

# Lesson 13

## Bank Qualified Bonds – Section 265

### Overview

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#### Introduction

Lesson 13 covers qualified tax-exempt obligations, also known as bank qualified bonds. This lesson is an overview of the requirements related to bank qualified bonds

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#### Objectives

At the end of this lesson, you will be able to:

- Define the general rules for interest expense disallowance on tax-exempt indebtedness
  - Define the exception for qualified tax-exempt obligations
  - Define the TEFRA rule related to qualified tax-exempt bonds
  - Identify ARRA Provisions: Special rules for obligations issued during 2009 and 2010
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## Overview, Continued

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## Legislative History

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### Overview

As a general rule, a nonbank taxpayer cannot deduct expenses or interest incurred in connection with acquiring or carrying assets that produce tax-exempt interest. Historically, banks were not subject to these rules. As such, a bank could deduct interest and other expenses on indebtedness incurred in the ordinary course of business where the expenses were not directly related to the purchase of tax-exempt bonds.

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### Historical Background

The deduction of interest expense related to tax-exempt bonds was scaled back under § 291(a)(3) enacted, effective for tax years beginning after December 31, 1982. Section 291(a)(3) was enacted as part of “*The Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA).” This provision disallowed 15% of the “allowable” related interest expense for “financial institution preference items.” The Tax Reform Act of 1984 increased the disallowance of the interest expense deduction as a tax preference item from 15 percent to 20 percent for municipal securities purchased after December 31, 1982. The amount of the allowable related interest expense subject to the 20% deduction disallowance under § 291 is calculated based on a portion of the interest expense deduction claimed by a bank attributable to its investment in tax-exempt obligations.

The term “financial institution preference item” includes: “In the case of a financial institution which is a bank (as defined in [section 585\(a\)\(2\)](#)), the amount of interest on indebtedness incurred or continued to purchase or carry obligations acquired after December 31, 1982, and before August 8, 1986, the interest on which is exempt from taxes for the taxable year, to the extent that a deduction would (but for this paragraph or [section 265\(b\)](#)) be allowable with respect to such interest for such taxable year.” See section 291(e)(1)(B)(i).

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## Legislative History, Continued

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**Historical  
Background**  
(continued)

The Tax Reform Act of 1986 expanded the 20% disallowance rules under § 291 by adding § 265 to the Code effective for tax years beginning after December 31, 1986. Section 265(a) provides in part that “no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax.” The general rule under § 265(a)(2) is that 100 percent of a financial institution’s interest expense allocable to tax exempt income on obligations acquired after August 7, 1986 is disallowed as a deduction. However, § 265(b)(3) provides an exception to this general for *qualified* tax exempt obligations. Moreover, qualified tax exempt obligations acquired after August 7, 1986 are treated as acquired by a financial institution on August 7, 1986 for purposes of applying § 265(b)(2), allocation rules to determine the allowable amount of interest expense before any adjustments, and for applying § 291(e)(1)(B), the 20% disallowance of interest expense for financial institution preference items.

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## General Rules

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### Statutory Provisions

Section 265 provides the requirements for expenses and interest relating to tax exempt income:

(a) **General Rule:** No deduction shall be allowed for:

(1) **Expenses:** Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under [section 212](#) (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

(2) **Interest:** Interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle.

- This is generally referred to as the carrying cost (i.e. the interest expense incurred to purchase or carry an inventory of municipal securities) of tax exempt bonds which financial institutions may not deduct.

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### Regulations

Treas. Reg. §§ 1.265-1 and -2 provide rules for expenses and interest relating to tax exempt income and -3 provides rules for non-deductibility of interest relating to exempt interest dividends.

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## General Rules, Continued

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**Definition of  
Interest  
Expense**

Section 265(b)(4)(A) defines interest expense as the aggregate amount allowable to the taxpayer as a deduction for interest for the taxable year (determined without regard to this subsection, section 264 and section 291). For purposes of the preceding sentence, the term “interest” includes amounts (whether or not designated as interest) paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares.

