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Should the IRS Continue to Deny Banks the Benefits of the LLC Structure?

Though traditionally an entity affording its owners limited liability has also subjected them to a double layer of taxation, the separation of limited liability from pass-through taxation has been largely eliminated. The convergence began in 1958, when Congress created a limited exception by adopting Subchapter S, which enabled corporations complying with an extremely specific set of criteria to elect pass-through taxation without losing limited liability. The benefits of Subchapter S, however, are made costly, often prohibitively so, by the restrictions it imposes upon capital structure. It was not until 1988, when the Internal Revenue Service (IRS) confirmed that certain limited liability companies (LLCs) would be taxed as partnerships, that limited liability and pass-through taxation came together in a flexible structure.

1. See Armando Gomez, Rationalizing the Taxation of Business Entities, 49 TAX LAW. 285, 286-98 (1996). The author discusses the history of the taxation of business entities, indicating that limited liability was a predominant factor in determining whether a business entity was to be taxed in the following legislative and regulatory acts: 1) the Tariff of 1909, which established an excise tax that applied to corporations but not to partnerships “because of the distinct feature of limited liability”; 2) Regs. 45, art. 1503 (1919), which emphasized limited liability in requiring certain entities to be taxed as corporations; 3) Regs. § 301.7701-2(a)(1) (1960), which listed limited liability as a factor in distinguishing a partnership from a corporation; and 4) Prop. Regs. § 301.7701-2, 45 Fed. Reg. 75,709 (1980), stating that “the proposed rules would have established limited liability as a 'super factor'” in determining whether a business entity was taxable as a corporation. Id.

2. See id. The first layer of tax is at the corporate level, on corporate earnings; the second layer of tax is at the shareholder level, as shareholders are taxed on dividends received from the corporation. Id.; see infra text accompanying notes 30-32.

3. See infra text accompanying notes 4-9, 31-40.


5. Unlike a corporation, an entity that is afforded pass-through taxation (i.e. an entity taxed as a partnership) is subject to only one layer of tax. See Susan Pace Hamill, The Origins Behind The Limited Liability Company, 59 OHIO ST. L.J. 1459, 1460 (1998). Pass-through taxation eliminates the tax at the corporate level, taxing the entity’s income only at the shareholder level. Id.

6. See infra notes 111-112 and accompanying text.

7. See infra notes 122-126 and accompanying text.

8. Charles W. Murdock, Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future, 56
Banks, however, have not traditionally benefited from this convergence of limited liability and pass-through taxation. Subchapter S was not extended to banks until the Small Jobs Protection Act of 1996. More importantly, banks have been unable to enjoy the benefits of the LLC structure. The primary reason for this has been the IRS's position that banks will be taxed as corporations, regardless of how they are organized. Part I of this note will explore the regulatory elements that must be present for a bank to successfully organize as an LLC. Part II seeks to identify the rationale employed by the IRS in denying banks organized as LLCs (Bank LLCs) pass-through taxation. Part III assesses the extent to which subsequent developments have strengthened or weakened the IRS's stated reasons for its treatment of Bank LLCs.

I. THE REGULATORY ENVIRONMENT

Three regulatory elements must be present for a bank to successfully implement an LLC structure. First, no bank can organize as an LLC until authorized to do so by a chartering authority. This is because banks are chartered entities, limited to

10. See infra text accompanying notes 11-14.
11. Marc D. Levy et al., Conversion of Banks to S Corporations – Opportunities and Issues, 86 J. TAX’N 81 (1997) ("Prior to the [Small Business Job Protection Act], a financial institution generally was precluded from electing to be an S corporation because the IRS viewed it as an 'ineligible corporation.'").
13. See infra text accompanying notes 43-100.
14. See infra text accompanying notes 43-100.
15. See infra text accompanying notes 18-40.
16. See infra text accompanying notes 41-100.
17. See infra text accompanying notes 101-180.
18. See infra text accompanying notes 19-40; Dreyer, supra note 9, at 576 (discussing the uselessness of a state charter authorizing a Bank LLC in the absence of deposit insurance and pass-through taxation).
only those activities authorized by their charters. Banks do, however, have the option of choosing either a federal charter, issued by the Office of the Comptroller of the Currency (OCC), or a state charter, issued by the state within which their principal place of business will reside. Due to the relative ease of switching charters, the LLC structure becomes readily available as soon as it is authorized by one of the bank's chartering authorities. An increasing number of states explicitly authorize banks to organize as LLCs. Further, a bill is currently before Congress that would allow the OCC to create a national charter for Bank LLCs.

Second, for the LLC structure to be a viable option, Bank LLCs must be eligible for federal deposit insurance. The Federal Deposit Insurance Act of 1933 (FDIA) implemented a system of federal deposit insurance in an attempt to stabilize the nation's banking system. To this end, the FDIA created a federal agency, the Federal Deposit Insurance Corporation (FDIC), to administer the deposit insurance. Federal deposit insurance is required for federal banks, and although it is not required for all state banks, "as a practical matter, all state banks have elected to obtain this coverage. Indeed, in many states federal deposit insurance

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20. See id.
21. Id. at 181-82. The National Bank Act of 1864 created this "dual bank chartering system" by establishing a system of National Banks without eliminating the existing system of State Banks. Id.
22. Id.
25. See Dreyer, supra note 9, at 583.
26. See BROOME & MARKHAM, supra note 19, at 463. "Federal deposit insurance ... helps to prevent bank runs or panics because customers have no need to withdraw amounts on deposit at a bank - even if the bank is failing - if the government has guaranteed the depositor will receive back the amount of his deposit." Id.
27. See id. at 44.
coverage is a prerequisite to obtaining a state charter." The FDIC has recently promulgated regulations stating that Bank LLCs are eligible for deposit insurance under the FDIA.

