Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201341017**
Release Date: 10/11/2013

CC:FIP:B02:SHarrison
POSTF-105934-13

UILC: 581.00-00; 864.04-00

date: May 17, 2013

to: Guy H. Glaser
Associate Area Counsel (Laguna Niguel)
(Large Business & International)

from: Robert A. Martin
Senior Technician Reviewer, Branch 1
(Financial Institutions & Products)

---

subject: Treatment of Subsidiary as a Bank for Purposes of Section 581

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Sub A =

X =

Y =

Z =

State A =

State B =

State C =

State D =

State E =

State F =

State G =

State H =

State I =

State J =

State K =

State L =

State M =

State N =

State O =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

Date 2 =

Date 3 =

a =

b =

c =

d =

e =

f =

g =

h =

j =

k =

m =

n =

State Agency A =

State Agency A-1 =

State Agency A-2 =

State Agency B =

State Agency C =

State Agency D =

State Agency E =

State Agency F =

State Agency G =

State Agency H =

State Agency I =

State Agency J =

State Agency K =

State Agency L =

State Agency M =

State Agency N =

State Agency O =

Division J-1 =

Division J-2 =

Division K-1 =

Division K-2 =

State A Statute 1 =

ISSUES

For the year at issue, does Taxpayer's subsidiary Sub A satisfy the requirements of § 864(e)(5)(C), thereby allowing the Taxpayer affiliated group to exclude it from its interest expense allocation and apportionment calculations?

CONCLUSIONS

Sub A does not satisfy the requirements set forth in § 864(e)(5)(C), and therefore cannot be excluded from Taxpayer's affiliated group for purposes of allocating and apportioning interest expense. Specifically, Sub A fails to meet the requirements of subparagraph 864(e)(5)(C)(i) because it is not a "financial institution" described in § 581 or § 591.

FACTS

Sub A is an included affiliate on the U.S. consolidated federal income tax returns of the Taxpayer affiliated group. Taxpayer is

.

Sub A incorporated in State A in Year 1. Its articles of incorporation state that its purpose is to

. That statement of corporate purpose is standard and required for corporations incorporated in State A. Sub A's business consists primarily of

. Sub A also provides for certain other uses.

A. Activities

Sub A derives over a% of its revenues from . Approximately b% of such comprising the remaining portion. As of Date 1, Sub A's totaled over $c. Sub A performs various activities and functions in connection with its . Such activities include the following:

- Designing and customizing ;
- Setting and ;
- Entering into ;
- Holding ;
- Administering and ; and
- Engaging in .

Sub A typically requires to provide , which Sub A . As of Date 1, Sub A held for over d , with an average aggregate balance of approximately $e from Year 2 through Year 3.

B.

Sub A establishes

. Interest generally accrues each month . That rate generally , subject to the discussion below of .

. Under the

. The amount of

. As of Date 1, approximately $f had been transferred to Sub A under . That number grew to $g and $h by Date 2 and Date 3, respectively.

may demand

. Sub A has the right to

. Pursuant to grants Sub A

. The

. That is, Sub A has full ownership of such funds.

Sub A is required to provide with monthly statements that include

.

C. Sub A's Sources of

Sub A finances its primarily by

. In addition, Sub A receives funding from

. As of Date 1, Sub A owed approximately $j .

As of Date 1, Sub A owed approximately $k

. At Date 1, Sub A had approximately $m .

Sub A

. During the fiscal year ending on Date 1, Sub A approximately $n of in this manner.

According to the Taxpayer's , none of received by Sub A from

.

D. Legal and Regulatory Restraints on Sub A

For governed by the laws of State J, are required to be .

Sub A is by its home state, State A, . As a , Sub A cannot engage in without prior approval of the State Agency A

. To date, Sub A has not sought approval to .

In addition, the Taxpayer maintains that Sub A is , and that Sub A has . In

.

