INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Service Provider =

Custodian =

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 bank holding company incorporated in State A that files a consolidated federal income tax return. Taxpayer owns virtually all of the stock of numerous (about) commercial banks (the Banks), most of which are located in State A. Each Bank owns all of the stock of its own investment subsidiary (the Subsidiaries). The Subsidiaries are 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, the income of the Subsidiaries is not subject to any state income tax.

Each Subsidiary was formed with the exchange of cash and securities of its respective Bank for the stock of the Subsidiary. The Banks later transferred additional cash and securities to their respective Subsidiaries. The Banks transferred no liabilities or debts to the Subsidiaries. All income received by each Subsidiary is investment income on assets held by the Subsidiary. Each Subsidiary's assets and liabilities are consolidated with those of its respective Bank for financial accounting (book) purposes and also for bank regulatory purposes. When the Banks formed the Subsidiaries, Taxpayer received a private letter ruling requiring that the assets (including tax-exempt obligations) and interest expense of each Subsidiary be treated as those of its respective Bank for purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B).

According to Taxpayer, the Banks created the Subsidiaries to centralize and thereby improve the efficiency of holding, servicing, investing, and reinvesting long-term investment assets. All of the Subsidiaries have the same board of directors and the same investment policy, which is established by the Subsidiaries' board of directors. According to this written investment policy, all of the Subsidiaries' securities transactions are reviewed by their board of directors and must be executed through securities dealers approved by the board. The investment policy states the following as its purpose and objective: "In general, securities will be purchased to provide a source of liquidity for future growth needs, to provide profitable deployment of available capital resources, and to assist in the management of the asset/liability position of this [Subsidiary's] parent bank, all while maintaining prudent risk exposures."

Pursuant to the Subsidiaries' investment policy, Taxpayer's Asset/Liability Committee is responsible for reviewing and maintaining the investment policy and presenting it to Taxpayer's board of directors for annual or more frequent approval. The Subsidiaries' investment policy also states that Taxpayer's Investment Committee is responsible for "implementation and compliance monitoring" of the policy. In addition, the Subsidiaries' investment policy provides that the Subsidiaries' securities transactions must conform to strategic financial objectives defined by Taxpayer's Asset/Liability Committee and are subject to review by Taxpayer's Investment Committee "on no less than a monthly basis."

The Subsidiaries' board of directors has six members. Four of those members are officers of Taxpayer and/or one or more Banks. One member of the Subsidiaries' board of directors is Taxpayer's Executive Vice President, Chief Financial Officer, and Director, as well as Vice President of a large Bank. Another member of the Subsidiaries' board of directors is Taxpayer's Senior Vice President and Corporate Treasurer, as well as Vice President of a large Bank. The third member of the Subsidiaries' board of directors is a Vice President of Taxpayer and also Vice President—Investments for each of the Banks. The fourth member is Controller of a large Bank. The fifth member is the President, Secretary, and Treasurer of each Subsidiary (Individual A). The sixth member is outside counsel to each Subsidiary.

The Subsidiaries do not have any direct employees. Each Subsidiary receives services under an identical agreement with Service Provider (the Agreement). Service Provider is a wholly-owned subsidiary of Taxpayer and located in State B. The Agreement appoints Individual A to serve as the President, Secretary, and Treasurer of each Subsidiary. Under the Agreement, Individual A is responsible for the investment management of each Subsidiary's securities portfolio. Individual A also is responsible for providing or contracting to provide such services as the following: payment of custody and accounting service fees, maintenance of bond accounting and general ledger systems, preparation of financial statements and accounting reports, shared office space at Service Provider's place of business in State B, and legal counsel services. Each Subsidiary also has an Accounting Officer (Individual B). Service Provider's compensation under the Agreement is based on the size of each Subsidiary's securities portfolio. Individuals A and B receive compensation from Service Provider, reside and work in State B, and were longtime employees of Taxpayer before the Banks formed the Subsidiaries. Each Subsidiary also has an agreement with Custodian to provide custody of the Subsidiary's securities; Custodian, a State B corporation, is a wholly-owned subsidiary of a large Bank.