Finally, for a bank to enjoy the most predominant benefit of the LLC structure, Bank LLCs must be granted pass-through taxation. Historically, the tax system has imposed a tax on corporations and individuals but not on partnerships. Thus, a corporation’s earnings are taxed twice, once at the entity level and again at the shareholder level. However, entity structures have emerged that fail to fit within the established definitions of "corporation" or "partnership." The IRS formerly classified such "unincorporated" entities as corporations or partnerships based on whether they have "more corporate characteristics than noncorporate characteristics" (Characteristic Test). To this end, the IRS identified four corporate characteristics. Unincorporated entities found to demonstrate three or more of the characteristics were taxed as corporations. In 1997, the IRS replaced the Characteristic Test with an elective regime (Check-the-Box Regs). These regulations allow most unincorporated entities to choose how they are taxed regardless of their underlying characteristics, even classifying them as pass-through entities by default. However, the IRS has denied Bank LLCs access to either of these classification systems, treating them as

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28. Id. at 464.
29. 12 C.F.R. § 303.15 (2003); see infra text accompanying notes 130-167.
30. See Dreyer, supra note 9, at 583.
31. See Gomez, supra note 1, at 286.
32. See Hamill, supra note 5, at 1460.
33. Id. at 285.
35. See Treas. Reg. § 301.7701-2(b)-(e) (as amended in 1993). The corporate characteristics included: 1) continuity of life; 2) centralization of management; 3) limited liability; and 4) free transferability of interests. Id.
36. See Treas. Reg. § 301.7701-2(a)(3) (as amended in 1993). Because of this classification structure, LLC statutes were traditionally drafted carefully by state legislatures to ensure partnership taxation by statutorily eliminating at least two of the corporate characteristics. See Hamill, supra note 5, at 1470-75.
corporations rather than unincorporated entities. Because chartering authorities increasingly allow banks to organize as LLCs and because Bank LLCs are now eligible for federal deposit insurance, the IRS’s treatment of Bank LLCs as corporations stands as the lone remaining regulatory factor precluding banks from enjoying the benefits of the LLC structure.

II. DENIAL OF PASS-THROUGH TAXATION FOR BANK LLCs

Two IRS issuances shed light on the reasons the IRS has denied Bank LLC’s pass-through taxation: a 1995 private letter ruling and the notice of the Check-the-Box Regs.

A. The 1995 Private Letter Ruling

Texas was the first chartering authority to attempt to extend the benefits of the LLC structure to banks; it did so in 1993 with the creation of the Texas Limited Banking Association (Texas Bank LLC), an entity with the attributes of an LLC. The Texas Bank LLC structure was only viable, however, if coupled with deposit insurance and pass-through taxation. Accordingly, supporters asked the FDIC and the IRS to comment on the Texas Bank LLC’s eligibility under their respective regimes. The IRS responded first, issuing a private letter ruling (PLR), and in doing so, eliminated the need for a response by the FDIC. In requesting the private letter ruling, the supporters of the Texas Bank LLC asserted that because it would lack two of the four corporate characteristics, it would be properly taxed as a

39. See infra text accompanying notes 41-100.
40. See supra text accompanying notes 18-40; Dreyer, supra note 9, at 576.
41. Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995); see infra text accompanying notes 43-81.
42. Proposed Simplification of Entity Classification Rules, supra note 38; see infra text accompanying notes 82-100.
43. Dreyer, supra note 9, at 582 (citing Tex H.B. 1212, 73rd Leg., R.S. (1993) (enacted)).
44. See supra text accompanying notes 18-40.
45. Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995); Dreyer, supra note 9, at 583.
46. Dreyer, supra note 9, at 583.
partnership under the Characteristic Test.\(^{47}\) However, the IRS declined to apply the Characteristic Test, instead classifying the Texas Bank LLC as a “corporation, per se.”\(^{48}\) Specifically, the IRS found that the Texas Bank LLC structure was simply a specific form of incorporation.\(^{49}\) Thus, the Characteristic Test, needed only to classify “unincorporated organization[s],” was not applicable.\(^{50}\) The IRS supported its classification of the Texas Bank LLC as a corporation, per se, in two ways.\(^{51}\)

1. Texas Bank LLC Treated As a Corporation by the Laws of Texas

The IRS relied heavily on its finding that the Texas Constitution and several Texas statutes treated the Texas Bank LLC as a corporation.\(^{52}\) The IRS first concluded that the Texas Constitution precluded the Texas legislature from chartering a bank not organized as a corporation.\(^{53}\) This contention was based upon a provision of the Texas Constitution, which grants the legislature the power to “authorize the incorporation of state banks.”\(^{54}\) The IRS interpreted the meaning of “incorporation” given the context within which this provision was drafted in 1904, stating:

Texas has had a limited partnership statute since 1846. Just as §16 did not authorize unincorporated entities such as limited partnerships to be state banks at the time of its adoption, we do not believe that it today authorizes an unincorporated entity to be a state bank.\(^{55}\)