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**Definition of  
Financial  
Institution**

Section 265(b)(5) defines a “financial institution” as any person who:

- accepts deposits from the public in the ordinary course of such person’s trade or business and is subject to Federal or State supervision as a financial institution, or
  - is a corporation described in § 585(a)(2)
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## Financial Institutions and Interest Expense

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### General Rule

Section 265(b)(1) provides that in the case of a financial institution, no deduction shall be allowed for the portion of the taxpayer's interest expense which is allocable to tax-exempt interest.

This rule is designed to prevent taxpayers from excluding from taxable income the interest income earned on tax-exempt securities while at the same time deducting interest expense used to purchase the investments.

Section 265(b)(1) is effective for tax years ending after December 31, 1986.

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### Interest Expense Disallowance

Application of the interest expense rules to financial institutions:

- § 265(a)(2) disallows 100% of the interest expense incurred to carry or purchase tax exempt obligations.
  - § 265(b)(3) excepts “qualified tax exempt obligations” also commonly known as “bank qualified obligations” from the 100% disallowance of § 265(a)(2).
  - § 265(b)(3) treats “qualified tax exempt obligations” issued after August 7, 1986 as issued on August 7, 1986 for purposes of §291(e)(1)(B), financial institution preference items.
  - § 291(e)(1)(B) financial institution preference items are subject to § 291(a)(3) 20% disallowance of tax exempt interest expense for obligations issued before August 8, 1986.
  - § 291 applies to § 265(b)(3) bank qualified obligations to reduce the interest expense allowable to carry or acquire tax exempt obligations by 20%.
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## Interest Expense Disallowance

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### **Pro Rata Allocation of Interest Expense of Financial Institutions to Tax-Exempt Interest**

Section 265(b) applies generally to obligations acquired after August 7, 1986. This section provides the formula to determine the pro rata allocation of interest expense of a financial institution to tax exempt interest as a determination of the financial institution's interest expense deduction.

Section 265(b)(2) provides:

- that for purposes of paragraph (b)(1), the portion of the taxpayer's interest expense which is allocable to tax-exempt interest is an amount which bears the same ratio to such interest expense as—
    - (A) the taxpayer's average adjusted bases (within the meaning of [section 1016](#)) of tax-exempt obligations acquired after August 7, 1986, bears to
    - (B) such average adjusted bases for all assets of the taxpayer
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## Exception for Certain Tax-Exempt Obligations

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### Introduction

Section 265(b)(3) provides an exception to the general rule disallowing a deduction for interest expense related to tax exempt obligations.

**Note:** The exception allows financial institutions to deduct interest expense subject to the pro rata allocation rules of § 265(b) and the limitation of § 291(a)(3).

Exception: Section 265(b)(3) provides that any “qualified tax exempt obligation” (QTEO) acquired after August 7, 1986, shall be treated for purposes of:

- Section 265(b)(2) relating to the pro rata allocation of interest expense of financial institutions to tax exempt interest and
- Section 291(e)(1)(B) related to interest on debt to carry tax exempt obligations

as if the QTEO were acquired on August 7, 1986.

Generally, this means that the Code allows a financial institution to deduct 80 percent of the carrying cost of a qualified tax-exempt obligation.

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### Definition of Qualified Tax Exempt Obligation

Section 265(b)(3)(B) states that the term “qualified tax-exempt obligation” means a tax-exempt obligation (1) which is issued after August 7, 1986 by a qualified small issuer; (2) which is not a private activity bond and (3) which is not designated by the issuer for purposes of section 265..

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## Exception for Certain Tax-Exempt Obligations, Continued

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### Qualified Small Issuer

Section 265(b)(3)(C) defines a “qualified small issuer” as:

- with respect to an obligation issued during any calendar year, any issuer, if the reasonably anticipated amount of tax exempt obligations (other than certain obligations described in § 265(b)(3)(C)(ii) including certain current refunding obligations, private activity bonds other than qualified § 501(c)(3) bonds and other specified obligations) that will be issued by the issuer during such calendar year does not exceed \$10,000,000.
  - Section 265(b)(3)(D) addresses the limitations on the amount of obligations which may be designated for purposes of the \$10,000,000 limitation.
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### Certain Bonds Not Treated as Private Activity Bonds

Section 265(b)(3)(B)(ii) states that certain bonds are not treated as private activity bonds.

