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Memorandum

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to: Director, Financial Services
(Large & Mid-Size Business)

from: Deputy Associate Chief Counsel
(Financial Institutions & Products)

subject: Subchapter S Banks and the Special Bank Rules

This memorandum addresses the treatment of subchapter S banks with respect to the special rules applicable to banks under the Internal Revenue Code (the special bank rules).

ISSUES

(1) If a bank is an S corporation or a qualified subchapter S subsidiary (QSub), do all of the special bank rules (other than § 585) continue to apply to the bank?

(2) If so, does the special bank rule of § 291(a)(3) and (e)(1)(B) apply to the bank regardless of whether it (or any predecessor) was a C corporation for any of the three immediately preceding taxable years?

CONCLUSIONS

(1) If a bank is an S corporation or a QSub, all of the special bank rules (other than § 585) continue to apply to the bank.

(2) Section 291(a)(3) and (e)(1)(B) applies to the bank regardless of whether it (or any predecessor) was a C corporation for any of the three immediately preceding taxable years.

LAW AND ANALYSIS

Section 1361(a)(1) defines an S corporation, and § 1361(b)(2) describes corporations that are ineligible to be S corporations (ineligible corporations). Until 1996, § 1361(b)(2)(A) treated as ineligible corporations all banks as defined in § 581 (§ 581 banks). In that year, Congress amended § 1361(b)(2)(A) to treat a bank as an ineligible corporation only if it “uses the reserve method of accounting for bad debts described in section 585.” Section 585 provides a reserve method of accounting available only to banks, and a § 581 bank is eligible to be an S corporation only if it does not use that method of accounting. Thus, § 1361(b)(2)(A) has the effect of making § 585 inapplicable to any bank that is an S corporation (an S corporation bank).

Section 585 is one of many special bank rules. Examples of other special bank rules include §§ 582(c), 265(b), and 291(a)(3) and (e)(1)(B). In 1996, Congress made banks eligible to be S corporations by amending § 1361(b)(2)(A) to treat them as ineligible only if they use the special bank rule of § 585. In amending § 1361(b)(2)(A), Congress could have treated banks as ineligible if they used additional special bank rules, but Congress did not do so. Thus, § 1361(b)(2)(A) indicates that Congress expected and intended the special bank rules other than § 585 to apply to S corporation banks.

If the special bank rules did not apply to S corporation banks, Congress could have made banks eligible to be S corporations simply by deleting § 1361(b)(2)(A). Because § 585 is a special bank rule, it would have been unnecessary to make § 585 inapplicable to S corporation banks if the special bank rules did not apply to them. In other words, if the special bank rules did not apply to S corporation banks, § 1361(b)(2)(A) would be superfluous.

Notice 97-5 and Rev. Proc. 97-18

Section 1361(b)(3), enacted in 1996, allows an S corporation to elect to treat a domestic corporation as a QSub if that corporation is not an ineligible corporation and all of its stock is held by the S corporation. Because a QSub may not be an ineligible corporation, a QSub is subject to § 1361(b)(2)(A) and therefore may not use the reserve method of § 585. In general, a QSub is not treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a QSub are treated as those of the S corporation. Section 1.1361-4(a)(2) of the Income Tax Regulations provides that if an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. (S corporations and QSubs that are banks, are referred to herein, collectively, as subchapter S banks.)

In late 1996, shortly after Congress revised § 1361(b)(2)(A) to make banks eligible to be S corporations and added § 1361(b)(3) to allow S corporations to treat subsidiaries as QSubs, the Department of the Treasury and the Internal Revenue

Service responded to these legislative changes by issuing Notice 97-5, 1997-1 C.B. 352. Notice 97-5 addressed the treatment of subchapter S banks that are affiliated with nonbanks, as most banks are. Although § 1361(b)(2)(A) indicated that Congress intended the special bank rules other than § 585 to apply to subchapter S banks, § 1361(b)(3) provided that a QSub was not treated as a separate corporation, which raised concerns about the entity to which the special bank rules would apply.

Notice 97-5 expressed these concerns as follows:

The Department of the Treasury and the Internal Revenue Service are concerned that the interaction of [revised § 1361(b)(2)(A) and new § 1361(b)(3)] creates unintended and inappropriate results for banks that are affiliated with nonbank entities. Treasury and the IRS believe that the special provisions of the Code that apply to banks should apply only to the specific state-law entity that qualifies as a bank under § 581 of the Code; such special bank treatment should not apply to nonbanks, even if the nonbank is affiliated with a bank and the parent elects to treat the subsidiary as a [QSub]. Treasury intends to work with Congress on appropriate technical corrections to the [legislation] to clarify the tax treatment of banks affiliated with nonbanks. It is anticipated that any technical corrections will be effective as of the effective date of [revised § 1361(b)(2)(A) and new § 1361(b)(3)]. ...

