

## **The Tax Court Holds For the IRS in Sub S Bank Interest Disallowance Case**

In a decision rendered by Judge Maurice B. Foley this week, the Tax Court held that, based on Treasury regulations, special financial institution rules apply separately to a qualified subchapter S subsidiary (QSub) bank that is owned by an S corporation, and therefore, the section 291 interest disallowance rule applies to a QSub bank's qualified tax-exempt obligations (QTEOs).

In the Tax Court case, *Vainisi v. Commissioner of Internal Revenue Service*, a sub S corporation (First Forest Park Corp.) owns 100 percent a sub S bank that was treated as a QSub. The QSub bank held QTEOs. As the sole shareholder of the QSub bank, all income, expenses and deductions of the QSub flow through to First Forest. Thus, First Forest deducted the entire interest expenses relating to the QTEOs held by the QSub. The IRS challenged the interest deduction and asserted that the 20 percent interest deduction disallowance rule relating to QTEOs applicable to banks under section 291 of the code also applies to a bank that is an S corporation. Thus, the shareholder's deduction was reduced under the rules of section 291.

According to the Court, Treasury had the authority to "provide, by regulations, instances where the separate corporate existence of a qualified subchapter S subsidiary may be taken into account for purposes of the Code. Thus, if an S corporation owns 100 percent of the stock of a bank (as defined in sec. 581) and elects to treat the bank as a qualified subchapter S subsidiary, it is expected that Treasury regulations would treat the bank as a separate legal entity for purposes of those Code provisions that apply specifically to banks (e.g., sec. 582)." The Court further noted that the Treasury issued such regulations, which state that special rules that apply to banks continue to apply separately to banks that are QSubs. Therefore, under section 291(a)(3), which provides special rules for the tax treatment of financial institution preference items, a financial institution, whether or not it is an S corporation, must reduce its interest expense deduction relating to QTEOs by 20 percent. In effect, each QSub bank must determine its income and deductions (i.e., by applying special bank rules like section 291) before the QSub bank's income and deductions can be treated as income and deductions of the S corporation parent.

The Court rejected Vainisi's argument that the Treasury's regulations exceed Treasury's authority and clearly override the plain language of the statute. While the Court agreed with Petitioner that "section 1363(b)(4), which sets forth the computation of an S corporation's taxable income, provides that section 291 applies if the S corporation was a C corporation for any of the 3 immediately preceding taxable years," the Court held that section 1363(b)(4) is not applicable to the QSub bank.

The Court's logic in the opinion warrants careful study. The Court attempts to bifurcate the QSub from the parent corporation in its literal reading of the Subchapter S provisions of the Code and regulations. This long-awaited ruling came as a big disappointment for the ABA and S banks. The issue involved is one that we had hoped that the Tax court would decide based on the clear language of the statute, and the Treasury's lack of authority to override that statute by regulations or rulings. The ABA had sent a letter to the IRS requesting that it withdraw proposed regulations issued in August 2006 stating that the interest disallowance rules of section 291 continue to apply to an S corporation bank after three years of being an S corporation. Based on the Court's ruling, it is very likely that the IRS would move to make the regulations final. Click [here](#) to read the Tax Court decision.