For purposes of § 265(b)(3)(B), there shall not be treated as a private activity bond:

- any qualified § 501(c)(3) bond (as defined in section 145), or
  - any obligation issued to refund (or which is part of a series of obligations issued to refund) an obligation issued before August 8, 1986, which was not an industrial development bond (as defined in [section 103\(b\)\(2\)](#) as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) or a private loan bond (as defined in [section 103\(o\)\(2\)\(A\)](#), as so in effect, but without regard to any exemption from such definition other than [section 103\(o\)\(2\)\(A\)](#)).
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## Rules under TEFRA – § 291

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### **Introduction**

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) promulgated § 291(a)(3) restricting the deductibility of interest expense for financial institutions that make tax exempt investments in bonds, securities or loans.

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### **TEFRA Limitation Related to Interest Expense Deduction**

Section 291(a)(3) provides that the amount allowable as a deduction with respect to any “financial institution preference item” shall be reduced by 20 percent.

Section 291(a)(3) disallows 20 percent of the related interest expense for qualified tax-exempt, bank qualified obligations. In other words, the Code allows banks to deduct 80 percent of the carrying cost of a qualified tax-exempt obligation.

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## Rules under TEFRA – § 291, Continued

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### Pro Rata Allocation of Interest Expense of Financial Institutions to Tax-Exempt Interest

Section 291(e)(1)(B)(ii) applies generally to obligations acquired after December 31, 1982 and before August 8, 1986 and provides the formula to determine the pro rata allocation of interest expense of a financial institution to tax exempt interest as a determination of the financial institution's interest expense deduction.

Section 291(e)(1)(B)(ii) provides:

- Unless the taxpayer establishes otherwise, the amount determined under the aggregate amount allowable shall be an amount which bears the same ratio to the aggregate amount allowable (determined without regard to this section and section 265(b)) to the taxpayer as a deduction for interest for the taxable year as—
  - (A) the taxpayer's average adjusted bases (within the meaning of [section 1016](#)) of tax-exempt obligations acquired after August 7, 1986, bears to
  - (B) such average adjusted bases for all assets of the taxpayer

**Note:** Although § 265(b)(3) treats all qualified tax exempt obligations as issued on August 7, 1986 subject to this allocation formula, it tracks the allocation formula set forth under § 265(b)(2).

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## Rules under TEFRA – § 291, Continued

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**Formula: IRC  
Sections 265  
and 291**

$$\begin{array}{l} \text{Step 1: } \frac{\text{Average Adjusted Bases of Tax Exempt Obligations}}{\text{Average Adjusted Bases of All Assets}^*} = \% \\ \text{Step 2: } \% \times \text{YTD Interest Expense} = \text{Disallowed Interest Expense } \$ \\ \text{Step 3: } \$ \times 20\% \text{ § 291Rate} = \text{Disallowed Interest Expense } \$ 281^{**} \end{array}$$

**Note:**

\*Rev. Rul. 90-44: Book assets can be used to determine average. Adjusted bases of tax exempt obligations can be based on monthly ending balances. Adjusted bases of all assets held can be based on assets at the end of each quarter.

\*\*Step 3 applies if the requirements of a “qualified tax exempt obligation” are met.

For financial reporting purposes the interest is reported, i.e., included in book income for GAAP. The 20 percent § 291 disallowance represents a permanent M-1 adjustment representing disallowed interest expense for tax purposes. A schedule M-1 adjustment will indicate the total amount of tax free interest received by the bank.

