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Report to the Joint Committee on Taxation

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TAX POLICY

Deducting Interest on Funds Borrowed to Purchase or Carry Tax-Exempt Bonds

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The Honorable Lloyd Bentsen
Chairman, Joint Committee on Taxation

The Honorable Dan Rostenkowski
Vice Chairman, Joint Committee on Taxation
Congress of the United States

This report responds to your Committee's request that we review various compliance aspects regarding Internal Revenue Code section 265(a)(2), which is designed to prevent certain tax arbitrage practices.

As arranged with your Committee, we are sending copies of the report to other interested congressional committees and members; the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of Henry L. Hinton, Deputy Associate Director. Other major contributors to this report are listed in appendix II.

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for

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Executive Summary

Purpose

Internal Revenue Code section 265 is designed to prevent one form of tax arbitrage, the simultaneous expense deduction and income exclusion that results from a taxpayer deducting interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds.

The Joint Committee on Taxation asked GAO to (1) determine whether the Internal Revenue Service (IRS) can adequately administer section 265, especially given the subjective nature of its disallowance rule; (2) quantify the extent of any potential compliance problems; and (3) evaluate the effects of establishing a 100 percent mechanical disallowance rule for all corporate taxpayers, similar to that established for the banking industry by the Tax Reform Act of 1986.

Background

The federal tax code is designed to tax net income—gross income minus the expenses incurred in the production of that income. If a deduction for interest expense incurred to produce tax-exempt income is allowed, a taxpayer can use the deduction to offset other taxable income. Section 265 disallows the deduction of interest on money borrowed to purchase or carry tax-exempt securities.

Congress has established different rules regarding the application of section 265 to individuals and nonfinancial corporations and to financial institutions.

Section 265(a)(2) applies a "subjective disallowance rule" to individuals and nonfinancial corporations. This section disallows deductions of interest expense if evidence exists that the purpose of the loan was to purchase or carry tax-exempt securities. This determination can be made if loan proceeds can be directly traced to the purchase of tax-exempt securities, if tax-exempt securities are used as collateral for loans, or through an analysis of all the facts and circumstances surrounding related transactions. IRS will not ordinarily analyze all the facts and circumstances under the de minimis rule (i.e., if less than 2 percent of total assets are tax-exempt securities).

A "mechanical disallowance rule" has been applied to financial institutions (i.e., banks, savings and loan associations, and mutual savings banks) since 1982. Under section 265(b), a proportion of total interest expense is automatically allocated to tax-exempt securities. This amount is calculated by multiplying total interest expense by the ratio of tax-exempt assets to total assets. A percentage of the interest expense allocated to tax-exempt securities is not allowed to be deducted. This percentage, originally 15 percent, was increased to 20 percent in 1984 and to 100 percent by the Tax Reform Act of 1986.

Results in Brief

Section 265(a)(2) is difficult to administer. Before tax year 1987, individuals were not required to report tax-exempt interest income, so IRS could not readily identify potential instances of noncompliance. However, tax-exempt interest income is not subject to Form 1099 information reporting so the amount reported cannot be readily verified by IRS. Since corporations are not required to separately report taxable and tax-exempt assets on the corporate tax form, IRS cannot readily check whether a nonfinancial corporation is subject to the de minimis rule or evaluate whether large numbers of nonfinancial corporations are avoiding tax by avoiding the facts and circumstance test. With this information, IRS could also identify cases where a financial institution has likely incorrectly applied the mechanical disallowance rule.

Evidence on the extent of individual compliance with section 265(a)(2) is limited and inconclusive. IRS has not studied corporate taxpayer compliance.

IRS officials believe that extending the mechanical disallowance rule to all corporations would aid administration. Property and casualty insurance companies now own most of the tax-exempt securities held by nonfinancial corporations and are already subject to a rule that is similar to the mechanical rule. Thus, the effect of extending the mechanical rule on the market for tax-exempt securities will depend on whether the rule is added to or replaces existing tax provisions.

Principal Findings

Administering Section 265(A)(2) Is Difficult

To administer section 265(a)(2), IRS needs to identify taxpayers who deduct interest expense and own tax-exempt securities. Income tax forms now require individual taxpayers to report tax-exempt income. However, IRS presently has no mechanism, such as Form 1099 information reporting, with which it can readily verify the amount reported. Because of this, IRS does not have adequate assurance that it is targeting its limited resources at those returns having the highest section 265 audit potential. IRS officials stated that information reporting would be useful in the administration of section 265(a)(2).