1997-1 C.B. 352. In Notice 97-5, Treasury and the Service announced their belief that the special bank rules should apply only to the specific state-law entity that qualifies as a § 581 bank and should not apply to nonbanks. In Notice 97-5, Treasury also announced its intent to seek a retroactive technical correction to clarify the treatment of subchapter S banks affiliated with nonbanks – in other words, to clarify that the special bank rules apply only to state-law entities that are § 581 banks. In making these announcements, Treasury and the Service made clear their understanding that the special bank rules apply to subchapter S banks.

In early 1997, the Service issued Rev. Proc. 97-18, 1997-1 C.B. 642, which provided an automatic procedure for banks to use in changing off the reserve method of § 585 to qualify for subchapter S. Section 5 of Rev. Proc. 97-18 discussed the § 481 adjustment required for such a change and, in doing so, called attention to the special bank rules. Rev. Proc. 97-18 warned that “banks should be aware of the effects of the interaction between provisions specially applicable to banks and provisions of subchapter S, for example, (i) §§ 593(e) and 1368 with respect to earnings and profits, and (ii) §§ 593(e) and (g)(3) and 1374.” 1997-1 C.B. 643. This statement reaffirmed that the special bank rules apply to subchapter S banks.

Technical correction

Later in 1997, Congress enacted the retroactive technical correction Treasury had sought. In response to the concerns expressed in Notice 97-5, Congress amended § 1361(b)(3) to allow the Secretary to prescribe regulations treating a QSub as a separate corporation. Congress provided this regulatory authority, in part, to allow Treasury regulations to apply the special bank rules only to the specific state-law entity that qualifies as a § 581 bank. H.R. Rep. No. 148, 105th Cong., 1st Sess. 644 (1997), 1997-4 (Vol. 1) C.B. 966; S. Rep. No. 33, 105th Cong., 1st Sess. 319-320 (1997), 1997-4 (Vol. 2) C.B. 1399-1400. Thus, the technical correction confirmed the implication of § 1361(b)(2)(A) and the understanding Treasury and the Service had made clear in Notice 97-5 and Rev. Proc. 97-18, that the special bank rules apply to subchapter S banks.

Section 1.1361-4(a)(3)

Accordingly, Treasury and the Service implemented §§ 1361(b)(2)(A) and 1361(b)(3) by issuing § 1.1361-4(a)(3), which provides the following guidance on applying the special bank rules to subchapter S banks:

(3) *Treatment of banks—(i) In general.* 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 [§ 1.1361-4(a)(2)] 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 [§ 1.1361-4(a)(2)]). For any QSub that is a bank, however, all assets, liabilities, and items of income, deduction, and credit of the QSub, as determined in accordance with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. For purposes of this paragraph (a)(3)(i), the term bank has the same meaning as in section 581.

Like §§ 1361(b)(2)(A) and 1361(b)(3), § 1.1361-4(a)(3) is effective for taxable years beginning after December 31, 1996.

Pursuant to § 1.1361-4(a)(3)(i), the special bank rules continue to apply separately to each subchapter S bank. As an exception to this general rule of § 1.1361-4(a)(3)(i), the parenthetical phrase in that section allows other published guidance to apply the special bank rules of § 265(b) and § 291(a)(3) and (e)(1)(B) in a manner other than separately to each bank. The preamble to the regulation refers to Rev. Rul. 90-44, 1990-1 C.B. 54 (at page 57), as an example of such other published guidance. 65 Fed. Reg. 3848. Thus, the parenthetical phrase in § 1.1361-4(a)(3)(i) specifically identifies § 265(b) and § 291(a)(3) and (e)(1)(B) as special bank rules that continue to apply to subchapter S banks.

The following example in § 1.1361-4(a)(3)(ii) illustrates these provisions of the regulation:

Example 1. X, an S corporation, is a bank as defined in section 581. X owns 100 percent of Y and Z, corporations for which valid QSub elections are in effect. Y is a bank as defined in section 581, and Z is not a financial institution. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to X and Y and do not apply to Z. Thus, for example, section 265(b), which provides special rules for interest expense deductions of banks, applies separately to X and Y. That is, X and Y each must make a separate determination under section 265(b) of interest expense allocable to tax-exempt interest, and no deduction is allowed for that interest expense. Section 265(b) does not apply to Z except as published guidance may provide otherwise.

This example concludes generally that the special bank rules continue to apply separately to each of the two subchapter S banks (X and Y) and do not apply to the nonbank (Z). In illustrating the application of § 265(b), the example also acknowledges the parenthetical exception in § 1.1361-4(a)(3)(i) by noting that § 265(b) does not apply to Z except as published guidance may provide otherwise.

General rule of § 1363(b)

In 1982, more than a decade before banks became eligible for subchapter S, § 1363(b) became part of the Code. Subject to certain exceptions, the general rule of § 1363(b) provides that the “taxable income of an S corporation shall be computed in the same manner as in the case of an individual.” This rule relates to the computation of taxable income and does not affect an entity’s status as a bank within the meaning of § 581. The special bank rules apply only to corporations, however, because § 581 banks must be corporations for federal tax purposes. As a result, questions have arisen as to whether the general rule of § 1363(b) may prevent all of the special bank rules, including § 291(a)(3) and (e)(1)(B), from applying to subchapter S banks.

