INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director of Field Operations, Manhattan

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year Involved:
Date of Conference:

LEGEND:

Taxpayer =

Bank =

Subsidiary =

State A =

State B =

Year 1 =

Year 2 =

Year 3 =

ISSUE

If a bank creates a wholly-owned subsidiary to manage, invest, and reinvest the bank's investment assets, should the assets (including tax-exempt obligations) and interest expense of the subsidiary be treated as those of the bank for purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B) of the Internal Revenue Code?

CONCLUSION

A bank that creates a wholly-owned subsidiary to manage, invest, and reinvest the bank's investment assets must treat the subsidiary's assets (including tax-exempt obligations) and interest expense as those of the bank for purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B).

FACTS

Taxpayer is a one-bank holding company incorporated in State A that files a consolidated federal income tax return. Taxpayer owns all of the common stock of Bank, a commercial bank formed in Year 1 and located in State A. Bank owns all of the stock of Subsidiary, which is incorporated in State B. Subsidiary operates in State A and does not have offices or employees in State B.

In Year 2, when Bank formed Subsidiary, Bank obtained a private letter ruling from State A on the tax treatment of Subsidiary under the law of State A. That letter ruling provides, in effect, that (1) Subsidiary's income is not subject to the corporate income tax of State A, and (2) dividends received by Bank from Subsidiary are free of the State A corporate income tax . State B does not have a state corporate income tax. Thus, Subsidiary's income is not subject to any state income tax.

Subsidiary was formed in Year 2 with the exchange of securities owned by Bank for the stock of Subsidiary. Bank later transferred cash to Subsidiary as additional capital. Bank transferred no liabilities or debts to Subsidiary. All income received by Subsidiary is investment income on assets held by Subsidiary. Subsidiary's assets and liabilities are consolidated with those of Bank for financial accounting (book) purposes and also for bank regulatory purposes.

According to Taxpayer, Bank created Subsidiary to improve the efficiency of managing investment assets that Bank did not expect to need for its immediate, day-to-day operations. Bank's Year 2 letter to the Comptroller of the Currency notifying the Comptroller of Bank's intent to create Subsidiary (the Notice) states, "The establishment of the subsidiary is intended to improve the efficiency of the management, safekeeping and operations for the securities investment portfolio of the Bank." The Notice also states that Subsidiary "will manage, invest and reinvest the cash, U.S. government obligations and other investment securities contributed to it from time to time by its parent bank, within overall investment guidelines established by its parent." In addition, the Notice states, "All of the business of the subsidiary will be transacted solely for the ultimate benefit of the Bank, with investment returns provided to the Bank through periodic dividends from its subsidiary."

Subsidiary's board of directors has members. One member is Subsidiary's Chairman of the Board, Chief Executive Officer, and President (Individual A). Individual A also holds the same three positions for Taxpayer. In addition, Individual A is Chairman of the Board and Chief Executive Officer of Bank. During the taxable year involved in this technical advice memorandum (Year 3), Individual A received substantial total compensation from Taxpayer and Bank and nominal wages of about from Subsidiary. Individual A makes all of the investment decisions for both Bank and Subsidiary.

Another member of Subsidiary's board of directors is Subsidiary's Secretary/Treasurer (Individual B). Individual B also is a Senior Vice President and the Secretary of Taxpayer. In addition, Individual B is an Executive Vice President and the Secretary of Bank. During Year 3, Individual B received substantial total compensation from Taxpayer and Bank and nominal wages of about from Subsidiary. Individuals A and B, who reside and work in State A, are Subsidiary's employees.

The third member of Subsidiary's board of directors is Subsidiary's Vice President (Individual C). Individual C also is the Executive Vice President of Taxpayer and the President and Chief Operating Officer of Bank.

The investment policy established by Bank's board of directors applies to both Bank and Subsidiary. According to this written investment policy, all of Bank's and Subsidiary's securities transactions are subject to monthly review by Bank's board of directors and must be executed through securities dealers approved by the board. The investment policy designates Bank's Chief Executive Officer (Individual A) and Bank's President (Individual C) as responsible for the day-to-day formulation and implementation of investment strategies. The investment policy also designates Individuals A, B, and C (by name) as investment personnel responsible for implementing the investment policy and "authorized to act on behalf of the Bank" without trading limit. The investment policy generally does not distinguish between the investment portfolios of Bank and Subsidiary but, rather, treats them as a single portfolio. For example, the investment policy provides as follows:

> Total investment in *municipal issues* … will be limited to of the total portfolio …. The mix between *tax exempt and taxable investment securities* will be determined by the Chief Operating Officer in conjunction with recommendations from the bank's tax advisors. This will be done to minimize taxes and increase net income.

(Italics in original.)

