DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

IRB No. 2010-52
December 27, 2010

ACTION ON DECISION

Subject: Jerome R. Vainisi and Deloris L. Vainisi v. Commissioner

Vainisi v. Commissioner, 599 F.3d 567 (7th Cir. 2010), rev'g 132 T.C. No. 1 (2009), Docket Nos. 23699-06, 23701-06.

Issue:

Whether in 2003 and 2004, I.R.C. § 291 applies to a bank that converted in 1997 from a C corporation to a qualified subchapter S subsidiary as defined in § 1361(b)(3)(B).

Discussion:

Jerome Vainisi and Doris Vainisi (Taxpayers) owned First Forest Park Corp. (First Forest), a C corporation holding company, which wholly owned Forest Park National Bank and Trust Co. (the Bank), a bank under § 581. Effective January 1, 1997, First Forest elected to be treated as an S corporation pursuant to § 1361(a)(1) and (b)(1) and for the Bank to be treated as a qualified subchapter S subsidiary (QSub) pursuant to § 1361(b)(3)(B).

In 2003 and 2004, the Bank held debt obligations that, pursuant to § 265(b)(3)(B), were qualified tax-exempt obligations (QTEOs) subject to a 20-percent interest expense disallowance rule under § 291(a)(3) and (e)(1)(B). In 2003 and 2004, the Bank received interest income attributable to QTEOs. For each of the taxable years at issue, First Forest filed its consolidated Federal income tax return that included the Bank. First Forest did not apply the 20-percent disallowance rule that § 291(a)(3) and (e)(1)(B) imposes upon interest expenses relating to QTEOs; rather, First Forest claimed a deduction for the entire amount of the Bank's interest expenses relating to the QTEOs.

Although banks that hold QTEOs are typically subject to the 20-percent disallowance rule, § 1363(b), which sets forth the computation of an S corporation's taxable income, provides in subsection 1363(b)(4) that § 291 shall apply if the S corporation was a C

corporation for any of the 3 immediately preceding taxable years. Taxpayers' primary position was the that the QSub Bank's interest expense deductions were not subject to § 291(a)(3) because in the years at issue, First Forest, the S corporation holding company, had been an S corporation for more than 3 years. The Service's position was that § 291(a)(3) applied to the QSub Bank, regardless of § 1363(b)(4), because Treas. Reg. § 1.1361-4(a)(3) provides that special bank rules continue to apply separately to each QSub that is a bank. Thus, the Service argued that QSub banks must determine income and deductions by employing special bank rules such as § 291(a)(3) before the QSub bank's income and deductions can be treated as income and deductions of the S corporation parent.

The United States Court of Appeals for the Seventh Circuit, reversing the Tax Court, agreed with the Taxpayers that § 1363(b)(4) precluded application of § 291 to First Forest because it had not been a C corporation for any of the 3 preceding years.

In light of the circuit court's findings, the Service will not apply § 291(a)(3) and (e)(1)(b) to a QSub bank or an S corporation bank unless the bank (or any predecessor) was a C corporation for any of the three immediately preceding taxable years.

Recommendation: Acquiescence in result only.

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Reviewers:

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