

Tax Definition of “Bank” Relevance in the Modern World

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Evolution of Financial Institutions

- Historical distinction between banks and thrifts
- Historical prohibition on interstate activity/branching
- Repeal of Glass-Steagall prohibition on non-banking activities (insurance, securities)
- Expansion of the use of subsidiaries
- Consolidation of banking industry
- Non-Bank Financial Players (CLOs, CDOs, etc.)
- Dodd-Frank

Section 581 Definition of Bank

- The term “bank” means a bank or trust company incorporated or doing business under the laws of the United States (including the laws of the District of Columbia) or of any State, 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 authority of the Comptroller of Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.
- Domestic Building and Loan Association defined by Section 7701(a)(19).

Breakdown of Section 581 Definition

- Must be taxable as a corporation (Reg. § 1.581-1(a))
- Statutory Requirements –
 - Chartering Requirement-Incorporated and doing business under federal or state law
 - Deposit & Loans Requirement-Substantial part of its business consists of either receiving deposits and making loans or exercising fiduciary powers similar to those permitted to national banks
 - Subject to state or federal regulatory authority

Evolution of Taxation of Banks

- Historically more favorable tax treatment to thrift institutions because they made home mortgage loans

Section 582 – A Sword Which Cuts Both Ways

- Character of Losses – § 582 provides favorable rules permitting banks to treat certain losses as ordinary losses in contrast to other entities which would treat those losses as capital with attendant limitations –
 - losses on securities treated as bad debts
 - worthless stock in affiliated bank
 - losses on debt instruments generally
 - however, rule does not apply to subsidiaries – this exception INCLUDES disregarded entities.
- Character of Gains – Section 582 cuts both ways in that gains are also ordinary income.

Reserve Method / De-Facto Reserve Method?

- Bad Debt Reserves limited to banks where the adjusted basis of assets (of it or its parent-subsidiary controlled group) doesn't exceed \$500 million. § 585.
- Charge-Offs – § 166 requires determination that a debt is worthless for a bad debt deduction to be taken. Evidentiary bar for worthlessness high. Reg. § 1.166-2(d) favorable rule presuming worthlessness in the year of a charge-off.
- Use of 166 by non-banks

Corporate Status

- Per Se Corporate Status –
 - State Bank - Reg. § 301.7701-2(b)(5) provides that a state chartered bank is a per se corporation if any deposits are FDIC insured.
 - National Bank will be a per se corporation pursuant to Reg. § 301.7701-2(b)(1) because of its characterization as a corporation under 12 U.S.C. 24.
 - To be taxed as a bank, Reg. § 1.581-3 requires corporate tax status.

S Corporation Election

- Banks are eligible to make an election to be taxed as a subchapter S Corporation.
 - S Corporation status is not available if a bank would otherwise not qualify as an S Corporation
 - 100 shareholder limit
 - Generally no shareholders which are entities
 - No non-US shareholders
 - One class of stock

Limitations on Deductibility of Certain Interest

- § 265 generally disallows deductions for interest expense which is related to tax exempt income.
 - § 265(b) provides an unfavorable rule for financial institutions deeming the relationship between income and expenses pursuant to a pro-ration of tax exempt assets to all assets.
- Some authority suggests that an S Corp bank may avoid the application of § 265(b)

Special Rules Applicable to Banks

- (1) Federal Financial Assistance; (2) Deduction for dividends paid on deposits for mutual savings banks without capital stock; (3) Requirement to currently include in income discount on certain short-term obligations
- Finance as an active business (personal holding company purposes, etc.)

To be or not to be a bank

- Character of income and losses; possible mismatch of character for non-banks
- Ability to use charge-off method for bad debts
- Easier to retain flow-through treatment for non-banks
- Onerous regulatory requirements under Dodd-Frank

Uncertain Arrangements

- EG 1– Wholly owned disregarded entity of a bank.
- EG 2– Wholly owned subsidiary of a bank. This subsidiary is authorized to receive deposits but does not.
 - *Seattle First*; Given evolution of financial industry, is this case still good law?
- EG 3– Lending institution which finances its operations solely through issuing notes rather than deposits.
- EG 4– Industrial Loan Company which is under the authority of a non-banking regulator.
- EG 5– Joint venture between two banks.

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