In Year 3, Subsidiary paid substantial dividends to Bank. In Year 3, Subsidiary also borrowed funds from Bank (on which Subsidiary paid interest to Bank) and used the borrowed funds to acquire investment securities. Subsidiary leased office space in Bank's headquarters building in State A.

At the end of Year 3, Subsidiary's investment portfolio consisted of tax-exempt bonds ("qualified tax-exempt obligations" under § 265(b)(3) issued primarily by municipalities in State A) and U.S. Government obligations. (Virtually all of the tax-exempt bonds that Bank had transferred to Subsidiary in Year 2 matured before Year 3. Thus, the tax-exempt bonds held by Subsidiary at the end of Year 3 had been purchased either from cash that Subsidiary received from Bank or from earnings and proceeds of assets that Subsidiary received from Bank.) At the end of Year 3, Bank held U.S. Government obligations, mortgage and real estate loans, and no tax-exempt bonds. During Year 3, Bank incurred considerable interest expense, while Subsidiary incurred a negligible amount. For purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B) in Year 3, Bank did not take into account the tax-exempt bonds held by Subsidiary. Bank did take into account the value of its stock in Subsidiary, which was nearly equal to the average adjusted bases of all of Subsidiary's assets.

LAW AND ANALYSIS

Section 291(a)(3) reduces by 20 percent the amount allowable as a deduction with respect to any "financial institution preference item." Pursuant to § 291(e)(1)(B), a financial institution preference item is the portion of a financial institution's interest expense that is allocable to tax-exempt obligations acquired after December 31, 1982, and before August 8, 1986. This portion is the amount that bears the same ratio to the taxpayer's interest expense as the taxpayer's average adjusted bases of these tax-exempt obligations bears to the taxpayer's average adjusted bases of all its assets. Section 291(e)(1)(B) applies to any financial institution that is a bank as defined in § 585(a)(2).

Section 265(b)(1) disallows entirely the portion of a financial institution's interest expense that is allocable to tax-exempt interest. Pursuant to § 265(b)(2), this portion is the amount that bears the same ratio to the taxpayer's interest expense as the taxpayer's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to the taxpayer's average adjusted bases of all its assets. Section 265(b)(5) defines the term "financial institution" to mean any person that (a) accepts deposits from the public in the ordinary course of that person's trade or business and is subject to federal or state supervision as a financial institution, or (b) is a corporation described in § 585(a)(2).

Section 265(b)(3) provides a special rule for "qualified tax-exempt obligations," as defined in § 265(b)(3)(B). Any qualified tax-exempt obligation that is acquired after August 7, 1986, is treated for purposes of §§ 265(b)(2) and 291(e)(1)(B) as if it were acquired on August 7, 1986. Thus, qualified tax-exempt obligations result in the disallowance of interest expense deductions under § 291(a)(3) and (e)(1)(B), rather than § 265(b).

Legislative purpose of § 291(a)(3) and (e)(1)(B) and § 265(b)

Congress enacted § 291(a)(3) and (e)(1)(B) in 1982 and § 265(b) in 1986. Before the enactment of these sections, a financial institution's investment in tax-exempt obligations generally did not result in any disallowance of interest expense deductions. Although § 265(a)(2) (formerly § 265(2)) disallows deductions for interest on indebtedness incurred to purchase or carry tax-exempt obligations, this section requires evidence of a direct connection between the borrowing and the tax-exempt investment. In effect, this requirement virtually exempts financial institutions from disallowance of interest deductions under § 265(a)(2).

To correct this problem, Congress first enacted § 291(a)(3) and (e)(1)(B), which restricts the interest expense deductions of financial institutions without requiring evidence of connection between borrowing and tax-exempt investment. Unlike § 265(a)(2), § 291(a)(3) and (e)(1)(B) applies to all of a financial institution's otherwise deductible interest expense and provides for a pro rata disallowance of interest expense deductions on the basis of the institution's holdings in tax-exempt obligations. Section 265(b) strengthens the disallowance rule of § 291(a)(3) and (e)(1)(B) by increasing from 20 percent to 100 percent the disallowance of interest expense deductions allocable to tax-exempt obligations acquired after August 7, 1986. The purpose and structure of § 265(b) are essentially the same as those of § 291(a)(3) and (e)(1)(B), and § 265(b) applies to any financial institution to which § 291(a)(3) and (e)(1)(B) applies.