Sub A is also subject to supervision by various state authorities. Below is a summary of the known state regulatory agencies that were identified by :

State B	State Agency B
State C	State Agency C
State D	State Agency D
State E	State Agency E
State F	State Agency F
State G	State Agency G
State H	State Agency H
State I	State Agency I
State J	State Agency J
State K	State Agency K
State L	State Agency L
State M	State Agency M
State N	State Agency N
State O	State Agency O

LAW AND ANALYSIS

Under § 901 a domestic corporation may elect to claim a credit for the amount of any income, war profits, and excess profits taxes paid or accrued during a taxable year to any foreign country or to any possession of the United States. Section 904 limits the amount of the foreign tax credit to the pre-credit U.S. tax on the foreign source taxable income. The § 904 limitation is calculated separately for different categories of foreign source income. I.R.C. § 904(d).

In order to compute the § 904 foreign tax credit limitation, taxpayers must first determine their taxable income from foreign and domestic sources by deducting the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. See I.R.C. §§ 861(b), 862(b), and 863(a). Special rules for the allocation and apportionment of interest expense exist in Treas. Reg. §§ 1.861-9 through 1.861-12 and Treas. Reg. §§ 1.861-9T through 1.861-13T. The taxable income of each member of an affiliated group, for foreign tax credit purposes, is determined in part by allocating and apportioning the aggregate interest expense of all members of such group as if they were one single corporation. I.R.C. § 864(e)(1). In this context, the term "affiliated group" generally has the same meaning as when used in § 1504. See I.R.C. § 864(e)(5)(A). However, affiliated corporations that are "financial institutions" within the meaning of § 864(e)(5)(C) are treated as members of a separate affiliated group for purposes of allocating and apportioning interest expense. The interest expenses incurred by each of the financial and non-financial subgroups must be allocated separately based on the assets (not income) of each subgroup. Temp. Treas. Reg. § 1.861-11T(d)(4).

To qualify as a financial institution for purposes of § 864(e)(5)(C), Sub A must be a financial institution: (i) described in either § 581 or § 591, (ii) whose business is predominantly with persons other than related persons or their customers, and (iii) that is required by state or federal law to be operated separately from any other entity which is not such an institution. Sub A fails to meet element (i) and therefore is not a financial institution for purposes of § 864(e)(5)(C).

A. Sub A is not a financial institution described in § 581 or § 591

Section 581 defines "bank" for purposes of §§ 582 and 584. Section 591 describes "mutual savings banks, cooperative banks, and domestic building and loan associations and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law." Taxpayer does not assert that Sub A is a financial institution described in § 591, so this memorandum provides no analysis under § 591.

To qualify as a bank under § 581, a corporation (that is not a domestic building and loan association) must meet three requirements: (1) it must be a bank or trust company incorporated and doing business under the laws of the United States or of any state; (2) a substantial part of its business must consist of receiving deposits and making loans and discounts (or exercising certain fiduciary powers); and (3) it must be subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Taxpayer does not assert that Sub A is a domestic building and loan association or that it exercises the fiduciary powers that would satisfy requirement (2).

1. Sub A is not a "bank" incorporated and doing business under the laws of the United States or of any state

To be a bank under § 581, a corporation must be a "bank or trust company." Taxpayer has not asserted that Sub A is a trust company. As discussed below, Sub A is also not a bank as that word is used in the definition set forth in § 581.

Words in a statute must be given their ordinary meanings unless there are persuasive reasons against it. *See Perrin v. United States*, 444 U.S. 37, 42 (1979); *Burns v. Alcala*, 420 U.S. 575, 580-581 (1975). Thus, to be a bank under § 581, a corporation must be a bank within the ordinary sense of that term. *See Staunton Industrial Loan Corp. v. Commissioner*, 120 F.2d 930, 933 (4th Cir. 1941).

Whether a taxpayer is a bank for purposes of § 581 does not depend on the name given to a business by the taxpayer or by the state, but to whether the business is a banking business as the term is commonly understood. For example, the court in *Staunton* considered whether a taxpayer, an industrial loan association under Virginia law, was a bank under a predecessor to § 581.[1] On the basis of several dictionary definitions set forth in the opinion, the court concluded that the primary functions of a bank are "(1) the receipt of deposits from the general public, repayable to the depositors on demand or at a fixed time, (2) the use of deposit funds for secured loans, and (3) the relationship of debtor and creditor between the bank and the depositor." *Staunton*, 120 F.2d at 933-34. The court found that the taxpayer was a bank even though, under Virginia law, the taxpayer could not be called a bank and its deposits could not be called deposits. Such state law classifications were not controlling, and the taxpayer was functioning as a bank; its business was accepting deposits from the public and using deposited funds to make loans.