The corporate tax form does not contain data on the amount of tax-exempt assets held by corporations, so IRS cannot determine if a nonfinancial corporation is subject to the de minimis rule or check whether a financial institution has incorrectly applied the mechanical disallowance rule. If corporations were required to report this information, audit procedures could be simplified and policymakers could better evaluate whether nonfinancial corporations take advantage of the de minimis rule to reduce tax liability through tax arbitrage and, if so, measure any loss in federal revenue from this provision.

IRS has done audits in which section 265 was an issue, but determining noncompliance given the lack of information concerning tax-exempt interest income and the subjectivity of the existing rules can be difficult. The new reporting requirement should make it easier to at least identify whether there is some potential for audit. But court decisions involving section 265(a)(2) show that applying the subjective disallowance rule often requires a complex analysis of the facts and circumstances surrounding all related transactions. (See pages 15 to 23.)

The Extent of Compliance With Section 265(A)(2) Is Unknown

The extent of taxpayer compliance with section 265 is not known. Due to limited IRS data, GAO was unable to do an independent analysis of compliance. A 1985 IRS study under the Taxpayer Compliance Measurement Program (TCMP) concluded that no significant individual taxpayer compliance problem exists with section 265(a)(2), but GAO believes that methodological problems with this study raise some doubts about the validity of the conclusion. IRS has not studied corporate taxpayer compliance. (See pages 24 to 27.)

Effects of Extending the Mechanical Disallowance Rule

GAO interviewed IRS revenue agents who were familiar with both the subjective and mechanical disallowance rules. The agents stated that the mechanical rule was generally easier to administer.

Federal Reserve Board data indicate that the proportions of tax-exempt securities held by different sectors of the market have changed over the last 10 years. The share owned by households and money funds has grown, while the share owned by financial institutions has declined. Since the third quarter of 1986, when the 100 percent mechanical rule became effective, financial institutions have been net sellers of tax-exempt securities.

The effect on the tax-exempt securities market of extending the mechanical disallowance rule would depend on whether the rule replaced or was added to existing provisions dealing with how insurance companies are allowed to treat tax-exempt income. If the mechanical rule was added to existing provisions, nonfinancial corporations would likely hold fewer tax-exempt securities because they would become in effect more expensive relative to other investments. If the rule replaced the existing provisions, nonfinancial corporations as a group might increase rather than decrease holdings of tax-exempt securities. (See pages 28 to 40.)

Recommendations

GAO recommends that the Commissioner of Internal Revenue

- study the costs and benefits of requiring information reporting for tax-exempt interest income and
- consider changing Schedule L on the U.S. Corporation Income Tax Return to separately identify tax-exempt securities from other securities.

Agency Comments

GAO provided a draft of this report to IRS for comment. IRS generally agreed with the report's recommendations but expressed some concern about the availability of some data needed to study information reporting. IRS' comments are included in appendix I. GAO's evaluation of these comments is on page 23.

Contents

Abbreviations

IRC	Internal Revenue Code
IRS	Internal Revenue Service
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TCMP	Taxpayer Compliance Measurement Program

Introduction

The tax code has generally allowed a taxpayer to deduct interest expenses paid or accrued during a taxable year.[1] Historically, the tax code has also exempted from federal income tax the interest earned on many state and local government securities. Thus, without additional statutory rules, a taxpayer could accrue a double benefit by deducting interest paid on money borrowed to invest in tax-exempt securities.

Congress enacted Internal Revenue Code (IRC) section 265 to prevent this simultaneous interest deduction and income exclusion by disallowing a deduction for "[i]nterest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle (federal income tax) . . . ." Such a provision has been part of the tax code since 1917, originally as section 1201(1) of the Revenue Act of 1917, reordered as section 234(a)(2) of the Revenue Act of 1918, and denoted as section 265 in the Internal Revenue Code of 1954.