The basic policy underlying these provisions, as explained in the President's 1985 proposal to enact § 265(b), is as follows:

> Basic measurement of income principles require that income be matched with the costs of its production. In line with these principles, the costs of producing tax-exempt income, including interest expense incurred

> to carry tax-exempt bonds, are properly nondeductible. Since the income to which such costs are attributable is exempt from tax, disallowance of a deduction is necessary to prevent the taxpayer from offsetting other nonexempt income.
>
> The exception from the above principles for interest paid or incurred by commercial banks and thrifts has enabled these institutions to hold a substantial portion of their investment portfolios in tax-exempt obligations, substantially reducing their Federal tax liability. The full allowance of interest deductions to banks holding tax-exempt obligations contributes to the relatively low effective tax rates of banks. …
>
> In addition, the special [nondisallowance] rule for commercial banks and thrifts provides them with a competitive advantage over other financial institutions that are disallowed interest deductions for carrying tax-exempt obligations. …

<u>The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity</u> 243-244 (May 1985).

Like the Administration, Congress was concerned about the unfairness and the revenue effects of allowing financial institutions to deduct interest expense allocable to tax-exempt obligations. The Ways and Means Committee report accompanying the enactment of § 265(b) explains the change as follows:

> The committee believes that the present law treatment of financial institutions for purposes of the interest disallowance rule should be changed for two reasons. First, the present law rules, by allowing financial institutions to deduct interest payments regardless of tax-exempt holdings, discriminate in favor of financial institutions at the expense of other taxpayers. Second, the committee was concerned that financial institutions may drastically reduce their tax liability as a result of the present law rules. For example, under present conditions, a bank may totally eliminate its tax liabilities by investing one-third or less of its assets in tax-exempt obligations.
>
> To correct these problems, the committee bill denies financial institutions an interest deduction in direct proportion to their tax-exempt holdings. The committee believes that this proportional disallowance rule is appropriate because of the difficulty of tracing funds within a financial institution, and the near impossibility of assessing a financial institution's "purpose" in accepting particular deposits. The committee believes that the proportional disallowance rule will place financial institutions on approximately an equal footing with other taxpayers.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 588-589 (1985), 1986-3 (Vol. 2) C.B. 588-589. In 1982 the Finance Committee expressed similar reasons for approving § 291(a)(3) and (e)(1)(B). S. Rep. No. 494 (Vol. 1), 97th Cong., 2d Sess. 118-120 (1982).

In short, Congress enacted these provisions to prevent financial institutions from receiving deductions for interest expense attributable to tax-exempt investment. Because of "the difficulty of tracing funds within a financial institution, and the near impossibility of assessing a financial institution's 'purpose' in accepting particular deposits," Congress found these proportional disallowance rules necessary. Otherwise, deductions for interest expense attributable to tax-exempt investment would continue to shelter nonexempt income of financial institutions, allowing them to substantially reduce their federal income tax liability and giving them an unfair advantage over other taxpayers.

Treatment of related taxpayers

Rev. Rul. 90-44, 1990-1 C.B. 54, sets forth guidelines for applying the disallowance provisions. These guidelines include the following statement on the treatment of related taxpayers:

> If one or more financial institutions are members of an affiliated group of corporations (as defined in section 1504 of the Code), then, even if the group files a consolidated return, each such institution must make a separate determination of interest expense allocable to tax-exempt interest, rather than a combined determination with the other members of the group.
>
> However, in situations involving taxpayers which are under common control and one or more of which is a financial institution, in order to fulfill the congressional purpose underlying section 265(b) of the Code, the District Director may require another determination of interest expense allocable to tax-exempt interest to clearly reflect the income of the financial institution or to prevent the evasion or avoidance of taxes.

Thus, Rev. Rul. 90-44 provides a general approach to applying the disallowance provisions to related taxpayers, and it also provides an exception.

Under the general approach, the disallowance provisions apply separately to each financial institution, rather than on a combined basis to an affiliated group. That is, each financial institution "must make a separate determination of interest expense allocable to tax-exempt interest, rather than a combined determination with the other members of the group." This general approach reflects the references to "a financial institution" in §§ 265(b)(1) and 291(e)(1)(B). Similarly, under § 1.1502-11(a) of the consolidated return regulations, taxable income is first computed separately for each member of an affiliated group, before determining the group's consolidated taxable income.

Under Rev. Rul. 90-44, the exception to the general approach applies "in situations involving taxpayers which are under common control and one or more of which is a financial institution." In these situations, more flexibility is needed in order to fulfill the congressional purpose underlying the disallowance provisions. Therefore, the Service may require "another determination of interest expense allocable to tax-exempt interest to clearly reflect the income of the financial institution or to prevent the evasion or avoidance of taxes."