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## Rules under TEFRA – § 291, Continued

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**Financial  
Institution  
Preference Item**

Section 291(e)(1)(B)(iv) provides the following with respect to the term “financial institution preference item”:

- For application of this subparagraph to certain obligations issued after August 7, 1986, see § [265 \(b\)\(3\)](#).
  - In other words, for obligations issued after August 7, 1986 § 291(e)(1)(B)(iv) refers to the § 265(b) pro rata allocation of interest expense rules of financial institutions to tax exempt interest.
  - Generally, for interest on debt to carry tax exempt obligations acquired after December 31, 1982, and before August 8, 1986, see § 291(e)(1)(B).
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## Section 265 and 291 Interaction

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### Section 265 and 291 Applicable Dates

- Interest Expense on Obligations Issued Before August 8, 1986:
  - A financial institution can generally deduct interest expense incurred in the ordinary course of its business.
  - Section 291(a)(3) provides that the amount of interest that a bank incurred to purchase and carry tax-exempt obligations was considered a tax preference item.
  - Section 291(a)(3) provides that the allowable deduction for any financial institution preference item shall be reduced.
  - The term financial institution preference item includes a financial institution's interest expense that is allocable to tax exempt obligations acquired after December 31, 1982, and before August 8, 1986.
  - The Tax Reform Act of 1984 increased the disallowance of the interest expense deduction (for preference items) from 15 percent to 20 percent for securities purchased after December 31, 1982.

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## Section 265 and 291 Interaction, Continued

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**Section 265 and  
291 Applicable  
Dates**  
(continued)

- Interest Expense on Obligations Issued After August 7, 1986:
    - The Tax Reform Act of 1986 significantly changed the rules governing the tax exemption of interest for obligations issued after August 7, 1986.
    - Section 265(b)(1) was added to the Code effective for years after December 31, 1986. This section provides in part that “no deduction shall be allowed for that portion of the taxpayer’s interest expense which is allocable to tax-exempt interest.” In other words, 100 percent of a financial institutions interest expense allocable to tax-exempt income on obligations acquired after August 7, 1986 is not allowed as a deduction.
    - Section 265(b)(2) and 291(e)(1)(B)(ii) both include references to the same allocation formula as setout in the pro rata allocation section. As a note § 291(e)(1)(B)(ii) gives reference to 265(b).
    - Exception: § 265(b)(3) provides that the 100 percent disallowance rule (under paragraph (b)(2) of this section) does not apply to qualified tax-exempt bonds.
  - Interest Expense on Obligations Treated as Issued On August 7, 1986
    - Section 265(b)(3) treats qualified tax exempt bonds for purposes of §§ 265(b)(2) and 291(e)(1)(B) as if they were acquired on August 7, 1986.
    - Section 291(a)(3) 20% disallowance of interest expense applies to qualified tax-exempt bonds issued before August 8, 1986.
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## Other Rules Generally

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### **Aggregation of Issuers**

Section 265(b)(3)(E)(i) provides that for purposes of a qualified small issuer under subparagraph (C) and the limitation on the amount of obligations under subparagraph (D), an issuer and all entities which issue obligations on behalf of such issuer shall be treated as one issuer.

Section 265(b)(E)(ii) and (iii) provide that all obligations issued by a subordinate entity shall, for purposes of applying subparagraphs (C) and (D) to each other entity to which such entity is subordinate; be treated as issued by such other entity and an entity formed to avoid the purposes of subparagraph (C) and (D) and all entities benefitting thereby shall be treated as one issuer.

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### **Treatment of Composite Issues**

Section 265(b)(3)(F) provides that in the case of an obligation which is issued as part of a direct or indirect composite issue, such obligation shall not be treated a a qualified tax exempt obligation unless (i) the requirements of this paragraph are met with respect to such composite issue (determined by treated such composite issue as a single issue) and (ii) the requirements of this paragraph are met with respect to each separate lot of obligations which are part of the issue (determined by treated each such separate lot as a separate issue.)

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## Other Rules Generally, Continued

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### **Subsidiaries of a Financial Institution – Determination of Average Adjusted Basis**

In *PSB Holdings, Inc. v. Commissioner*, the Court rejected the IRS's position that a bank is required under §§265(b) and 291 to include a non-bank subsidiary's tax-exempt obligations that were purchased and owned by the subsidiary in calculating the bank's average adjusted bases of tax-exempt obligations for purposes of determining the bank's interest expense disallowance.

Thus, a financial institution is not required to include the investments of its non-bank subsidiary in calculating its interest expense disallowance under § 265(b).