Rationale for IRC Section 265

An underlying principle of the federal tax code is to tax net income, or gross income minus the expenses incurred (e.g., interest expense), in the production of that income. Allowing a deduction for the interest expense incurred to produce tax-exempt income would deviate from this principle because a taxpayer could use this interest expense as a deduction against other income that is taxable. This method of avoiding taxes through such a series of transactions is referred to as tax arbitrage.

To see how tax arbitrage can work, suppose a taxpayer with an annual income from taxable dividends of $5,000 borrows $100,000 at 5-percent interest and uses the $100,000 to purchase tax-exempt securities that pay 5-percent interest. In this example, the $5,000 tax-exempt interest income received from the tax-exempt securities offsets the $5,000 interest expense paid on the loan. But if the $5,000 interest expense is allowed as a deduction, no tax would be due on the $5,000 in taxable dividends. As long as the return on the tax-exempt securities plus the tax savings from the interest deduction is greater than the interest owed on the loan, a taxpayer could offset wage or investment income, reducing his taxes at no risk with no increase in net savings. While any taxpayer with currently taxable income could use this series of transactions

[1]The Tax Reform Act of 1986 limited the type and amount of deductible interest expenses for individual taxpayers. Consumer interest expense deductions were reduced and will eventually be eliminated. Investment interest expenses can be deducted if they do not exceed investment income; any expenses beyond this amount can be carried forward and deducted in future tax years.

to reduce taxes, the value of the interest deduction is greater for taxpayers with higher marginal tax rates, i.e., in higher tax brackets.

While Congress designed IRC section 265 to prevent manipulation of the tax code in this fashion, it did not intend that taxpayers with interest expenses be automatically penalized for holding tax-exempt municipal securities. Congress intended that an interest expense deduction be disallowed if the taxpayer's purpose in borrowing the funds was to purchase or carry tax-exempt securities. Earning tax-exempt income and deducting interest expenses is not a violation if the taxpayer can show that the purpose of the borrowing was not to purchase or carry tax-exempt securities.

Internal Revenue Service (IRS) revenue procedures and recent tax legislation have established different rules regarding the application of IRC section 265 to individuals and nonfinancial corporations and to financial institutions (i.e., commercial banks, savings and loan associations, and mutual savings banks).

Application of IRC Section 265 to Individuals and Nonfinancial Corporations

IRC section 265(a)(2) applies this provision to individuals and nonfinancial corporations, and Revenue Procedure 72-18 sets forth IRS' rules for its implementation. Generally, IRC section 265(a)(2) is only applicable where the indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt securities. Accordingly, its application requires a subjective determination, based on all the facts and circumstances, as to the taxpayer's purpose in incurring or continuing each item of indebtedness.

Revenue Procedure 72-18 focuses on the evidence that is needed to show that a taxpayer's purpose in borrowing the funds was to purchase or carry tax-exempt securities. A taxpayer's purpose may be established either by direct evidence or by indirect evidence. Direct evidence of a purpose to <u>purchase</u> exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase of tax-exempt securities. Direct evidence of a purpose to <u>carry</u> tax-exempt securities exists where tax-exempt securities are used as collateral for indebtedness. Indirect evidence of a purpose to <u>purchase or carry</u> exists where the totality of facts and circumstances establishes a "sufficiently direct relationship" between the borrowing and the investment in tax-exempt securities.

Under this revenue procedure, an individual taxpayer can incur a variety of indebtedness of a personal nature without being subject to IRC section 265(a)(2). Such indebtedness may range from short-term credit for purchases of goods and services for personal consumption to a mortgage incurred to purchase or improve a residence or other real property that is held for personal use. The revenue procedure states that the purpose to purchase or carry tax-exempt securities cannot reasonably be inferred where a personal purpose unrelated to the tax-exempt securities ordinarily dominates the transaction. Interest deductions for these types of personal expenditures are now limited by IRC section 163. IRC section 265(a)(2) is a possible issue when a taxpayer claims interest deductions for portfolio investments while simultaneously purchasing or carrying tax-exempt securities.

IRC section 265(a)(2) generally does not apply to indebtedness incurred or continued in connection with the active conduct of a trade or business by individuals or nonfinancial corporations (other than a dealer in tax-exempt obligations), unless it is determined that the borrowing was in excess of business needs. However, the purpose to carry tax-exempt securities may exist if the taxpayer reasonably could have foreseen at the time of purchasing the tax-exempt securities that indebtedness would have to be incurred to meet future economic needs of an ordinary, recurrent variety. The purpose to carry tax-exempt securities can also be inferred if a nonfinancial corporation continues indebtedness that it could discharge, in part or in whole, by liquidating its holdings of tax-exempt securities without withdrawing any capital that is committed to, or held in reserve for, the corporation's regular business activities.