\(^{47}\) Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995).
\(^{48}\) Id.
\(^{49}\) See id.
\(^{50}\) See id.; see also Treas. Reg. § 301.7701-2(a)(3) (as amended in 1993).
\(^{51}\) See infra text accompanying notes 52-78.
\(^{52}\) Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995).
\(^{53}\) Id. (citing TEX. CONST. art. XVI, § 16).
\(^{54}\) Id. (emphasis added).
\(^{55}\) Id. (citing Jones v. Ross, 173 S.W.2d 1022, 1024 (Tex. 1943) for the proposition that “constitutional provisions must be construed in light of conditions existing at the time of adoption”).
The IRS then solidified its position by citing the Texas Supreme Court's earlier statement that "where a power is expressly granted by the Texas Constitution and the means by or the manner in which it is to be exercised is prescribed, that means or manner is exclusive."\(^{56}\)

The IRS also emphasized the extent to which Texas statutory law treated Texas Bank LLCs as corporations, focusing heavily on provisions of the Texas Banking Act (TBA).\(^{57}\) The TBA failed to distinguish between Texas Bank LLCs and other forms of bank charters in the definition of a "state bank."\(^{58}\) This was problematic because the TBA repeatedly applied the Texas Business Corporations Act and the Texas Miscellaneous Corporation Laws Act to all state banks.\(^{59}\) For example, one provision granted state banks all the powers of a Texas business corporation.\(^{60}\) Similarly, certain provisions of the TBA specifically incorporated corresponding sections of the Texas Business Corporations Act.\(^{61}\) The IRS also noted that the definition of "corporation" in the Texas Miscellaneous Corporation Laws Act included entities organized under the TBA.\(^{62}\)

2. If a Bank Is "Incorporated" Under the FDIA, it Will Not Be Considered an "Unincorporated Entity" for the Purposes of the Internal Revenue Code

The IRS also found support for its conclusion that the Texas Bank LLC was a corporation, *per se*, in the statutory language of the FDIA.\(^{63}\) The FDIA authorizes the FDIC to grant deposit insurance to "any depository institution which is engaged in

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56. *Id.* (quoting *Walker v. Baker*, 196 S.W.2d 324, 327 (Tex. 1946)).
57. *Id.*
59. *Id.*
60. See *id.*
61. *Id.* The TBA simply deferred to the Texas Business Corporations Act for the governance of the "establishment of a series of participation shares... declaration and payment of pro rata share dividends... [and] maintain[ance of] corporate books and records in a home office." *Id.*
62. *Id.*
the business of receiving deposits.” A “depository institution” is defined as “any bank or savings association,” and “bank” includes any “State bank.” The FDIA defines “State bank” as any bank “engaged in the business of receiving deposits . . . and . . . incorporated under the laws of any State.” Thus, the Texas Bank LLC must be “incorporated,” as that term is used in the FDIA, to be eligible for federal deposit insurance.

The IRS began its analysis by assuming that the Texas Bank LLC would be “incorporated” under the FDIA. It based this conclusion on a letter written to the FDIC by the Texas Department of Banking, maintaining that the Texas Bank LLC would be “incorporated” under the FDIA and thus eligible for deposit insurance. However, as “incorporated” is not defined by the FDIA, to assign meaning to this assumption the IRS first had to interpret that term as used in the FDIA. The IRS interpreted the FDIA, as it did the Texas Constitution, finding the existence of alternate entity structures at the time of its drafting to be dispositive proof that Congress intended the term “incorporated” to carry its traditional meaning, to create a corporation; had Congress intended otherwise, it would have used a broader term.

The IRS then turned to 26 U.S.C. § 581 of the Internal Revenue Code, which “defines the term bank for most purposes of the code” as “a bank or trust company incorporated and doing

64. 12 U.S.C. § 1815(a)(1) (2003) (emphasis added) (this provision has not changed since the writing of Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995)).
65. Id. § 1813(c)(1) (2003) (emphasis added) (this provision has not changed since the writing of Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995)).
66. Id. § 1813(a)(1) (2003) (emphasis added) (this provision has not changed since the writing of Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995)).
67. Id. § 1813(a)(2) (2003) (emphasis added) (this provision has not changed since the writing of Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995)).
68. See id.
70. Id.; see also Letter from Everette D. Jobe, General Counsel, Texas Department of Banking, to Douglas H. Jones, Acting General Counsel, Federal Deposit Insurance Corporation (Oct. 26, 1994), available at http://www.fdic.gov/regulations/laws/federal/02cTEXDEPART.pdf.
72. See id.
73. See id.
Stating that "[w]ithout explicit evidence to the contrary, the same term used in two federal statutes enacted close in time should be interpreted consistently," the IRS applied its narrow interpretation of "incorporated," as used in the FDIA (adopted in 1933), to the use of "incorporated" in § 581 (adopted in 1936). This conclusion had two ramifications. First, the IRS appeared to be asserting that a bank must actually incorporate to meet the definition of "bank" in § 581. This is the inescapable consequence of linking "incorporated" in § 581 to the IRS's interpretation of that term in the FDIA. Second, and more importantly the IRS used § 581 as a conduit to apply this narrow definition of "incorporated" to the entire Internal Revenue Code (IRC) and, specifically, to entity classification, stating:

[I]f you represent that [the Texas Bank LLC] is a state law corporation under the FDIA, it follows that [the Texas Bank LLC] is a state law corporation under the Code. We are unable to reconcile your conflicting positions presented to the two federal agencies with respect to the term "incorporated."