Similarly, in *Commissioner v. Valley Morris Plan*, 305 F.2d 610 (9th Cir. 1962), the taxpayer was an industrial loan corporation that issued "term thrift certificates" to the public. Under state law, it could not hold itself out as a bank, nor could it label as "deposits" the amounts invested in the thrift certificates. As in *Staunton*, however, the court found that the taxpayer was a bank. In reaching that conclusion, the court explained that the taxpayer was advertising and providing depository accounts to the public, even though the deposits were called "certificates" to comply with state law.

Courts may also consider whether a business is a banking business in substance even if conducted by an entity that is a characterized as a "bank" under state law. *See Austin State Bank v. Commissioner*, 57 T.C. 180, 186 (1971). In *Austin*, the taxpayer was

[1] Section 104 of the Revenue Act of 1936 provided: "As used in this section the term 'bank' means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act, as amended, and which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions."

registered as a bank, but the government challenged its status under § 581 because of its minimal banking activities. The court held that the taxpayer there was a bank because its business consisted of accepting deposits from the public and using the amounts on deposit for loans and investments. In the court's language, the taxpayer "looked like a bank, conducted business like a bank, and believed it was a bank." *Id*. at 186.

One of the government's arguments against treating the taxpayer in *Austin* as a bank was that its deposits were not from the "general public," because a significant portion of its deposits were from (i) the state of Indiana and (ii) persons with some relationship to the taxpayer. The court noted that "no reference is made in section 581 or its predecessors to the 'general public.'" 57 T.C. 180, 187 (1971). The court, however, did not read the "general public" element out of the definition used in *Staunton*. Instead, it characterized the significance of the term as differentiating "between deposits received from sources in some way connected with the bank and those received from ordinary and unrelated customers of banking services." *Id.* Applying that standard, the court found that the taxpayer was accepting deposits from the general public because the state of Indiana was an ordinary banking customer and that 65 percent of the taxpayer's deposits were from unrelated depositors. The court also noted that the taxpayer had regular office hours six days a week.

Sub A fails § 581's first requirement because it does not possess the essential characteristics of a bank. Sub A is under the laws of State A. Its articles of incorporation . We acknowledge that, under *Staunton* and *Valley Morris*, a company may be a bank for purposes of § 581 even if it is not characterized as a bank under state law. Nevertheless, Sub A's business is substantially different from a banking business, whereas the courts in *Staunton* and *Valley Morris* concluded that the taxpayers functioned like banks. Sub A does not . It does not

. Sub A might be described as , but even
.

Unlike the institutions in the cases , Sub A did
. Profiting from the rate spread between amounts deposited and amounts loaned or invested is the business of a bank. As discussed below under heading A.2, the issue of the use of does not really arise, because
.

2. Sub A does not receive deposits

A company is not a bank for purposes of § 581 unless a substantial portion of its business consists of receiving deposits and making loans. Sub A fails this requirement because it does not receive deposits.

Neither the Code nor the regulations provides a definition of "deposits" for purposes of § 581. Because the term is undefined, it should be given its ordinary meaning, within the context of the language with which it appears. *See The Limited v. Commissioner*, 286 F.3d 324, 340 (6th Cir. 2002) (in the context of another statute, certificates of deposits were "deposits" according to the plain meaning of the term).[2]

Black's Law Dictionary defines "deposit" as "[t]he act of placing money in the custody of a bank or banker, for safety or convenience, to be withdrawn at the will of the depositor or under rules and regulations agreed on." (6th ed. 1990). Similar definitions may be found in other legal and general dictionaries, and the case law has emphasized the elements of a transfer for safekeeping or convenience.

In *Valley Morris*, the court concluded that the purchases of the taxpayer's certificates were deposits on the basis of the form and purpose of the transaction. The court explained that the taxpayer acquired a permit from a state authority and advertised to the public that it had thrift certificates for sale and the rate of interest they bore. A person wishing to purchase a certificate would go to the taxpayer's place of business, provide a name for the certificate, state the amount desired, and deliver an equal amount in cash. The owner of the thrift certificate was entitled to receive the face amount of the certificate, plus interest, upon presenting it to the taxpayer. The court concluded that "[s]uch a transaction is nothing more nor less than a deposit transaction, the money to be kept safely for the purchaser and to be repaid according to the terms of the certificate with interest." *Valley Morris,* 305 F.2d at 617-18.