Revenue Procedure 72-18 also established a de minimis rule for IRC section 265. If a taxpayer's investment in tax-exempt securities is insubstantial and if direct evidence does not exist to link borrowing to the purchase or carrying of tax-exempt securities, IRS will not ordinarily seek indirect evidence to disallow the deduction of interest expense. In the case of an individual, investment in tax-exempt obligations is insubstantial if during the taxable year the average amount of the tax-exempt securities (valued at their adjusted basis) owned does not exceed 2 percent of the average adjusted basis of portfolio investments and any assets held in the active conduct of a trade or business. In the case of a nonfinancial corporation, investment in tax-exempt securities is insubstantial only if during the taxable year the average amount of the tax-exempt securities (valued at their adjusted basis) does not exceed 2 percent of the average total assets (valued at their adjusted basis) held in the active conduct of the trade or business. The de minimis rule does not apply to dealers in tax-exempt securities.[2]

Application of IRC Section 265 to Financial Institutions

From 1918 to 1982, IRC section 265 was generally not applicable to short-term indebtedness, such as bank accounts, certificates of deposit, or similar accounts incurred by financial institutions to depositors, unless circumstances demonstrated a direct connection between this "borrowing" and a tax-exempt investment. It was not felt that financial institutions accepted these deposits to obtain funds to purchase or carry tax-exempt securities. In setting forth IRS rules for applying the provision to banks, Revenue Procedure 70-20 defined short-term indebtedness as indebtedness of a term of 3 years or less. IRC section 265 was applicable to long-term indebtedness in the same general manner as for nonfinancial corporations.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) changed the applicability of IRC section 265 for financial institutions by establishing a mechanical disallowance rule for tax-exempt securities purchased after December 31, 1982. This rule allocates interest expense to tax-exempt securities in proportion to the ratio of the financial institution's tax-exempt assets to total assets. For example, if 30 percent of a financial institution's assets are tax-exempt securities, 30 percent of interest expense would be allocated to tax-exempt securities. This type of rule is generally based on an assumption that the purpose of any loan is to enable the borrower to carry all the assets that he chooses to continue to hold rather than sell to raise the loan proceeds. Under the TEFRA provision, 15 percent of interest expense allocated to tax-exempt securities by the rule was not allowed to be deducted. The formula below shows how the amount of disallowed interest expenses was determined.

$$\begin{matrix}\text{disallowed}\\ \text{interest}\\ \text{expense}\end{matrix} = \begin{pmatrix}\text{percentage}\\ \text{disallowed}\end{pmatrix} \times \begin{pmatrix}\text{total interest}\\ \text{expense}\end{pmatrix} \times \frac{\text{tax-exempt assets}}{\text{total assets}}$$

The Deficit Reduction Act of 1984 increased the percentage disallowed for deduction from 15 percent to 20 percent. The Tax Reform Act of

[2]A provision in the House version of H.R. 3545, Omnibus Budget Reconciliation Act of 1987, sought to establish a statutory de minimis rule. Under the proposed rule, an interest deduction would not be disallowed if the value of tax-exempt securities held by the taxpayer did not exceed the lesser of (1) $1 million or (2) 2 percent of all assets held by the taxpayer. This rule was contained in a provision to disallow interest expense allocable to installment obligations of state and local governments. However, the provision was not included in the bill as enacted.

1986 further increased the percentage disallowed from 20 percent to 100 percent. This 100 percent mechanical disallowance rule, IRC section 265(b), applies to tax-exempt securities purchased after August 7, 1986.

According to the Joint Committee on Taxation staff, Congress made these changes for two reasons.[3] First, the prior law was seen to discriminate in favor of financial institutions at the expense of other types of taxpayers. Second, Congress was concerned that financial institutions could drastically reduce their tax liability as a result of the prior law. Congress believed the proportional disallowance approach to be appropriate because of the difficulty of tracing funds within a financial institution and the near impossibility of assessing a financial institution's purpose in accepting particular deposits.