3. The Functional Impact of these IRS Positions

The first prong of the IRS's argument, that the Texas Bank LLC is a corporation because of its treatment under Texas law, could at best be remedied by a revision of the applicable statutes,

76. See id. Banks meeting the definition of "bank" in § 581 may be eligible under 26 U.S.C. § 585 to use the reserve method of accounting for bad debts, allowing them to take a deduction for bad debts before they are actually written off. 26 U.S.C. § 585 (2003); see Levy, supra note 11, at 81.
77. Cf. Proposed Simplification of Entity Classification Rules, supra note 38, at 21,991 (applying the narrow definition of "incorporated" to § 581).
and at worst by an amendment to the state constitution. However, the second argument — that the Texas Bank LLC was a corporation for tax purposes if it was "incorporated" for the purposes of the FDIA — placed the Texas Bank LLC in a seemingly irreconcilable quandary. This position by the IRS made deposit insurance and pass-through taxation mutually exclusive by definition, a result that had a chilling effect on the movement of state legislatures to authorize Bank LLCs.

### B. The Simplification of the Entity Classification Rules

On December 18, 1996 the IRS promulgated a group of regulations (Simplification Regs), a large portion of which eliminated the Characteristic Test and replaced it with an elective regime (Check-the-Box Regs). The Simplification Regs reaffirm the position taken by the IRS in the 1995 private letter ruling (PLR). In fact, they codify the IRS's application of "incorporated," as used in the FDIA, to § 581 and to the determination of whether an entity is a corporation, per se.

Just as the Characteristic Test applied only to "unincorporated entities," the Check-the-Box Regs only allow those entities "not classified as a corporation" to elect their tax classification. The regulations then define "corporation" to include any "State-chartered business entity conducting banking activities, if any of its deposits are insured under the [FDIA]." Thus, the Check-the-Box Regs codify the IRS's assertion in the PLR that if an entity is "incorporated" under the FDIA, it will be

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79. See supra text accompanying notes 52-62.
80. See Dreyer, supra note 9, at 584-85.
81. Id.
82. See Final Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584 (Dec. 18, 1996) (codified at Treas. Reg. §§ 301.7701-1, -2, -3). These regulations are commonly referred to as the "Check-the-Box" regulations because of the elective system they put into place. See Annette Nellen, Tax Aspects of Business Transactions: A First Course 109 (1999). Under these regulations, eligible entities may elect their tax status simply by checking a box on a form filed with the IRS (Form 8832). See id.
83. See infra text accompanying notes 85-100.
84. See infra text accompanying notes 85-100.
treated as a corporation under the IRC. The IRS’s explanation of this provision in the proposed regulations further reinforces the link with the PLR. In that explanation the IRS states: “[t]his rule reflects Congress [sic] requirement that these organizations be incorporated to be eligible for federal deposit insurance.”

The reference to congressional intent is no doubt anchored in the IRS’s view that Congress must have intended “incorporated” to have the same restricted meaning in FDIA and § 581.

However, the Check-the-Box Regs go beyond both the PLR, which applied only to the Texas Bank LLC, and the provision applying to state-chartered banks just described. The Check-the-Box Regs also preclude any federally chartered bank from being eligible to elect pass-through taxation. They achieve this by including in the definition of “corporation” “a business entity organized under a Federal or State statute . . . if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic.” This language matches that of 12 U.S.C. § 24, which describes the charter of a national bank as creating “a body corporate.” Thus, even if a federal LLC charter were an option, without an amendment to § 24 a federally chartered Bank LLC would also be considered a corporation, per se. The IRS’s explanation of the rule in the proposed regulation reveals that this was an intended consequence, stating that the definition of “corporation” achieves the goal of “provid[ing] comparable tax treatment to state-chartered banks and national banks chartered under the National Bank Act.”

87. See supra text accompanying notes 63-78.
88. Proposed Simplification of Entity Classification Rules, supra note 38, at 21,991.
89. Id.
90. See supra text accompanying notes 63-78.
91. See infra text accompanying notes 92-96.
92. See Proposed Simplification of Entity Classification Rules, supra note 38, at 21,991.
95. See supra notes 92-94 and accompanying text.
96. Proposed Simplification of Entity Classification Rules, supra note 38, at 21,991.
Finally, the Simplification Regs also officially codify the IRS's finding in the PLR that Congress intended "incorporated" to have that same meaning in the FDIA and § 581. They achieved this by amending the regulations to § 581 to require that an entity be "a corporation for federal tax purposes" to qualify for § 581 treatment.

The close correlation between the wording and structure of the Simplification Regs and the PLR indicates that the conclusions set forth in the PLR remain the ones that continue to drive the IRS's insistence that banks be taxed as corporations, regardless of the entity structure created by their charter. However, since the issuance of the PLR in September, 1995, several events have called into question whether the logic in the PLR remains sound.

III. EVALUATING THE IRS'S POSITION: REGULATORY DEVELOPMENTS

A. New Structure of State Bank LLC Statutes

As noted above, the IRS assigned great significance to its finding that "for most purposes of the Texas Banking Act, [Texas Bank LLCs] are considered corporations." The Texas Limited Banking Act (TLBA) created a totally new entity structure, "patterned after the LLC concept, altering the design only where necessary to conform to bank regulatory requirements." However, as noted in the PLR, the statutes set in place by the TLBA treated Texas Bank LLCs as corporations in many ways, deferring governance of certain aspects of the Texas Bank LLC to the Texas Business Corporation Act.