Similarly, the taxpayer in *Staunton* accepted funds from the public and issued "certificates of investment" or passbooks. It reserved the right to require advance notice of withdrawals but in practice always allowed withdrawals without notice. The court did not expressly define "deposit," but treated the certificates offered by the taxpayer as deposits in concluding that the taxpayer was a bank. Moreover, a law dictionary definition of "bank" quoted in the opinion calls a bank an "institution of a quasi public character" that is "chartered by the government for the purpose *inter alia* of holding and safely keeping the moneys of individuals and corporations". *Staunton,* 120 F.2d at 933 (citing Bouvier's Law Dictionary, Baldwin's Students' Ed. 1934).

In *Morris Plan Bank v. Smith*, 125 F.2d 440 (2nd Cir. 1942), the court likewise concluded that "certificates of indebtedness" issued by an industrial bank constituted

[2] We note that to *The Limited* for purposes of § 581. The court in that case was interpreting the phrase "banking business" then set forth in § 956, and the court explained that the definition of "bank" under § 581 was inapplicable for the purpose of interpreting § 956. *The Limited*, 286 F.2d at 336-37.

"deposits". Holders of the certificates could withdraw what they had paid, though the certificates did not yield interest until the customer had "fully paid" for the certificate. The court, in concluding that the certificates constituted deposits, observed that the taxpayer issued certificates "in form similar to that of deposit books issued by savings banks." *Id*. at 441. Moreover, the court noted that while customers holding certificates were required to pledge those certificates as collateral if they sought a loan from the taxpayer, "a substantial part of [the taxpayer's] business consisted in the receipt of installment payments for which it issued . . . certificates of indebtedness which were never assigned to [the taxpayer] as collateral security for loans. *Id*.[3]

Courts have held that funds transferred to an institution are not deposits where the purposes are other than safekeeping and convenience. In *Jackson Finance v. Comm'r*, 260 F.2d 578 (10th Cir. 1958), the taxpayer was an industrial loan association that issued thrift certificates. Unlike in *Staunton, Valley Morris*, and *Morris Plan Bank*, the court in *Jackson* found that the higher risk and higher rate of return associated with the thrift certificates (in comparison to deposits in institutions that were banks under Utah law) caused them to be investments rather than deposits. The court explained that "[d]epositors place their money in banks primarily for safekeeping, secure in the knowledge that many governmental restrictions. . . are placed upon banks to assure and sometimes . . . to insure the safety of the deposit." *Id*. at 582. In *Magruder v. Safe Deposit & Trust Co. of Baltimore*, 121 F. 2d 981, 985 (4th Cir. 1941) the court determined that certain customer funds held by a trust company were not "deposits" because the company's custody of the funds was incidental to its role as trustee or paying agent.

Definitions employed by banking statutes (such as 12 U.S.C. § 1813(l)(1) and (l)(3)) are not controlling for the purposes of defining the terms set forth in §§ 581 and 864. Neither § 581 nor § 864 refers to Title 12, and the definitions of 12 U.S.C. § 1813(l)(1) and (l)(3) are limited to the chapter of Title 12 in which they are found. See *The Limited*, 286 F.2d 336-39 (refusing to import analysis of § 581 or Title 12 onto a tax statute that used the word "deposits" without reference to either body of law).

In the present case, Taxpayer correctly asserts that the term "deposit" has been applied to arrangements with varying state-law labels. What such arrangements had in common, however, is that they were banking deposits in substance. As discussed below, none of the payments that Taxpayer seeks to characterize as a deposit is in substance a deposit.

a. The are not "deposits" for purposes of § 581

[3] At the trial court level, the taxpayer in *Morris Plan Bank* did not argue for the "deposit" characterization of payments received on certificates that holders had assigned as collateral for loans from the taxpayer. *See Morris Plan Bank v. Smith*, 41-2 U.S. Tax Cas. (CCH) ¶ 9511 (D. Conn. 1941), *rev'd on other grounds*, 125 F.2d 440. The Court of Appeals for the Second Circuit thus disagreed with the trial court's conclusion that unassigned certificates were not deposits.

