

## IRS Files Brief in TEFRA Appeal

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Shortly after the dawn of the New Year, the Internal Revenue Service (IRS) filed its brief in the TEFRA disallowance appeal, *Jerome R. Vainisi, et al. v. Commissioner of Internal Revenue*. As anticipated, the IRS raised no new issues before the Seventh Circuit Court of Appeals, relying instead on the same points they argued in the original case before the U.S. Tax Court.

The IRS's brief argues that Sections 291(a)(3) and (e)(1)(B) of the Internal Revenue Code (IRC)—which requires the disallowance of 20% of banks' deductions for interest expense attributable to qualified tax-exempt obligations (QTEOs)—apply to all banks regardless of whether they are organized as a C corporation, S corporation or a qualified Subchapter S subsidiary (QSub). The IRS relies on provisions in Section 1361(b)(3) of the IRC and on Treasury Regulation § 1.1361-4(a)(3) which provide that a QSub must apply certain "special bank rules" before the QSub's items of income and deductions are merged with those of its parent corporation. In making this argument however, the IRS dismisses the fact that Section 1363(b)(4) of the IRC clearly states that Section 291 of the IRC applies to an S corporation only for the first three years after it converts from a C corporation.

The language of 1363(b)(4), the IRS argues, does not extend to QSub banks because it does not expressly reference QSubs or banks, only S corporations. The Tax Court applied this same logic in reaching its decision, suggesting that the 20% disallowance of Section 291 may apply differently to a QSub bank than it would to a stand-alone S corporation bank. The *Vainisi* appellants', in their opening brief, argued that in fact there are no bank rules whatsoever that apply only to QSub banks and not to S corporation banks and thus, the Tax Court's ruling must have been incorrect.

The IRS attempts to negate this very basic premise, but ultimately fails to reconcile how Section 291—purportedly a "special bank rule" and thus applicable to *all* banks—can apply to QSub banks and S corporation banks in the same manner as it does to C corporation banks despite plain language in Section 1363(b)(4) that clearly states the contrary.

The next step is for the *Vainisi* appellants to file their reply brief, which will be due by February 2nd. From there, oral arguments will be heard, which will then be followed by the Court's decision. We anticipate it will be late spring or early summer before the Court's decision is rendered.

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