DESCRIPTION OF AND BACKGROUND INFORMATION

RELATING TO

REVENUE PROCEDURE 80-55: DEDUCTION OF INTEREST BY BANKS

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I. Introduction

When a state or local government has excess funds, it will often seek to invest those funds until they are needed. In many cases, it will invest those funds by depositing them with a bank. Because the amounts involved are generally substantially in excess of limits on insured deposits, many state or local governments require that certain types of securities be pledged to secure repayment of the deposit. Each state has its own list of acceptable securities that may be pledged, but they generally allow pledging of Federal securities or tax-exempt obligations of the depositing state or other governmental unit within that state. Indeed, some governmental units require that the securities to be pledged must be securities issued by the same governmental unit making the deposit. A summary of the pledging requirements of various state and local governments is set forth in Table 1.

Section 265(2) of the Internal Revenue Code provides 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 Federal income tax. In Rev. Proc. 80-55, the Internal Revenue Service took the position that Code section 265(2) should be applied generally to disallow interest deductions for interest paid on <u>time</u> deposits of states where the deposit is secured by the pledge of tax-exempt obligations.

State and local governments have argued that the position of Rev. Proc. 80-55 will adversely affect them in a number of ways. First, in order for banks to avoid the application of the revenue procedure, the banks would use taxable obligations to meet pledging requirements. It is argued that this will force banks to sell substantial amounts of their existing portfolios of tax-exempt bonds and, thereby, depress the price of tax-exempt bonds in the short run. This will make it difficult for states and local governments to issue bonds during this transitional period. Second, it is argued that this same tendency will decrease the demand for tax-exempt bonds in the long run and, thus, will drive up interest rates that state and local governments must pay on their obligations. Finally, it is argued that implementation of the revenue procedure will result in banks paying lower rates of interest on deposits to state and local governments.

TABLE 1

SUMMARY OF PLEDGING RATIOS FOR STATE AND LOCAL GOVERNMENT DEPOSITS

1978

States with Comprehensive Pledging Requirements (i.e., requirement covers all deposits)	State	County	Municipa
Alabama	100 S	100 D	100 D
Arizona	100 D	100 S	100 S
California	110 D	110 S	110 S
Colorado	100 S	100 S	100 S
Florida	100 D	100 D	100 D
Kentucky	110 S	110 S	110 S
Louisiana	100 S	100 D	100 D
Maryland	100 D	100 D	100 D
Minnesota	110 S	110 S	110 S
Mississippi	110 S	110 S	110 S
Missouri	110 S	110 S	110 S
Montana	100 S	100 D	100 D
Nebraska	110 S	110 S	100 S
New York	100 D	100 D	100 D
North Carolina	100 S	100 S	100 S
Ohio	100 S	100 S	100 S
Oklahoma	110 S	100 S	100 S
Pennsylvania	100 D	100 D	100 D
Texas	120 S	100 D	100 S
Wyoming	100 S	100 S	100 S

States with Partial Pledging Requirements (i.e., requirement covers a substantial portion but not all deposits)	State	County	Municipa
Alaska	100 D	N	N
Delaware	100 S	N	N
Georgia	110 S	100 S	N
Hawaii	100 S	100 S	N
Illinois	115 S	0 D	0 D
Kansas	70 S	70 S	70 S
Michigan	100 D	0 D	0 D
Nevada	100 D	N D	N D
New Mexico	50 S	50 S	50 S
North Dakota 1/	0	110 S	110 S
Oregon	25 S	25 S	25 S
South Carolina	100 S	N	N
Tennessee	110 S	D	D
Virginia	50 S	50 S	50 S
West Virginia	110 S	100 S	N

TABLE 1
(Continued)

