a)(2) to determine the amount of its deductions for charitable contributions.[26] Section 170(a)(2) applies to "a corporation reporting its taxable income on the accrual basis." Although we are not expressing a view in these Comments as to the policy underlying these rulings, both are consistent with the statutory rule that an S corporation generally computes its income in the same manner as an individual.

3. Treatment of Banks as Corporations. As noted above, the Preamble observes that "the special bank rules . . . apply only to corporations, because section 581 banks must be corporations for Federal tax purposes." While this statement is correct, the interpretation of this statement manifested in the Proposed Regulations confuses the difference between the classification of an entity as a corporation for Federal tax purposes and the appropriate tax treatment of the entity depending on whether it is a "C" corporation or an "S" corporation. Section 581 defines a bank by reference to its legal organization and its authority under applicable Federal or state law to receive deposits and make loans. Because it is "incorporated," as that term is used in section 581, a bank has historically been classified as a corporation for Federal tax purposes.[27] However, not all entities that are classified as corporations for federal income tax purposes are taxed the same way. If a bank is a "C" corporation, it is taxed under both the special bank rules of subpart H and the rules applicable to "C" corporations, including section 291. If a bank is an "S" corporation, its tax treatment is governed both by the special bank rules of subpart H (other than section 585) and by the rules applicable to S corporations. It simply does not follow that, because an S corporation bank must first be *classified* as a corporation,[28] it is also *taxed* in a manner identical to a C corporation bank. The application of generic banking rules, such as sections 265(b) and 582(c), to S corporation and QSub banks is appropriate because such application is premised on their legal status and authority pursuant to section 581. In contrast, where there is a rule for which the method of taxation differs for "S" corporations and "C" corporations, as is the

[25] 1993-1 C.B. 187.
[26] 2000-2 C.B. 333.
[27] Moreover, even if a state law permits a banking business to be conducted in an unincorporated form, an entity conducting a banking business is on the "per se" list of entities that must be classified as corporations for Federal tax purposes. Treas. Reg. § 301.7701-2(b)(5) provides that an entity conducting banking activities must be classified as an association if any of its deposits are insured under the Federal Deposit Insurance Act, or a similar federal statute.
[28] Section 1361(b)(1) provides that a "small business corporation" must be a "domestic corporation." Treas. Reg. § 1.1361-1(c) provides that the term "domestic corporation" means a domestic corporation as defined in Treas. Reg. § 301.7701-5, and the term "corporation" includes an entity that is classified as an association taxable as a corporation under Treas. Reg. § 301.7701-2.

case with respect to section 291 in light of section 1363(b), the directive of section 1363(b) must govern.

4. Drawing Inferences from the Reserve Method Rules. The Service notes that the reserve method was the only "special bank rule" that Congress made "inapplicable" to S corporation banks, thus suggesting that Congress intended that all other such rules should continue to be applied. As was noted above, we believe that the language of section 1363(b) is clear and provides the best evidence of Congressional intent with respect to the application of section 291. Further, we believe that the relevant history to the 1996 Act belies such a conclusion. The staff of the Joint Committee on Taxation, in its explanation of tax laws enacted in the 104th Congress, identified the reserve method of accounting for bad debts under section 585 as a tax *benefit* that should only be enjoyed by banks subject to taxation as C corporations. The purpose of the 1996 Act amendment to section 1361(b)(2)(A) was to require otherwise eligible institutions to choose between the *benefits* of S corporation status and the continued use of the reserve method of accounting for bad debts.[29] There is no suggestion in this language that Congress intended to apply all other banking tax provisions—whether favorable or unfavorable—to banks regardless of other provisions set forth in subchapter S.

5. The QSub Regulations. As indicated above, Treas. Reg. § 1.1361-4(a)(3)(i) provides for the separate application of "special rules applicable to banks" to S corporations and their QSubs. This regulatory provision was apparently considered to be relevant to the issue addressed by the Proposed Regulations, inasmuch as the Preamble quoted from that regulation. This regulation, however, did not provide general guidance on the taxation of S corporation banks. Rather, the regulation was a narrow exercise of the authority granted to the Service and Treasury to provide exceptions to the rule that a QSub is a disregarded entity for all purposes of the Code. Thus, Treas. Reg. § 1.1361-4(a)(3)(i) provides no support for ignoring the clear mandate of section 1363(b)(4).

III. SUMMARY AND CONCLUSION

We believe that the Proposed Regulations are inconsistent with the underlying statutory provisions. The TEFRA disallowance applicable to banks was one of several other tax preferences reduced by section 291. Section 1363(b)(4) provides, in the most unambiguous terms, that all of the provisions of section 291 apply to an S corporation only for the first three taxable years following its conversion from C corporation status. We find no ambiguity or conflict in the provisions of either section 1361(b)(3) (relating to the treatment of QSubs) or section 1363(b) (relating to the taxation of S corporations), that would support the validity of the Proposed Regulations. There is no clear evidence that Congress intended the result that would be produced by the Proposed Regulations.

[29] Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress, at 129 (Dec. 18, 1996) (explaining that "Congress believed that any otherwise eligible corporation should be allowed to elect to be treated as an S corporation regardless of the type of trade or business conducted by the corporation, so long as special corporate tax benefits provided to such trades or businesses did not flow through to individual taxpayers.").

Indeed, it could even be argued that, having specifically addressed the section 585 bad debt reserve provisions for banks intending to make S corporation elections, Congress considered all other provisions of the Code applicable to S corporations and banks and concluded that the anticipated application of such provisions required no further adjustment.

We believe that, if Congress determines to apply the provisions of section 291(a)(3) and (e)(1)(B) to an S corporation bank or QSub bank, it is certainly within its legislative power to do so. However, we do not take a position in these Comments on whether a legislative change should be enacted.