When Congress enacted § 1363(b) in 1982, banks were not eligible for subchapter S. Thus, at that time Congress had no reason to consider whether the special bank rules should apply to subchapter S banks. More recently, when Congress made banks eligible for subchapter S, it expressed its expectation and intent that those rules apply.

As explained above, § 1361(b)(2)(A) indicates that Congress intended the special bank rules other than § 585 to apply to subchapter S banks. In 1996, Congress amended § 1361(b)(2)(A) to make banks eligible for subchapter S by treating them as ineligible only if they use the § 585 reserve method, which is a special bank rule. If the

special bank rules did not apply to subchapter S banks, Congress could have made banks eligible for subchapter S simply by deleting § 1361(b)(2)(A). Because § 585 is a special bank rule, it would have been unnecessary to make § 585 inapplicable to subchapter S banks if the special bank rules did not apply to them. In other words, if the special bank rules did not apply to subchapter S banks, § 1361(b)(2)(A) would be superfluous. Thus, in amending § 1361(b)(2)(A), Congress did not expect or intend the pre-existing general rule of § 1363(b) to prevent the special bank rules from applying to subchapter S banks. Congress did not expect or intend to deny subchapter S banks the benefits, or shield them from the burdens, ordinarily applicable to banks.

As also explained above, the 1997 retroactive technical correction to § 1361(b)(3) confirms that Congress did not expect or intend the pre-existing general rule of § 1363(b) to prevent the special bank rules from applying to subchapter S banks. In response to the concerns Treasury and the Service expressed in Notice 97-5, Congress amended § 1361(b)(3) in 1997 to allow the Secretary to prescribe regulations treating a QSub as a separate corporation. Congress provided this regulatory authority, in part, to allow Treasury regulations to apply the special bank rules only to the specific state-law entity that qualifies as a § 581 bank. Thus, the 1997 technical correction confirmed that Congress intended the special bank rules to apply to subchapter S banks.

As also detailed above, Treasury and the Service have consistently carried out this congressional intent by publishing guidance making it clear that the special bank rules apply to subchapter S banks – in Notice 97-5, Rev. Proc. 97-18, and final regulation § 1.1361-4(a)(3). Moreover, § 1.1361-4(a)(3)(i) specifically identifies § 291(a)(3) and (e)(1)(B) as a special bank rule that continues to apply.

For these reasons, the general rule of § 1363(b) does not prevent any of the special bank rules, including § 291(a)(3) and (e)(1)(B), from applying to subchapter S banks.

Section 1363(b)(4)

Questions also have arisen as to the impact of § 1363(b)(4). Like the general rule of § 1363(b), § 1363(b)(4) pre-dates the 1996 legislation making banks eligible for subchapter S. Section 1363(b)(4) provides that § 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, enacted in 1982, provides special rules for various corporate preference items. Most of the rules in § 291 apply to corporations generally, but one of those rules – § 291(a)(3) and (e)(1)(B) – applies only to banks. Section 291(a)(3) and (e)(1)(B) 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 § 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.

When Congress enacted § 1363(b)(4) in 1984, banks were not yet eligible for subchapter S, and thus § 1363(b)(4) had no applicability to § 291(a)(3) and (e)(1)(B), which applies only to banks. At that time, § 1363(b)(4) affected only the rules in § 291 that apply to corporations generally. Section 1363(b)(4) historically subjected certain nonbank S corporations to § 291 if the S corporation or any predecessor was a C corporation for any of the 3 immediately preceding taxable years, even if § 291 would not otherwise apply.

By its terms, § 1363(b)(4) simply provides that § 291 "shall apply" to an S corporation in a specified circumstance (*i.e.*, if the S corporation or any predecessor was a C corporation for any of the 3 immediately preceding taxable years). Section 1363(b)(4) does not provide that § 291 shall not apply to an S corporation in any other circumstance. Section 1363(b)(4) causes § 291 to apply to an S corporation in the specified circumstance, but § 1363(b)(4) does not prevent § 291 from applying to an S corporation to which § 291 otherwise applies.

As explained above, the general rule of § 1363(b) does not prevent any of the special bank rules, including § 291(a)(3) and (e)(1)(B), from applying to subchapter S banks. As also explained above, § 1363(b)(4) does not prevent § 291 from applying to a subchapter S bank to which § 291 otherwise applies. Thus, if § 291(a)(3) and (e)(1)(B) applies to a subchapter S bank in the absence of § 1363(b)(4), § 1363(b)(4) does not affect the continuing application of § 291(a)(3) and (e)(1)(B) to that bank.

Conclusions

Section 1361(b)(2)(A) makes banks ineligible for subchapter S if they use the special bank rule of § 585. Neither the general rule of § 1363(b), nor § 1363(b)(4), prevents any of the special bank rules – including § 291(a)(3) and (e)(1)(B) – from applying to subchapter S banks. All of the special bank rules other than § 585 continue to apply to subchapter S banks, in accordance with § 1.1361-4(a)(3). Thus, § 291(a)(3) and (e)(1)(B) applies to a subchapter S bank regardless of whether it (or any predecessor) was a C corporation for any of the three immediately preceding taxable years.

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