SUMMARY OF PLEDGING RATIOS FOR STATE AND LOCAL GOVERNMENT DEPOSITS

1978

States with Low or No Pledging Requirements	State	County	Municipal
Arkansas	1 D	N D	N D
Connecticut	3 S	3 S	3 S
Idaho	0 S	0 S	0 S
Indiana	0 S	0 S	0 S
Iowa	0 S	0 S	0 S
Maine 2/	0 S	0 S	0 S
Massachusetts 3/	0 S	0 S	0 S
New Hampshire	0 S	0 S	0 S
New Jersey	5 S	5 S	5 S
Rhode Island	0 S	N D	N D
South Dakota	5 S	5 S	5 S
Utah	0 S	0 S	0 S
Vermont	0 S	0	0
Washington	5 S	5 S	5 S
Wisconsin	0 S	0 S	0 S

Legend: S - Statutory requirements.
D - Discretionary: The listed ratio appears to be the prevailing practice.
N - No information available; in most instances, state statutes are silent and pledging does not appear to be in widespread practice.

1/ State funds are required to be deposited in the Bank of North Dakota; other public units deposits are not required to be collateralized if held in Bank of North Dakota.

2/ If deposit exceeds 25 percent of bank capital and surplus, 100 percent pledging is required.

3/ If state deposits exceed 40 percent of bank capital and surplus or if any local government's deposit exceeds 60 percent, then 100 percent of that deposit must be collateralized.

(SOURCE: "An Analysis of the Impact of RP 80-55 on the Tax-Exempt Bond Market", Ronald Forbes and Paul Leonard (School of Finance, State University of New York at Albany) January 30, 1981) (NOTE: The staff has not verified the material in this table.)

II. Present law

A. In general

Section 163(a) of the Internal Revenue Code allows as a deduction all interest paid or accrued within the taxable year on indebtedness. Thus, for example, banking institutions generally are permitted to deduct interest payments made to customers with respect to amounts they have on deposit.

Section 265(2) of the Code provides 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 Federal income tax.

B. Prior rulings and cases

Over the past 20 years, the Internal Revenue Service has issued a number of revenue rulings and revenue procedures concerning the application of Code section 265(2) to interest paid by banking institutions on deposits where the bank makes investments in tax-exempt obligations.

In Rev. Rul. 61-222, 1961-2 C.B. 58, [1] the Service took the position that Code section 265(2) has no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be indebtedness incurred or continued to purchase or carry obligations which are exempt from Federal income tax within the meaning of Code section 265. This ruling is based, in part, on legislative history indicating that Congress did not intend that section 265(2) be applied to indebtedness incurred by a bank to its depositors. [2]

In Rev. Rul. 67-260, 1967-2 C.B. 132, the Service held that Code section 265(2) applies where a bank issues certificates of deposit for the specific purpose of acquiring tax-exempt obligations. The facts of that ruling involved a bank which issued certificates of deposit in consideration of, and in exchange for, a State's tax-exempt obligations, which had approximately the same maturity as the certificates of deposit. The interest deduction on the indebtedness incurred by the bank in this transaction was disallowed under Code section 265(2).

1/ This ruling updated a position initially taken by the IRS in 1924 in I.T. 2028, III-I C.B. 296.

2/ See S. Rept. No. 558, 73d Cong. 2d Sess., p. 24 (1934) and S. Rept. No. 830, 88th Cong. 2d Sess., p. 80 (1964). However, this legislative history does not explicitly cover the situation addressed in Rev. Proc. 80-55.

Rev. Rul. 67-287, 1967-2 C.B. 133, held that the provisions of Code section 265(2) do not apply to a bank that incurs interest expense as a result of short-term loans of Federal funds from other banks or as a result of short-term loans from a Federal Reserve Bank where such loans are obtained solely for the purpose of meeting the Federal Reserve System requirements for reserves against deposits.

