Subchapter S Banks — Sections 1362 and 265

Notice 97–5

BACKGROUND

Section 1315 of the Small Business Job Protection Act of 1996 (the Act), P.L. 104–188, amended § 1361(b)(2) of the Internal Revenue Code to allow banks (as defined in § 581) that do not use the reserve method of accounting for bad debts to qualify as small business corporations (and therefore qualify to elect S corporation status), effective for tax years beginning after December 31, 1996.

Section 1308(b) of the Act added new § 1361(b)(3) to allow an S corporation to own a qualified subchapter S subsidiary (QSSS). A subsidiary qualifies as a QSSS if (1) the subsidiary would be eligible to elect subchapter S status if its stock were owned directly by the shareholders of its S corporation parent; (2) the S corporation parent owns 100 percent of the subsidiary's stock; and (3) the parent elects to treat the subsidiary as a QSSS. If the QSSS election is made, the subsidiary is not treated as a separate corporation, and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

This notice provides guidance on the effect of the QSSS election under § 1361(b)(3) on banks affiliated with nonbanks; the application of the S corporation passive investment income rules of § 1362(d)(3); the application of the interest expense disallowance rules of § 265; and an automatic change in method of accounting for bad debts.

BANKS AFFILIATED WITH NONBANKS

The Department of the Treasury and the Internal Revenue Service are concerned that the interaction of § 1315 and § 1308(b) of the Act 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 QSSS.

Treasury intends to work with Congress on appropriate technical corrections to the Act 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 the Act. In the interim, banks (including banks for which QSSS elections are made) should continue to comply with applicable information reporting and filing requirements of the Code (e.g., § 6049 (Returns Regarding Payments of Interest)).

PASSIVE INVESTMENT INCOME

Under § 1362(d)(3)(A), the S election of a corporation with accumulated earnings and profits terminates if the passive investment income of the corporation constitutes more than 25 percent of its gross receipts for each of three consecutive tax years. In general, § 1362(d)(3) defines ‘‘passive investment income’’ as gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. Passive investment income does not include gross receipts directly derived from the active and regular conduct of a lending or finance business, provided the corporation meets the requirements of § 542(c)(6) (lending or finance company excluded from the definition of personal holding company).

Similarly, § 1.1362–2(c)(5)(iii)(B)(*1*)-(*i*) provides that passive investment income does not include gross receipts directly derived in the ordinary course of a trade or business of lending or financing. Under § 1.1362–2(c)(5)(iii)-(B)(*2*), gross receipts directly derived in the ordinary course of a trade or business of lending or financing include gain (as well as interest income) from loans originated in a lending business; however, interest earned from the investment of idle funds in short-term securities does not constitute gross receipts directly derived in the ordinary course of business.

The Service will treat income earned by an S corporation on the following banking assets as gross receipts directly derived from the active and regular conduct of a banking business—

* All loans and REMIC regular interests owned, or considered to be owned, by the bank regardless of whether the loan originated in the bank's business. For these purposes,¬ securities¬ described¬ in § 165(g)(2)(C) are not considered loans.
* Assets required to be held to conduct a banking business (such as Federal Reserve Bank, Federal Home Loan Bank, or Federal Agricultural Mortgage Bank stock or participation certificates issued by a Federal Intermediate Credit Bank which represent nonvoting stock in the bank).
* Assets pledged to a third party to secure deposits or business for the bank (such as assets pledged to qualify as a depository for federal taxes or state funds).
* Investment assets (other than assets specified in the preceding paragraphs) that are held by the bank to satisfy reasonable liquidity needs (including funds needed to meet anticipated loan demands).

As a result, income and gain from these assets will not be considered subject to the passive investment income limitation applicable to S corporations.

INTEREST EXPENSE DISALLOWANCE

Section 265(a)(2) denies taxpayers (including banks) a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income taxes.

Section 265(b) denies banks and other financial institutions a deduction for the portion of a bank's interest expense that is allocable to tax-exempt interest and not otherwise disallowed by § 265(a). The portion of a bank's interest expense that is allocable to tax-exempt interest is an amount that bears the same ratio to the interest expense as (1) the bank's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to (2) the average adjusted bases for all assets of the bank.

Section 1366(a)(1) requires S corporation shareholders to determine their tax liability by taking into account their pro rata¬ share¬ of¬ the¬ corporation's nonseparately computed income or loss and their share of the items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder.

Because § 265(b) provides a special disallowance rule for banks, the Service will apply § 265(b) only at the bank level in determining the amount, if any, of the bank's interest expense that is disallowed. To the extent indebtedness and tax-exempt obligations are taken into account in applying § 265(b) at the bank level, they are not taken into account again in applying § 265(a) at the shareholder level.

AUTOMATIC CHANGE IN METHOD OF ACCOUNTING

The Service will issue further guidance granting permission for an automatic change in method of accounting for banks that change from the reserve method of accounting for bad debts. This guidance will permit changes to be effective as of the bank's first taxable year beginning after December 31, 1996. A bank that wishes to be an S corporation effective January 1, 1997, must file the change in method of accounting and the S election by March 15, 1997.

The principal authors of this notice are Martin Schäffer and Deane Burke of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Martin Schäffer or Deane Burke at (202) 622–3080 (not a toll-free call).