In Year 1, each Subsidiary made significant dividend distributions to its respective Bank. According to Taxpayer, the Subsidiaries only make distributions to the Banks when the Banks have a specific need for large amounts of cash that was unanticipated when the original contributions were made to the Subsidiaries. According to Taxpayer, the Subsidiaries' dividend distributions in Year 1 all went to the purchase of a specific long-term investment that was made by each Bank at Taxpayer's direction, as part of its strategic plan. According to Taxpayer, the Subsidiaries could make large dividend distributions to the Banks in connection with other unanticipated needs for cash, such as acquisitions of other companies or spikes in loan demand by the Banks' customers.

In Years 1, 2, and 3, each Subsidiary and each Bank held tax-exempt bonds. Many of these tax-exempt bonds were issued by municipalities in State A, and many were "qualified tax-exempt obligations" under § 265(b)(3). In Years 1, 2, and 3, each Bank incurred interest expense, while most of the Subsidiaries incurred none. Taxpayer's original federal income tax returns for those years treated all of each Subsidiary's tax-exempt bonds as those of its respective Bank for purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B). Each Bank also took into account the value of its stock in its Subsidiary, which was nearly equal to the average adjusted bases of all of the Subsidiary's assets. On amended federal income tax returns for those years, however, Taxpayer did not treat all of each Subsidiary's tax-exempt bonds as those of its respective Bank. Rather, each Bank took into account only the tax-exempt bonds then held by its Subsidiary that the Subsidiary had received from the Bank or purchased from cash received from the Bank, and did not take into account those that the Subsidiary had purchased by reinvesting earnings and proceeds of assets received from the Bank.

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. …

The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 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.

<u>Treatment of related taxpayers</u>

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, Taxpayer owns numerous Banks, each Bank owns all of the stock of its Subsidiary, and each Subsidiary holds, services, invests, and reinvests assets received from its respective Bank. Since the income of the Subsidiaries is not subject to any state income tax, the existence of the Subsidiaries has the effect of reducing the overall state income tax liability of the affiliated group. According to Taxpayer, the Banks created the Subsidiaries to centralize and thereby improve the efficiency of holding, servicing, investing, and reinvesting long-term investment assets. All of the Subsidiaries have the same six-member board of directors, four of whose members are officers of Taxpayer and/or one or more Banks. All of the Subsidiaries' securities transactions are reviewed by their board of directors. All of the Subsidiaries have the same investment policy; the content of that policy is subject to regular review by Taxpayer's Asset/Liability Committee and Taxpayer's board of directors, and the implementation of that policy is subject to regular review by Taxpayer's Investment Committee. In addition, the Subsidiaries' securities transactions must conform to strategic financial objectives defined by Taxpayer's Asset/Liability Committee. The Subsidiaries do not have any direct employees; each Subsidiary receives services under an identical agreement with Service Provider, a wholly-owned subsidiary of Taxpayer. Each Subsidiary's assets and liabilities are consolidated with those of its respective Bank for financial accounting purposes and also for bank regulatory purposes. The Subsidiaries make significant dividend distributions to the Banks. In short, the assets of the Subsidiaries are controlled by Taxpayer and the Banks and held for the benefit of the Banks. This is true for both assets that the Subsidiaries received from the Banks and assets that the Subsidiaries purchased from earnings and proceeds of assets they received from the Banks.

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 Years 1, 2, and 3, each Bank properly took into account the value of its stock in its Subsidiary, which was nearly equal to the average adjusted bases of all of the Subsidiary's assets. In determining the average adjusted bases of its tax-exempt obligations on the amended returns, however, each Bank took into account the tax-exempt obligations then held by its Subsidiary that the Subsidiary had received from the Bank or purchased from cash received from the Bank, but not those that the Subsidiary had purchased by reinvesting earnings and proceeds of assets received from the Bank. Thus, each Bank received the benefit of including virtually all of its Subsidiary's assets in the denominator of the ratio, but not the detriment of including all of the 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 the Banks.

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 each Bank must treat all of its Subsidiary's assets (including all of the Subsidiary's tax-exempt obligations) and all of its Subsidiary's interest expense as those of the Bank for purposes of applying § 265(b) and § 291(a)(3) and (e)(1)(B).