



DEDUCTION LIMITATION NOT APPLICABLE TO BANK TAXED AS S CORPORATION

The United States Court of Appeals for the Seventh Circuit recently issued an opinion that benefits banks that are taxed as S corporations or disregarded wholly owned subsidiaries of S corporations. In *Vainisi v. Commissioner*, No. 09-3314 (7th Cir., 2010), the Court held that a deduction limitation applicable to banks holding tax-exempt bonds did not apply to a bank that is taxed as an S corporation or a qualified subchapter S subsidiary (“QSUB”).

Mr. Vainisi and his wife owned all of the stock of First Forest Park Corp. (“Parent”). Parent owned all the stock of Forest Park National Bank and Trust Co. (“Bank”), an entity meeting the definition of a bank under section 581 of the Internal Revenue Code (the “Code”). Parent was taxed as a C corporation until January 1, 1997, at which time the Vainisis elected to have Parent taxed as an S corporation and the Bank taxed as a QSUB. These elections consolidated the income of the Parent and the Bank, and allowed the combined income to pass through to the Vainisis without being subject to the corporate income tax. For the periods at issue in the case, 2003 and 2004, the Bank owned qualified tax-exempt obligations (“QTEOs”) as defined in Code section 265(b). On their tax return, the Vainisis took a deduction for 100 percent of the interest expense of the Parent and Bank that was allocated to the QTEOs. The IRS audited the return and took the position that Code section 291 disallowed 20 percent of the interest expense deduction.

In order to fully understand the Court’s decision, some background is required. The Code contains special rules that apply to a financial institution that owns tax-exempt state or local governmental bonds (“Tax-Exempt Bonds”). Generally, such financial institutions are not allowed a deduction for interest expense that is allocable to such Tax-Exempt Bonds. IRC § 265(a). This disallowance prevents a financial institution from deducting interest on debt that is incurred to carry an asset that generates tax-exempt interest income. An exception to this general rule allows a deduction for interest expense that is allocable to QTEOs. IRC § 265(b)(3). A QTEO generally is a Tax-Exempt Bond that is issued by State and local governments that issue less than \$10 million of Tax-Exempt Bonds for the year (\$30 million in 2009 and 2010). This exception is intended to broaden the market for QTEOs. Notwithstanding this exception, IRC § 291(a)(3) disallows 20 percent of the interest deduction allowed for interest allocated to QTEOs. Code section 291(a)(3) applies only to corporations. To summarize:

- § 265 General Rule: No deduction allowed for interest allocable to Tax-Exempt Bonds held by a financial institution.
- § 265 QTEO Exception: Allows deduction for interest allocable to QTEOs held by a financial institution.
- § 291 Haircut: Disallows 20% of the interest deduction allowed under the QTEO exception.

In *Vainisi*, the Court faced the issue of whether Code section 291 applied to a financial institution that was a QSUB. Prior to 1996, a bank could not elect to be taxed as an S corporation. In that year, Congress amended Code section 1361 to remove the restriction preventing banks from electing to be taxed as an S corporation. Since that date, any bank that does



not use the reserve method of accounting and otherwise meets the S corporation eligibility requirements may elect to be taxed as an S corporation. S corporations can elect to treat wholly-owned subsidiaries as disregarded entities, referred to as qualified subchapter S subsidiaries (“QSUBs”).

The Court of Appeals, reversing the decision of the Tax Court, held that Code section 291 did not apply to the Bank because the Bank was a QSUB. Accordingly, the Court allowed the Vainis to take a deduction for 100 percent of the interest expense allocated to the QTEOs.

The Court began its analysis by stating that the operations of an S corporation and a QSUB are not taxed at the corporate level, but flow through to shareholders and are taxed at the shareholder level. The Court then noted that Code section 291, which contains rules applicable to corporate preference items, does not generally apply to S corporation. However, Code section 1363(b)(4) provides that Code section 291 does apply to an S corporations, but only if the S corporation or any predecessor corporation was a C corporation for any of the three immediately preceding taxable years. Because the Parent had not been a C corporation for any of the three years prior to the years at issue in the case, the Court held that Code section 291 did not apply.

The Court noted that the Code does provide an advantage to banks that are taxed as S corporations when compared to banks that are C corporations or are recent converts to S corporations. Nevertheless, the Court based its decision on the express language of the Code.

Banks that hold QTEOs and that are taxed as S corporations should be aware of this decision for future tax years. In addition, such banks should review their tax returns for any open tax years to determine whether they have improperly applied Code section 291 to limit interest expense deductions. If they have, such banks should consider filing amended returns and sending amended K-1s to their shareholders.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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