Rev. Rul. 90-44 provides its guidelines for purposes of § 265(b) and does not directly address their application for purposes of § 291(a)(3) and (e)(1)(B). As explained above, however, the history, purpose, structure, operation, and effects of § 291(a)(3) and (e)(1)(B) are inextricably intertwined with those of § 265(b). Moreover, the legislative history of § 265(b) states that the amount of interest expense allocable to tax-exempt obligations is to be determined in the same manner for purposes of § 265(b) as for purposes of § 291(a)(3) and (e)(1)(B). H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-332 to II-333 (1986), 1986-3 (Vol. 4) C.B. 332-333; and H.R. Rep. No. 426, 99th Cong., 1st Sess. 589 (1985), 1986-3 (Vol. 2) C.B. 589. For these reasons, the Service has consistently applied the guidelines set forth in Rev. Rul. 90-44 on the treatment of related taxpayers not only for purposes of § 265(b), but also for purposes § 291(a)(3) and (e)(1)(B).

LTR 9205013 (Oct. 31, 1991) involves a corporation that has numerous bank subsidiaries, each of which forms a wholly-owned investment subsidiary to manage and reinvest investment assets transferred to it by its respective bank. LTR 9205013 holds that the assets (including tax-exempt obligations) and interest expense of each investment subsidiary will be treated as those of its respective bank for purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B). LTR 9235049 (June 3, 1992) reaches the same conclusion for another affiliated group of banks with wholly-owned investment subsidiaries. Neither letter ruling provides that these sections apply differently to assets transferred by the bank than to assets purchased from earnings and proceeds of assets transferred by the bank.

The present case

In the present case, Bank owns all of the stock of Subsidiary, and Subsidiary manages, invests, and reinvests assets received from Bank. Since Subsidiary's income is not subject to any state income tax, Subsidiary's existence has the effect of reducing the overall state income tax liability of the affiliated group. According to Taxpayer, Bank created Subsidiary to improve the efficiency of managing investment assets that Bank did not expect to need for its immediate, day-to-day operations. Bank's notice of intent to create Subsidiary states that all of Subsidiary's business "will be transacted solely for the ultimate benefit of the Bank, with investment returns provided to the Bank through periodic dividends from its subsidiary." The investment policy established by Bank's board of directors applies to both Bank and Subsidiary, and Bank's board of directors oversees the implementation of that policy. Each member of Subsidiary's board of directors is also an officer of Subsidiary, an officer and/or director of Taxpayer, and an officer and/or director of Bank. Subsidiary's employees are members of Subsidiary's board of directors who receive substantial compensation from Taxpayer and Bank and nominal compensation from Subsidiary. One of those employees makes all of the investment decisions for both Bank and Subsidiary. of those employees are authorized to make investments on behalf of both Bank and Subsidiary. Subsidiary's assets and liabilities are consolidated with those of Bank for financial accounting purposes and also for bank regulatory purposes. In Year 3, Subsidiary paid substantial dividends to Bank, and Subsidiary used funds borrowed from Bank to acquire securities. In short, the assets of Subsidiary are controlled by Bank and held for the benefit of Bank.

As explained above, under both § 265(b) and § 291(a)(3) and (e)(1)(B) the portion of a financial institution's interest expense that is allocable to tax-exempt interest is determined by reference to the ratio that (1) the taxpayer's average adjusted bases of tax-exempt obligations, bears to (2) the taxpayer's average adjusted bases of all its assets. In determining the average adjusted bases of all its assets in Year 3, Bank properly took into account the value of its stock in Subsidiary, which was nearly equal to the average adjusted bases of all of Subsidiary's assets. In determining the average adjusted bases of its tax-exempt obligations, however, Bank did not take into account the tax-exempt obligations held by Subsidiary. Thus, Bank received the benefit of including virtually all of Subsidiary's assets in the denominator of the ratio, but not the detriment of including Subsidiary's tax-exempt obligations in the numerator. Approving this approach to applying § 265(b) and § 291(a)(3) and (e)(1)(B) would have the effect of nullifying those provisions for Bank.

Congress enacted § 265(b) and § 291(a)(3) and (e)(1)(B) to prevent financial institutions from receiving deductions for interest expense attributable to tax-exempt investment. Without these proportional disallowance rules, deductions for interest expense attributable to tax-exempt investment would shelter nonexempt income of financial institutions, allowing them to substantially reduce their federal income tax liability and giving them an unfair advantage over other taxpayers. Generally, § 265(b) and § 291(a)(3) and (e)(1)(B) apply separately to each financial institution, rather than on a combined basis to an affiliated group. That is, each financial institution must make a separate determination of interest expense allocable to tax-exempt interest, rather than a combined determination with the other members of the group. However, in situations involving taxpayers that are under common control and one or more of which is a financial institution, more flexibility is needed in order to fulfill the congressional purpose underlying the disallowance provisions. Therefore, the Service may require another determination of interest expense allocable to tax-exempt interest to clearly reflect the income of the financial institution or to prevent the evasion or avoidance of taxes.

Accordingly, we conclude that Bank must treat Subsidiary's assets (including tax-exempt obligations) and interest expense as those of Bank for purposes of applying § 265(b)and § 291(a)(3) and (e)(1)(B).