#### **Note:**

See *PSB Holdings Inc. v Commissioner*, 129 T.C. 131 (2007) , (treatment of investment bank subsidiaries under section 265 and 291) and Rev. Rul. 90-44, 1990-20 IRB 5, 1990-1 CB 54 .

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## ARRA Provisions

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### Introduction

The American Recovery and Reinvestment Act of 2009 (ARRA) modified the provisions of the Internal Revenue Code of 1986, as amended, governing:

- a financial institution's disallowance of its interest expense deduction allocable to tax exempt obligations
  - qualified tax exempt obligations and
  - the application of the alternative minimum tax (AMT) to tax exempt interest
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### Interest Expense Deduction

Section 265(b)(7)(A) provides that tax exempt obligations issued during 2009 or 2010 and held by a financial institution, shall not be taken into account in determining the portion of the financial institution's interest expense subject to the pro rata interest expense deduction disallowance rule under § 265(b)(2)(A) (i.e. the numerator of the pro rata formula related to the average adjusted bases of tax exempt obligations).

**Limitation:** Section 265(b)(7)(B) provides that the amount of tax exempt obligations excluded in 2009 and 2010 will be limited to 2 percent of the average adjusted bases for all assets of the taxpayer under § 265(b)(2)(B) (i.e. the denominator of the pro rata allocation formula).

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## ARRA Provisions, Continued

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### **Qualified Tax Exempt Obligations**

Section 265(b)(3)(G):

- raised the \$10,000,000 qualified small issuer limit to \$30,000,000 for tax exempt obligations issued in 2009 or 2010
  - provided that in the case of a qualified 501(c)(3) bond issued in 2009 or 2010, the 501(c)(3) organization for whose benefit such bond was issued is treated as the issuer for purposes of § 265(b)(3) of the Code. Section 265(b)(3)(G)(iii) provides that section 265(b)(3)(F) restrictions on composite issues shall not apply, and any obligation issued as a part of such issue shall be treated as a qualified tax exempt obligation if the requirements of the paragraph are met with respect to each qualified portion of the issue (determined by treating each qualified portion as a separate issue which is issued by the qualified borrower with respect to which such portion relates.)
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### **Alternative Minimum Tax**

The Act amended §56 of the Code to provide that for new money (non refunding) bonds issued in 2009 and 2010, the interest on private activity bonds will not be treated as a tax preference item for individual and corporate alternative minimum tax (AMT) and the interest on governmental bonds will not be an adjustment to current earnings for purposes of corporate AMT. The temporary relief provided by ARRA also applied to refunding of bonds issued beginning in 2004, provided the refunding bonds are issued before 2011. The relief does not apply to refundings of pre-2004 bonds.

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## Examination Techniques

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**Examination  
Techniques  
Relating to  
Bank Qualified  
Bonds**

For further information regarding examination techniques related to bank qualified bonds, refer to the Department of Treasury IRS Training 3149-104 (05/2001) Catalog Number 89400K, MSSP Commercial Banking, Chapter 18.

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## Summary

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### Review of Lesson 13

This lesson discussed the requirements of bank qualified bonds. These bonds are subject to complex rules and the lesson is not intended to provide a comprehensive discussion of such rules, but rather an overview of relevant considerations.

Generally, the interest expense deduction related to tax exempt obligations are subject to the following rules:

- Section 265(a)(2) disallows a deduction for interest expense related to tax-exempt obligations.
- Section 265(b)(3) provides an exception to the rule that generally disallows the deduction for interest expense.
- Tax-exempt obligations must meet the requirements of a qualified tax-exempt bond for the exception to apply.
- Application of pro rata allocation of interest expense of financial institutions to tax-exempt interest formula to determine interest expense deductibility.
- Application of TEFRA limitation in determining interest expense deductibility.
- Application of ARRA provisions as related to the determination of interest expense deduction, qualified tax-exempt obligations, and alternative minimum tax.

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### Tax References

Section 265; Section 291; Treas. Reg. 1.265-1, -2 and -3; Rev. Rul. 90-44; PSB Holdings Inc. v Commissioner, 129 TC 131 (2007); Department of Treasury IRS Training 3149-104 (05/2001) Catalog Number 89400K

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