In Rev. Proc. 70-20, 1970-2 C.B. 499, the Service set forth guidelines for the application of Code section 265(2) to banks holding tax-exempt state and local obligations. The revenue procedure stated that Congress intended to disallow interest under Code section 265(2) only upon a showing of a purpose by the taxpayer to use borrowed funds to purchase or carry tax-exempt securities. Section 3.09 of that revenue procedure provides that Code section 265(2) shall not be deemed applicable to interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. Although it will ordinarily be inferred that a direct connection does not exist in cases involving certain types of short-term indebtedness, unusual facts and circumstances may demonstrate a direct connection between the borrowing and the investment in tax-exempt securities. Section 3.11 of the revenue procedure provides that types of borrowings not specifically dealt with therein are to be decided on a facts and circumstances basis. 3/

Rev. Proc. 72-18, 1972-1 C.B. 740, provides guidelines for the application of the provisions of Code section 265(2) to individuals, dealers in tax-exempt obligations, business enterprises that are not dealers in tax-exempt obligations, and banks in situations not dealt with in Rev. Proc. 70-20.

3/ Rev. Proc. 70-20 dealt specifically with the following classes of short-term bank indebtedness: bank deposits (including interbank deposits and certificates of deposit); short-term notes; short-term Euro-dollar deposits and borrowings; Federal funds transactions (and similar interbank borrowing to meet state reserve requirements and other day-to-day and short-term interbank borrowings); repurchase agreements (not involving tax-exempt securities); and borrowings directly from the Federal Reserve to meet reserve requirements. The revenue procedure did not specifically deal with the type of indebtedness at issue in Rev. Proc. 80-55.

Section 3.01 of the revenue procedure sets forth the general rule that Code section 265(2) is applicable only where the indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt securities. Accordingly, the application of Code section 265(2) requires a determination, based on all the facts and circumstances, of the taxpayer's purpose in incurring or continuing each item of indebtedness. The taxpayer's purpose may be established either by direct evidence or by circumstantial evidence. Section 3.03 of Rev. Proc. 72-18 provides that direct evidence of a purpose to carry tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness. The case of Wisconsin Cheeseman v. United States 388 F. 2d 420 (7th Cir. 1968), is cited therein for the proposition that: "[O]ne who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position. Section 265(2) makes no distinction between them."

Rev. Proc. 78-34, 1978-2 C.B. 535, was issued for the purpose of amplifying Rev. Proc. 70-20 to provide that Code section 265(2) will not be applied to disallow deductions for interest paid by commercial banks on borrowings of Treasury tax and loan funds when those borrowings are secured by pledges of tax-exempt obligations. The Service based its conclusion on the fact that the availability of these funds is subject to the exclusive discretion of the Treasury and, consequently, the obligation is in the nature of a demand deposit. In addition, access to the funds by depository banks is not subject to negotiated rates or any other market factors that normally influence arm's-length money market transactions; and all depository banks in a given class are affected pro-rata.

In addition to the foregoing rulings and procedures, the courts often have been involved in issues involving the application of section 265(2). The courts generally have held that section 265(2) does not apply unless the facts reveal that the purpose of incurring or continuing indebtedness is to purchase or carry tax-exempt obligations. Where a substantial independent business purpose for the acquisition and retention of tax-exempt securities exists, the courts generally have held section 265(2) inapplicable. (See, for example, Phipps v. United States, 414 F. 2d 1366 (1969) and Bishop v. Commissioner, 41 T.C. 154 (1963.) In general, the courts have held that the prohibited purpose (incurring or continuing indebtedness to purchase or carry tax-exempt obligations) must be established by the showing of a sufficiently direct relationship between the indebtedness and the exempt securities. For example, in Illinois Terminal Railroad Co. v. United States, 179 Ct. Cl. 674, 375 F. 2d 1016 (1967), it was held that

interest on a railroad's first mortgage bonds, which were issued by the railroad to pay off its debt for the purchase of certain assets, was not deductible to the extent that the debt was continued to enable the railroad to retain ownership of tax-exempt bonds. Similarly, in Wisconsin Cheeseman v. United States, 388 F. 2d 420 (7th Cir. 1968), section 265(2) was applied to deny an interest deduction to a corporation that took out short-term bank loans to meet recurrent seasonal needs for funds and pledged tax-exempt securities as collateral. The court found that the securities were acquired with receipts from peak business periods and were intended to be used as collateral to meet off-season needs for funds. Thus, it was concluded that there was no independent business purpose for the acquisition or retention of tax-exempt securities except for use as collateral.