An amount placed is not a deposit as that term is ordinarily understood in a banking context. A with Sub A is, economically, more like . When

cannot transfer

. Moreover,

.

A

. Section 581 and the case law interpreting it clearly describe making loans and deposits as two activities. A payment like , cannot also be a deposit.

Moreover, the . As mentioned,

. That indicates that Sub A is ; a bank seeks to maximize its deposits, because it derives its profits from lending and investing deposited funds at a rate higher than the rate paid to depositors. It also shows that Sub A , unlike the customers described in *Staunton*.

.

Likewise, bear only superficial similarities to depository accounts. Sub A

. The existence of monthly statements, however, adds little to the analysis; creditors often send monthly statements to their debtors.

b. are not "deposits" for purposes of § 581

The are also not deposits in the banking sense. do not transfer the funds for safekeeping. On the contrary, function . The are the

.

Further, for Sub A's banking services. They are

. Likewise, although

.

Finally, for governed by the laws of State J (and perhaps of other states), Sub A is .

3. Sub A is not subject, by law, to the supervision and examination by state or federal authority having supervision over banking institutions

Section 581's final requirement is that the corporation in question must be "subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions." This element focuses on the nature of the regulation rather than the name of the agency.

The language of § 581 was intended to describe institutions subject to regulation and supervision that protects depositors (e.g., by imposing minimum capital requirements). To meet the test, a corporation must be subject to supervision and examination that has as its end the protection of depositors. For example, in *Staunton*, the taxpayer's books were audited by the banking department of the Corporation Commission of Virginia, as were those of Virginia commercial banks. The examiners required the taxpayer to charge off worthless assets, establish certain reserves, and comply with other recommendations.

In *Valley Morris*, the taxpayer was found to be a bank even though it was supervised by the California Corporations Commissioner while California banks were supervised by the Superintendent of Banks. The court stressed the nature of the regulation rather than on the identity of the regulating agency; the opinion explains: "as in *Staunton* where the industrial loan association was organized under different state authority than

were banks, petitioners are organized in a manner different from banks and are controlled by different state authorities, albeit the state controls are stringent in either case." *Valley Morris.* 305 F.2d at 629-30. In other words, the state's decision to separate similar institutions into two categories supervised by separate authorities did not alter the conclusion that both categories were banks for federal tax purposes.

Sub A is not subject to supervision and examination as a bank. In State A, Sub A's state of incorporation, Sub A is subject to the supervision of State Agency A-1. State A's banks, on the other hand, are overseen by State Agency A-2. More importantly, however, State Agency A-1 does not regulate Sub A . Sub A is subject to regulations

.

Sub A is directly supervised by the same state authorities that regulate banks in State L, State M, and State N. Each of these authorities, however, regulates Sub A as a . In eleven other states, Sub A is supervised by a non-bank branch, bureau or division of the same state agencies that regulate banks. For instance, Sub A is subject to the supervision of State Agency J – Division J-1, but banks are supervised and examined by State Agency J – Division J-2. Likewise, Sub A is subject to the supervision of the State Agency K – Division K-1, but banks are supervised and examined by the State Agency K – Division K-2.

Such regulation is insufficient to meet the supervision element of the § 581 test. The peculiarities of state law are not controlling. A state may organize its agencies so that a single agency (with or without separate divisions) regulates both banks and certain other businesses, but that does not cause such other businesses to meet the supervision requirements of § 581.

B. Sub A predominantly did business with unrelated parties

Sub A satisfies the second element set forth in § 864(e)(5)(C)(ii) because that Sub A does business with are all unrelated to Sub A.

C. Whether Sub A is required by State or Federal law to be operated separately from entities that are not financial institutions

The final element set forth in § 864(e)(5)(C)(iii) looks to whether the financial institution in question is "required by State or Federal law to be operated separately from any other entity which is not such an institution." § 864(e)(5)(C)(iii). The Taxpayer does not claim federal law requires Sub A . Thus, the only question remaining is whether Sub A is required by a state statute to be so operated. No opinion is expressed at this time as to whether Sub A is required to be separately operated under a state statute.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions.