INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Bank =

Subsidiary =

Custodian =

Service Provider =

State A =

State B =

Year 1 =

Year 2 =

Year 3 =

ISSUE

If a bank creates a wholly-owned subsidiary to hold, service, invest, and reinvest the bank's investment assets, should all of 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 hold, service, invest, and reinvest the bank's investment assets must treat all of the subsidiary's assets (including all of the subsidiary's tax-exempt obligations) and all of the subsidiary's 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 State A bank formed in Year 1. Bank owns all of the stock of Subsidiary, which is incorporated and located in State B. Since State A does not recognize consolidated returns and State B does not have a state corporate income tax, Subsidiary's income is not subject to any state income tax.

Subsidiary was formed in Year 2 with the exchange of cash and securities of Bank for stock in Subsidiary. Bank later transferred more securities to Subsidiary as additional paid in 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. The stated purpose of Bank's corporate resolution authorizing the formation of Subsidiary is "to enable [Bank] to consolidate and improve the efficiency of the management, safekeeping and operations for the securities investment portfolio held by the Bank." That resolution also states the purpose of Subsidiary as "to hold, service, invest and reinvest that portion of the Bank's securities investment portfolio as may be transferred from time to time by the Bank to [Subsidiary]."

Subsidiary's board of directors establishes Subsidiary's investment policy. According to Subsidiary's written investment policy, all of Subsidiary's portfolio transactions are subject to the approval of Subsidiary's board of directors at their next regularly scheduled meeting and must be executed through a broker/dealer approved by the board. That policy also states that Subsidiary's "primary objectives are to meet the liquidity needs and help balance the asset/liability (interest rate risk) objectives of its Parent Bank." Four of the five members of Subsidiary's board of directors are the Chairman of Bank's board of directors, another director of Bank, the Treasurer of Taxpayer (who is also a Vice President of Bank), and the Vice President and Secretary of Taxpayer (who is also a Vice President of Bank). The fifth member of Subsidiary's board is an individual (Individual) who is also Subsidiary's only officer and employee. The two Bank Vice Presidents on Subsidiary's board of directors also are part of the Bank management team that manages investments held directly by Bank.

Subsidiary hired Individual as a part-time employee in Year 2 and has paid Individual the nominal annual salary of $ since then. Individual receives no commissions or brokerage fees on Subsidiary's portfolio transactions. According to Individual's written employment agreement with Subsidiary, Individual is responsible for Subsidiary's activities in State B, including executing Subsidiary's securities trades through approved broker/dealers, documenting Subsidiary's investment activity, and coordinating with the custodian of Subsidiary's investment securities (Custodian). Individual also works in a similar capacity for numerous (about 50) other investment subsidiaries (most of which are affiliated with State A banks), receiving a salary from each that varies with its portfolio size. In addition, Individual receives a salary and benefits from Service Provider, with which Subsidiary has a servicing agreement. As an employee of Service Provider, Individual provides bond accounting services and general ledger services for Subsidiary under the servicing agreement. An affiliated group of State A banks owns both Custodian and Service Provider, which are State B corporations.

Bank and Subsidiary also have a securities lending agreement that allows Bank to borrow securities from Subsidiary to pledge in securing Bank's repurchase agreement transactions and Bank's public deposit accounts. During the taxable year involved in this technical advice memorandum (Year 3), Bank borrowed securities from Subsidiary to pledge in securing a large deposit made by a member of Bank's board of directors. Although the securities lending agreement requires Bank to pay a fee to Subsidiary for borrowing its securities, no fee was paid for this borrowing until Bank discovered the failure during the Internal Revenue Service audit several years later. According to Taxpayer, this failure was an oversight resulting from the infrequency of Bank's borrowing from Subsidiary.

At the end of Year 3, Subsidiary's investment portfolio consisted of State A tax-exempt bonds ("qualified tax-exempt obligations" under § 265(b)(3)) and obligations other than tax-exempt bonds. At the same time, Bank held U.S. Government obligations and no tax-exempt bonds. During Year 3, Bank incurred considerable interest expense, while Subsidiary incurred none. For purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B) in Year 3, Bank took into account the tax-exempt bonds then held by Subsidiary that Bank had transferred to Subsidiary, but not those that Subsidiary had purchased by reinvesting earnings and proceeds of assets transferred by Bank. Bank also 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.

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).

<u>Legislative purpose of § 291(a)(3) and (e)(1)(B) and § 265(b)</u>

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.

<u>The present case</u>

In the present case, Bank owns all of the stock of Subsidiary, and Subsidiary holds, services, invests, and reinvests securities investment assets of 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. The primary objectives of Subsidiary’s investment policy are to meet the liquidity needs of Bank and help balance the interest rate risk objectives of Bank. Subsidiary’s board of directors establishes Subsidiary’s investment policy and oversees its investment activities, and four of the five members of Subsidiary’s board of directors are officers or directors of Bank. Subsidiary’s sole officer and employee receives a nominal annual salary from Subsidiary and performs similar investment activities for numerous other investment subsidiaries of banks. Subsidiary’s assets and liabilities are consolidated with those of Bank for financial accounting purposes and also for bank regulatory purposes. Bank may use Subsidiary’s assets by receiving dividends from Subsidiary and also by borrowing securities from Subsidiary under their securities lending agreement. In short, the assets of Subsidiary are controlled by Bank and held for the benefit of Bank. This is true for both assets that Subsidiary received from Bank and assets that Subsidiary purchased from earnings and proceeds of assets it received from 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, Bank took into account the tax-exempt obligations then held by Subsidiary that Bank had transferred to Subsidiary, but not those that Subsidiary had purchased by reinvesting earnings and proceeds of assets transferred by Bank. 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 all of Subsidiary's tax-exempt obligations in the numerator. Approving this approach to applying § 265(b) and § 291(a)(3) and (e)(1)(B) could eventually 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 all of Subsidiary's assets (including all of Subsidiary's tax-exempt obligations) and all of Subsidiary's interest expense as those of Bank for purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B).