97. Id. at 21,991; see Final Simplification of Entity Classification Rules, supra note 82, at 66,588.
98. See Final Simplification of Entity Classification Rules, supra note 82, at 66,588.
99. Compare supra text accompanying notes 52-78, with supra text accompanying notes 82-98.
100. See infra text accompanying notes 101-180.
101. See supra notes 52-62 and accompanying text.
103. See Dreyer, supra note 9, at 582.
Despite the failure of the TLBA, several states have subsequently extended to banks the ability to form as an LLC.\textsuperscript{105} In doing so, at least two of them, Maine and Vermont, did not create a separate entity structure as did the TLBA.\textsuperscript{106} Instead, they simply applied their general LLC statutes to Bank LLCs.\textsuperscript{107} This method of extending LLC status to banks should remedy many of the pitfalls encountered by the TLBA by eliminating the application of the general corporate statutes to Bank LLCs.\textsuperscript{108} A further analysis of the constitutions and banking statutes of these states would be required to definitively state that they are devoid of the problems that plagued the TLBA.\textsuperscript{109} While that analysis is beyond the scope of this article, the point should stand that legislative ingenuity is up to the task of creating a Bank LLC not treated as a corporation by state law.\textsuperscript{110}

B. Subchapter S and the Small Business and Job Protection Act

Congress first created Subchapter S in 1958 with the "basic purpose of eliminating the effect of tax consequences on the choice of business form by small businesses."\textsuperscript{111} Subchapter S accomplished this by permitting "small corporations that more nearly resembled partnerships to enjoy the advantages of the corporate form without being subjected to any tax disadvantages of incorporating."\textsuperscript{112} However, financial institutions were traditionally precluded from electing taxation under Subchapter S.\textsuperscript{113} One reason for this distinction lies in the fact that banks have

\begin{itemize}
\item \textsuperscript{105} See supra note 23 and accompanying text.
\item \textsuperscript{106} See Dreyer, supra note 9, at 585.
\item \textsuperscript{107} Id. (citing ME. REV. STAT. ANN. tit. 9-B, § 311 (2002); VT. STAT. ANN. tit. 8, § 12101 (2002)).
\item \textsuperscript{108} Compare supra text accompanying notes 52-62, with supra text accompanying notes 105-107.
\item \textsuperscript{109} A cursory analysis of the Vermont and Maine constitutions indicates that, unlike the Texas Constitution, they do not include provisions specifically governing the creation of financial institutions. Compare TEX. CONST. art. XVI, § 16(a), with ME. CONST., and VT. CONST.
\item \textsuperscript{110} See supra text accompanying notes 105-108.
\item \textsuperscript{111} Gomez, supra note 1, at 303.
\item \textsuperscript{112} Id.
\item \textsuperscript{113} Michael Duane Jones, S Banks: Should Banks Convert to S Corporations?, 4 N.C. BANKING INST. 627 (2000).
\end{itemize}
historically benefited from "a substantial tax break by being allowed to use methods of accounting for bad debts that were more generous than those permitted other taxpayers." 114 Over time, however, Congress has whittled away at these accounting benefits. 115 Recognizing this, in 1996 Congress relented and, with the Small Business and Job Protection Act, extended the option of electing to be taxed under Subchapter S to banks. 116

Thus, just one year after the IRS determined in the PLR that banks were corporations, per se, seemingly cementing the banking industry's fate to endure double taxation, Congress extended to banks the pass-through taxation benefits of Subchapter S. 117 However, this change in access to pass-through taxation does nothing to undermine the IRS's logic in the PLR that banks are corporations, per se. 118 This is because Subchapter S is simply a decision by Congress to extend pass-through taxation to certain corporations meeting a very specific set of criteria. 119 Thus, the IRS's decision that all banks are corporations remains undisturbed. 120

However, the resulting regime, which allows banks to receive pass-through taxation under Subchapter S while prohibiting access to pass-through taxation through the LLC structure, appears somewhat counterintuitive. 121 Corporations electing to be taxed under Subchapter S (S Corps) are highly restricted as to both the number and character of their shareholders. 122 S Corps are restricted to a maximum of seventy-five shareholders; 123 only one class of stock; 124 and only certain

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115. Id. at 649.


118. See infra text accompanying notes 119-120.


120. See supra text accompanying notes 63-78.

121. See infra text accompanying notes 122-129.

122. See Jones, supra note 113, at 630-34.

individuals, estates, and certain trusts may own their shares. These restrictions impair the ability of banks organized as S Corps to raise capital. Any restriction on access to capital is especially onerous for banks because their capital is subject to close regulatory scrutiny; “[a]s capital declines, more intense and intrusive regulatory attention can be expected.” Thus, an entity structure severely limiting the ability to raise capital is particularly ill suited for banks. Conversely, the LLC structure could afford pass-through taxation without the burdensome restrictions on access to capital.

C. FDIC Extends Deposit Insurance to Bank LLC’s

On February 13, 2003, the FDIC promulgated a final regulation, 12 C.F.R. § 303.15, that made certain state banks chartered as LLCs eligible for deposit insurance. The regulations accomplished this by expanding the FDIC’s interpretation of “incorporated,” as used in the FDIA, to include entities “chartered as an LLC under State law” and possessing the “four traditional, corporate characteristics” (State Bank LLCs). This change in policy, of course, did not affect the fact that, as concluded in the PLR and codified in the Check-the-Box Regs, any entity receiving deposit insurance will be considered a corporation, per se, by the IRS. Further, if the IRS