Objectives, Scope, and Methodology

On June 2, 1987, the Joint Committee on Taxation requested that we review various aspects of IRC section 265, which prohibits deducting interest expenses associated with borrowing funds to purchase or carry tax-exempt obligations. Specifically, the Joint Committee asked us to (1) determine whether IRS can adequately administer this provision of the IRC, given the subjective nature of its disallowance rule; (2) quantify the extent of any potential compliance problems; and (3) evaluate the effects of establishing a mechanical allocation and disallowance rule for all corporate taxpayers, similar to that established for the banking industry by the Tax Reform Act of 1986. Subsequent discussions resulted in our expanding the first objective to include a review of the de minimis rule.

To address the first objective, we reviewed various IRS tax and information return forms and instructions to learn how taxpayers are expected to report interest expenses and tax-exempt income. We also discussed issues relating to the administration of IRC section 265 with IRS officials in the Office of the Assistant Commissioner for Examination. Because IRS computerized data bases do not contain information on audit results by IRC section, we asked Examination Division officials in IRS' 63 district offices to provide us information on completed or ongoing audits that involved these issues. Revenue agents in 16 district offices provided us information on a total of 90 audits, made from 1974 through 1985, that

[3]Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, May 4, 1987, pp. 562 and 563.

involved this issue.[4] We interviewed 24 revenue agents who did the 90 audits to discuss their experiences in proposing tax liability adjustments and applying the subjective disallowance rule under IRC section 265(a)(2). We also reviewed the texts of court cases that involved IRC section 265(a)(2) to assess the complexity of issues involved with administering this IRC section, particularly the subjective disallowance rule and the carry provision.

With respect to the de minimis rule, we considered whether IRS has the ability to do a computer check to determine whether more than 2 percent of a nonfinancial corporation's assets are tax-exempt securities. To do this, we reviewed Form 1120, U.S. Corporation Income Tax Return, to find if IRS currently or in the past required taxpayers to report the value of tax-exempt assets and the value of total assets. We also assessed the usefulness of such information for tax policy formulation.

To address the second objective, we identified an IRS Taxpayer Compliance Measurement Program (TCMP) study that, as part of IRS' objective of measuring overall compliance with the tax laws, included a specific question about the compliance of individual taxpayers with IRC section 265(a)(2). This TCMP, completed in 1985, is the only one in which IRS has attempted to measure individual or corporate compliance with this IRC section. We discussed the TCMP methodology and results with IRS officials in the Compliance Measurement Group, Office of the Assistant Commissioner for Planning, Finance and Research; and in the Office of Examination Planning and Research Branch, Office of the Assistant Commissioner for Examination.

To address the third objective, we interviewed the 24 IRS revenue agents to obtain their views on the administrative effort required to apply the mechanical disallowance rule and the subjective disallowance rule.

To determine the effect of extending the mechanical rule to all corporations on the market for tax-exempt securities, we identified the holders of tax-exempt securities using the Federal Reserve Board of Governors' "Flow of Funds Accounts" report for March 1988, which shows the volume of tax-exempt securities held by various sectors of the economy for

[4]These 16 IRS districts are Baltimore, Birmingham, Buffalo, Cheyenne, Cincinnati, Cleveland, Hartford, Jacksonville, Little Rock, Los Angeles, Manhattan, Milwaukee, Nashville, Philadelphia, Providence, and San Francisco.

the period 1978 through 1987. Using this data source, we also determined the amounts of tax-exempt securities held by households, nonfinancial corporations, financial corporations, insurance companies, money funds (money market funds and mutual funds), and state and local governments. In addition, we reviewed existing literature (see bibliography) and sections of the IRC to analyze the current tax rules on treatment of tax-exempt interest income for various taxpayers. This information allowed us to identify the likely effects of an extension of the 100 percent mechanical disallowance rule to all corporations.

We did our work from June 1987 through May 1988 in accordance with generally accepted government auditing standards. We obtained written comments from IRS on the report, which are included in appendix I. Our evaluation of these comments is on page 23.