In two recent cases, the courts found that the holding of tax-exempt securities was independent of the borrowing of money. In Investors Diversified Services v. United States, 575 F. 2d 843 (Ct. Cl. 1978), the court found that the use of tax-exempt securities as collateral for face amount certificates was not sufficient evidence of a purpose to acquire or carry tax-exempt obligations and, thus, did not deny the deduction for interest paid on those certificates. There, the court stated that "where the issue is disputed there should always be an inquiry, more-or-less particularized, into the connection and relationship between the tax-exempts and the indebtedness so as to discover whether in fact the taxpayer used borrowed funds for the primary purpose of purchasing or carrying those securities." Finally, in New Mexico Bancorporation v. Commissioner, 74 T.C. ______, No. 100 (1980), the court permitted deductions for interest paid on repurchase agreements which were secured by tax-exempt obligations. The court concluded that the bank's purpose for offering the repurchase agreements was independent of, and not sufficiently related to, the holding of the tax-exempt obligations to cause the deduction to be denied.

III. Revenue Procedure 80-55

On December 15, 1980, the IRS issued Rev. Proc. 80-55, 1980-50 I.R.B. 20, for the stated purpose of amplifying the rules set forth in Rev. Proc. 70-20 and Rev. Proc. 72-18. Under Rev. Proc. 80-55, Code section 265(2) will be applied to disallow deductions for interest paid by commercial banks on certain time deposits made by a state when those deposits are made for a specific period of time and are secured by pledges of tax-exempt obligations.

Specifically, the revenue procedure provides that a depository bank that holds funds as time-deposits that it has collateralized with tax-exempt obligations is in virtually the same economic position as one who has borrowed to buy tax-exempt obligations. Direct evidence of a purpose to purchase or carry tax-exempt obligations is found to exist in this situation on the ground that the depository bank knows with certainty that it will have the amount of deposited funds available to it, without restriction, for a fixed period of time. Furthermore, the revenue procedure provides that commercial banks which participate in a state program that requires them to bid for state funds, negotiate the rate of interest, and requires the state to leave such deposits for a specified period of time will create an indebtedness of the type described in Code section 265(2).

Rev. Proc. 80-55 also describes two situations in which Code section 265(2) will not be applied to disallow interest deductions: (1) the holding by a depository bank of demand deposits that it has collateralized with tax-exempt obligations; and (2) the participation by a commercial bank in a state program in which funds are awarded in the manner described in Rev. Proc. 78-34 (discussed above) and where the placement of such funds is at the discretion of the state.

When initially issued, Rev. Proc. 80-55 was to have retroactive effect. However, it was modified subsequently to apply to time deposits made after May 31, 1981.

IV. Legislative Proposals Relating to Rev. Proc. 80-55

H.R. 1015, introduced by Representative Conable on January 22, 1981, would provide that Code section 265(2) must be applied without regard to Rev. Proc. 80-55 or any other regulation, ruling, or decision reaching the same, or similar, result. Under that bill, Code section 265(2) would be applied in accordance with the rules in effect prior to the issuance of Rev. Proc. 80-55.

H.R. 1375, introduced by Representative Downey on January 28, 1981, would provide that, for purposes of applying Code section 265(2) to interest paid by a bank, the term "indebtedness" does not include any deposit of public funds by a state or local government secured by tax-exempt obligations which qualify, under applicable state or local law, as collateral for the deposit of public funds.