124. Id. § 1361(b)(1)(D).
125. Id. § 1361(b)(1)(B)-(C).
126. Jones, supra note 113, at 636 (citing Raymond J. Gustini, Here Come the S Banks, AMERICA’S COMMUNITY BANKER, June 1, 1999, at 34).
127. BROOME & MARKHAM, supra note 19, at 522. See generally BROOME & MARKHAM, supra note 19, at 509-28 (discussing bank capital requirements).
128. See supra notes 122-127 and accompanying text.
129. See Dreyer, supra note 9, at 583.
131. See supra text accompanying notes 64-68.
132. Insurance of State Banks Chartered as Limited Liability Companies, supra note 130. The four characteristics are those used in the Characteristic Test. See id.; supra notes 33-36 and accompanying text.
133. See Laura K. Thompson, The Case for LLC Option Still Being Heard, AM. BANKER, Oct. 31, 2002, at 5. This is because the Check-the-Box Regs codify that concept, including in the definition of “corporation” any entity to which deposit insurance is extended. See supra text accompanying notes 85-87.
still used the Characteristic Test to determine taxation of unincorporated entities, State Bank LLCs would be taxed as corporations regardless of whether they were classified as corporations, \textit{per se}, as they would necessarily possess all four corporate characteristics.\textsuperscript{134} However, under the Check-the-Box Regs, which treat LLCs as partnerships by default, the lone barrier to pass-through taxation for State Bank LLCs is their classification by the IRS as corporations, \textit{per se}.\textsuperscript{135} Thus, § 303.15 exposes the IRS to the question of whether its policy of linking tax classification of state banks to the FDIA remains justified.\textsuperscript{136}

On the surface, the IRS's rationale seems to have been preserved by § 303.15.\textsuperscript{137} After all, in the PLR the IRS concluded that an entity “incorporated” for the purposes of the FDIA must also be “incorporated” for the purposes of the IRC, and § 303.15 simply brings State Bank LLCs within the FDIA definition of “incorporated.”\textsuperscript{138} In addition, many commentators feel that by requiring the State Bank LLCs to possess all four corporate characteristics,\textsuperscript{139} the FDIC further reinforced the IRS's position that all entities receiving deposit insurance should be considered corporations, \textit{per se}.\textsuperscript{140}

However, § 303.15 marks a philosophical departure from the IRS's previous position. In the PLR the IRS interpreted the FDIA to require that an entity be incorporated in the traditional sense to be eligible for deposit insurance, while simply viewing the FDIA in the context of the general legislative environment.\textsuperscript{141} In contrast, the FDIC, in promulgating § 303.15, views the statute in a

\begin{enumerate}
\item[134.] \textit{See supra} text accompanying notes 130-132.
\item[135.] \textit{See supra} text accompanying notes 30-40.
\item[136.] \textit{See supra} text accompanying note 135.
\item[137.] \textit{See infra} text accompanying notes 138-140.
\item[138.] \textit{See Insurance of State Banks Chartered as Limited Liability Companies, supra} note 130, at 7306-07.
\item[139.] \textit{See supra} text accompanying notes 31-36.
\item[140.] \textit{See}, e.g., Dreyer, \textit{supra} note 9, at 608-09. It should also be noted, however, that in installing the Check-the-Box regime, the IRS determined that corporate characteristics were no longer an efficient nor an entirely accurate means of classifying entities. \textit{See Final Simplification of Entity Classification Rules, supra} note 82, at 66,585.
\item[141.] \textit{See supra} text accompanying notes 63-78 (noting that the IRS anchored its interpretation of “incorporated” to the presence of alternative business forms, such as the limited partnership).
\end{enumerate}
more specific context.\textsuperscript{142} Citing the absence of any pertinent legislative history or judicial interpretation, the FDIC concluded that "the best approach is to interpret the term ["incorporated"] in a manner consistent with, and in aid of, the purpose of the FDI[A]."\textsuperscript{143} The FDIC then explained that it was created by the FDIA, "to restore and maintain public confidence in the nation's banking system by, among other things, promoting the safety and soundness of the institutions whose deposits the FDIC insures."\textsuperscript{144} Accordingly, the FDIC concluded that:

limiting the interpretation to only those entities that are labeled as "corporations" would seem unduly restrictive in that it would tend to unnecessarily limit the flexibility, and stifle the innovativeness, of State banking. Thus, such an approach could arguably impair or harm the viability of the nation's banking system.\textsuperscript{145}

Thus, in reaching the conclusion that State Bank LLCs will be considered "incorporated," the FDIC abandons the traditional definition applied by the IRS in favor of an interpretation that "focus[es] on the attributes of the entity," stating "[c]learly, the actual nature of an entity is much more important than its label [under state law]."\textsuperscript{146}

This finding by the FDIC, that Bank LLCs should be eligible for deposit insurance even though not incorporated in the traditional sense, is the very prospect argued unsuccessfully by the taxpayer in the PLR.\textsuperscript{147} The IRS's rejection of that argument served as the foundation for its conclusion that eligibility for both federal deposit insurance and for classification as an unincorporated entity must be considered mutually exclusive.\textsuperscript{148}

\textsuperscript{142} See Insurance of State Banks Chartered as Limited Liability Companies, supra note 130.
\textsuperscript{143} Id. at 7306.
\textsuperscript{144} Id.
\textsuperscript{145} Id.
\textsuperscript{146} Id. at 7306-07.
\textsuperscript{147} See supra text accompanying notes 45-50.
\textsuperscript{148} See supra text accompanying notes 63-81.
Accordingly, the FDIC's ruling that some entities not incorporated in the traditional sense are eligible for deposit insurance erodes the very foundation upon which the IRS's current position is based.149

