

PUBLICATION

S Corporation Banks: IRS Withdraws Controversial Proposed Regulations

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On October 25, 2011, five years after their proposal, the IRS has withdrawn controversial proposed regulations that would have disallowed a portion of the deduction for interest expense for banks organized as Subchapter S corporations. Specifically, the proposed regulations would have disallowed S corporation banks holding qualified tax-exempt bonds from deducting 20% of the interest expense incurred to acquire those bonds.

Generally, the deduction for interest paid by a financial institution to carry qualified tax-exempt debt, as defined by Internal Revenue Code Section 265(b), is reduced by 20% under Code Sections 291(a)(3) and 291(e)(1). However, beginning in 1996, Congress permitted banks to organize under Subchapter S of the Code. Subchapter S contains a provision, found at Section 1363(b)(4), which provides that Section 291 applies "if the S corporation ... was a C Corporation for any of the 3 immediately preceding taxable years." Relying on Section 1363(b)(4), many S corporation banks purchased qualified tax exempt bonds and priced into the purchase the impact of the 20% interest expense disallowance for that three year period, if applicable, but expected a full deduction for future years.

The Service's position in proposing the regulations had been that Congress did not intend to exclude S corporation banks from special rules applicable to all banks – including application of the 20% reduction in the interest deduction consistent with Sections 265(b) and 291. After the proposed regulations were introduced, the IRS began specifically targeting the 20% disallowance during audits. Controversy arose over the manner in which the IRS had apparently issued proposed regulations to support its audit and litigation positions.

The IRS has now withdrawn the proposed regulations, thus arguably signaling that S corporation banks will be able to fully deduct the interest expense carried on tax exempt bonds after any applicable three year waiting period. The IRS also may have indirectly assisted issuers of qualified tax-exempt bonds by making those bonds more attractive to S corporation banks.

If you have questions or otherwise wish to discuss this withdrawal by the Service, please contact any one of the attorneys associated with the Firm's Tax Department.