Further eroding that foundation is the Supreme Court's assertion in Cottage Savings Association v. Commissioner of Internal Revenue (Cottage Savings)150 that the IRS's interpretative powers are properly confined to the IRC.151 In Cottage Savings, the IRS tried to link its interpretation of the IRC provision governing when a taxpayer realizes a gain or loss to regulations promulgated by the Federal Home Loan Bank Board (FHLBB).152 The FHLBB was a federal administration created to regulate the savings and loan (S&L) industry; it had a relationship with that industry not dissimilar to the FDIC's relationship with the banking industry.153 The dispute in Cottage Savings centered around "Memorandum R-49," an attempt by the FHLBB to alleviate mounting financial pressure on the S&L industry.154 Memorandum R-49 allowed S&L's to defer recognition of losses for financial purposes when exchanging mortgages that were "substantially identical."155 The FHLBB acknowledged that the purpose of Memorandum R-49 was to allow S&L's to generate tax losses while avoiding corresponding financial recognition.156

149. See supra text accompanying notes 147-148.
151. See infra text accompanying notes 152-167.
152. Id. at 562. 26 U.S.C. § 1001 is the gain/loss provision discussed in Cottage Savings. Id.
153. See BROOME & MARKHAM, supra note 19, at 81-83 (stating that the FHLBB provided depository insurance for S&Ls while also serving a regulatory function).
154. Cottage Sav. Ass'n, 499 U.S. at 557. At this time many S&Ls were saddled with fixed, long term mortgages that were steadily decreasing in value due to rising interest rates. See BROOME & MARKHAM, supra note 19, at 102-23. Though the S&Ls would have benefited from selling the devalued mortgages, and recognizing the losses for tax purposes, they were reluctant to do so because of the corresponding financial losses that would have been incurred. Id. The S&Ls were particularly sensitive to financial losses due to the strict capital requirements placed on financial institutions. Id.
155. Cottage Sav. Ass'n, 499 U.S. at 557. Memorandum R-49 even included a list of factors that must be present in the exchange to achieve financial deferral to assure that the loans exchanged were virtually identical. Id. n.2.
156. Id. at 557.
The IRS argued that the loan did not trigger a tax loss pursuant to the appropriate standard for determining when this kind of transaction constituted a realization event for tax purposes, whether the properties exchanged were "materially different."\(^{157}\) The IRS pointed to the inconsistency of allowing the same transaction to be deemed "substantially identical" under regulations promulgated by the FHLBB while also being treated as "materially different" under regulations promulgated by the IRS.\(^{158}\) The Fifth Circuit\(^{159}\) and the District of Columbia Circuit,\(^{160}\) in opinions cited and not distinguished by the Court in Cottage Savings, which had previously addressed this argument by the IRS, rejected the IRS's reasoning, asserting that "the FHLBB is not in the business of interpreting the Internal Revenue Code. So also the IRS is not supposed to interpret the Federal Home Loan Bank Act."\(^{161}\) This assertion, that the IRS should not interpret non-tax statutes, tears at the very structure of the PLR.\(^{162}\)

However, the court in Cottage Savings does not appear to limit its finding to assigning the right of statutory interpretation.\(^{163}\) In stating that "there is no reason not to treat the exchange of these interests as a realization event, regardless of the status of the mortgages under the criteria of Memorandum R-49,"\(^{164}\) the Court seemed to assert that the classification of the transaction under the Federal Home Loan Bank Act is not relevant to the determination of the proper application of the IRC.\(^{165}\) The Court in Cottage Savings was not oblivious to the benefit afforded the taxpayer by allowing it to interpret two nearly identical federal regulations in

\(^{157}\) Id. at 560. § 1001 requires recognition of gain or loss, among other things, upon "disposition" of property. Id. at 559. The standard asserted by the IRS and agreed to by the Court for the application of §1001 required that an exchange of property be treated as a "disposition" "only if the properties exchanged are materially different." Id. at 560 (emphasis added).

\(^{158}\) Cottage Sav. Ass'n, 499 U.S. at 566-7.

\(^{159}\) San Antonio Sav. Ass'n v. Comm'r of Internal Revenue, 887 F.2d 577, 591 (5th Cir. 1989).


\(^{161}\) San Antonio Sav. Ass'n, 887 F.2d at 591.

\(^{162}\) See supra text accompanying notes 63-72.

\(^{163}\) See infra text accompanying notes 164-167.


\(^{165}\) See id.
different ways. Instead, it simply held that the interpretation of one phrase holds no logical bearing on the interpretation of the other. Perhaps the Court is inherently stating that each statute must be interpreted within the context of its purpose, a prospect that further validates the FDIC's interpretation of the FDIA.

D. National Bank LLCs

The Financial Services Regulatory Relief Act of 2003 would change the language of 12 U.S.C. § 24, which currently describes the entity created by a federal charter as "a body corporate," to read: "[u]pon duly making and filing articles of association . . . a national banking association shall become . . . a body corporate or other form of business organization provided under regulations prescribed by the Comptroller of the Currency under section 5136C." The effect of this change is best seen through the language of the Check-the-Box Regs, which currently classify as a corporation, per se, "a business entity organized under a Federal or State statute . . . if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic." Thus, banks organized under a federal charter issued pursuant to regulations creating "other form[s] of business" would not fall within the Check-the-Box Regs's definition of a corporation, per se, and therefore would be eligible to elect their tax status. Additionally, if the bill passes, the power that it vests in the Office of the Comptroller of the Currency would not likely lie idle. On January 31, 2003, Comptroller of the Currency John D. Hawke, after voting as a member of the Board of Directors of the FDIC to approve § 303.15, commented that the Office of the

166. Id. at 557.
167. See id. at 567.
168. See supra text accompanying notes 91-96.
171. See id.
172. See Rebecca Christie, FDIC OKs Plan To Let Insured State Banks Be LLCs, 1/31/03 DOW JONES CAPITAL MARKETS REPORT 15:47:00.
Comptroller of the Currency (OCC) planned to construct a rule allowing national banks to form as LLCs. The passage of this bill combined with corresponding action by the OCC would pave the way for national banks to organize as LLCs that would be eligible for deposit insurance and pass-through taxation.

This bill, however, would only facilitate the realization of a national Bank LLC. Thus, absent a corresponding amendment to the FDIA to allow deposit insurance to be extended to unincorporated state banks, banks seeking to organize as LLCs would be forced to pursue a national charter. Another alternative includes the possibility that passage of the Financial Services Regulatory Relief Act would force the IRS to amend the Check-the-Box Regs to extend pass-through taxation to State Bank LLCs as well. In the Simplification Regs, the IRS speaks approvingly of “provid[ing] comparable tax treatment to state-chartered banks and national banks chartered under the National Bank Act.” Thus, if the Financial Services Regulatory Relief Act is passed, the IRS will likely feel pressure to abandon the classification of banks as corporations, per se, altogether. However, unless and until Congress adopts this bill, the position of the IRS remains intact.

173. *Id.* Because the IRS takes the position that the National Bank Act authorizes the OCC only to create a “body corporate” any LLC charter created by the OCC, without changes made thereto by Congress, would not change the basis or effect of the IRS’s position. See *id.*; supra text accompanying notes 91-96. This comment by Hawke appears to indicate a change of heart by the Comptroller, as he previously objected to the issuance of the FDIC opinion, commenting that “the FDIC should not be used as ‘a pawn to apply pressure to the IRS.’” See Thompson, *supra* note 133, at 5.

174. See *supra* text accompanying notes 168-173.

175. See Financial Services Act § 110, *supra* note 24; *supra* text accompanying notes 168-171.

176. See *supra* text accompanying notes 19-24.

177. See *infra* text accompanying notes 178-179.


179. See *supra* note 178 and accompanying text.

180. See *supra* notes 91-96 and accompanying text.
IV. Conclusion

The IRS has traditionally classified any bank organized as an LLC as a corporation, *per se*.\(^{181}\) The foundation for this policy was outlined by the IRS in the PLR, in which the IRS buttressed its conclusion with two contentions.\(^{182}\) The first prong of the IRS’s findings in the PLR involved Texas statutory and constitutional provisions which treated a State Bank LLC formed under Texas statutory authority as a corporation.\(^{183}\) Because states have subsequently structured their statutes differently than the Texas Bank LLC statute, this position is not likely to apply to later statutes that extend the LLC form to banks.\(^{184}\) Thus, whether the IRS’s continued treatment of Bank LLCs as corporations, *per se*, remains valid hinges on the IRS’s remaining contention.\(^{185}\)

The second prong of the IRS’s argument in the PLR rested on its interpretation of the FDIA’s extension of deposit insurance to state banks which are “incorporated.”\(^{186}\) Once it interpreted the FDIA to require actual incorporation, the IRS concluded that any bank eligible for deposit insurance would be considered a corporation, *per se*, for tax purposes.\(^{187}\) This treatment was later extended to national banks by the Check-the-Box Regs, which treat all federally chartered banks as corporations, *per se*, as well.\(^{188}\) Recently, however, the FDIC has promulgated regulations that conflict with the IRS’s interpretation of the FDIA, concluding that certain, unincorporated entities fall within the FDIA’s use of the term “incorporated.”\(^{189}\) The FDIC, focusing on Congress’s intent in adopting the FDIA, concludes that limiting banks to only the corporate form “would seem unduly restrictive in that it would tend to unnecessarily limit the flexibility, and stifle the innovativeness of State banking. Thus, such an approach could

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181. See *supra* text accompanying notes 30-40.
182. See *supra* text accompanying notes 30-40.
183. See *supra* text accompanying notes 52-62.
184. See *supra* text accompanying notes 101-110.
185. See *supra* text accompanying notes 181-184.
186. See *supra* text accompanying notes 63-78.
187. See *supra* text accompanying notes 63-78.
188. See *supra* text accompanying notes 91-96.
189. See *supra* text accompanying notes 130-167.
arguably impair or harm the viability of the nation’s banking system.”¹⁹⁰ Further, the Court’s language in Cottage Savings confirms the definition of “incorporated” in the FDIA should not be determinative of its meaning in the IRC.¹⁹¹

However, despite this fundamental erosion of the justification for the IRS’s decision to treat State Bank LLCs as corporations, per se, these regulations do not have a compulsory effect on the IRS and are not likely to instigate a policy change. Ironically, some in Congress seem to agree with the IRS’s interpretation of the National Bank Act, but it is this arena which may yield substantive change, as Congress is considering action to circumvent that interpretation.¹⁹² It is likely that this very action by Congress is the sole event that would precipitate a change in the taxation of Bank LLCs.¹⁹³

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¹⁹⁰. Insurance of State Banks Chartered as Limited Liability Companies, supra note 130, at 7306.
¹⁹¹. See supra text accompanying notes 150-167.
¹⁹². See supra text accompanying notes 168-180.
¹⁹³. See supra text accompanying notes 168-180.