Administration of IRC Section 265 Is Difficult

IRC section 265 is difficult for IRS to administer. While income tax forms now require taxpayers to report tax-exempt income, IRS has no independent information to readily verify the tax-exempt income reported or identify the taxpayers who could be subject to this provision. IRS currently does not have a simple administrative tool to determine whether more than 2 percent of a nonfinancial corporation's assets are tax-exempt securities or to check whether financial institutions have correctly applied the mechanical disallowance rule. While IRS would still need to do audits to identify taxpayer noncompliance, better information would allow IRS to readily target cases of potential noncompliance. We found that while IRS has done some audits in which compliance with section 265 was an issue, determining noncompliance can be difficult given the subjectivity of the existing rules. We also found that court decisions involving IRC section 265 illustrate that the issues involved in applying this provision are complex, particularly regarding the subjective disallowance rule as it applies to the carrying of tax-exempt securities.

IRS Forms Contain Some Needed Information

To administer IRC section 265, IRS first needs to identify the taxpayers to whom the section may apply. This requires information on interest expense deductions and an indication that the taxpayer owns tax-exempt securities. IRS can obtain some of this information from tax returns. For individual taxpayers, interest expense deductions are reported on Schedule A (Itemized Deductions) of Form 1040 (U.S. Individual Income Tax Return). Until the Tax Reform Act of 1986, there was no requirement for all individual taxpayers to report tax-exempt interest income. Form 1040 for tax year 1987 was the first to require information on tax-exempt interest income from all individual taxpayers. A corporation's interest expense deductions are reported on line 18 of Form 1120 (U.S. Corporation Income Tax Return). Corporations with more than $25,000 in total assets report tax-exempt interest income on Schedule M-1 (Reconciliation of Income Per Books With Income Per Return) on Form 1120. All corporations report tax-exempt interest income on line R of Schedule J on Form 1120. Instructions for completing these forms note that interest expense resulting from debt incurred to purchase or carry tax-exempt securities is not deductible.

IRS cannot, however, readily verify all interest expense or the tax-exempt interest income reported by individuals or corporations. Some interest expense, such as mortgage interest expense, reported by taxpayers can be verified using a Form 1098 information return sent to IRS by the institution that received the interest payment. However, other types of interest expense, such as consumer interest expense and interest expense resulting from private agreements, are not subject to information reporting. Further, payers of tax-exempt interest are not required to report such payments to IRS on an information return.

IRS officials said that an information return for identifying the recipients of tax-exempt income would be particularly useful for their administration of IRC section 265. With this information, IRS could identify taxpayers to whom this section may apply and the tax returns that may require follow-up action. IRS has internally discussed requesting authority from Congress to establish information reporting for tax-exempt income as a means of verifying income for Social Security computations, for verifying taxpayer calculations for the alternative minimum tax, and for enforcing compliance with IRC section 265(a)(2). However, IRS has not studied this matter in any systematic fashion and no action has been taken. We believe that information reporting for tax-exempt income would aid the administration of IRC section 265(a)(2). Accordingly, IRS should study the taxpayer burden associated with such a requirement, and if the administrative benefits outweigh these costs, request legislative authority to require information reporting.

Another change that would provide important information for policymakers and aid the administration of both section 265(a)(2) and the mechanical disallowance rule, section 265(b), involves the reporting of tax-exempt assets on the corporate income tax return. Before tax year 1982, corporations reported ownership of federal securities and state and local securities separately on lines 4(a) and 4(b), respectively, on Schedule L, the balance sheet section of the corporation income tax return. While federal securities are not exempt from federal income tax, most state and local securities are exempt. IRS officials said that these items were combined into a single line item on Schedule L to reduce the reporting burden of corporations. We believe that reinstating the separate reporting of these items would have several benefits.

As discussed in chapter 1, Revenue Procedure 72-18 established a de minimis rule for IRC section 265(a)(2). If less than 2 percent of a corporation's assets are tax-exempt securities, its holdings are considered insubstantial, and IRS will ordinarily consider only direct evidence linking borrowing to the purchase or carrying of tax-exempt securities in applying IRC section 265(a)(2). Since checking for direct evidence is easier than evaluating the "totality of facts and circumstances" that might constitute indirect evidence, audit procedures would be simplified if IRS readily knew that a corporation had insubstantial holdings.

Requiring the separate reporting of tax-exempt state and local securities owned would enable IRS to readily ascertain whether a corporation had insubstantial holdings of tax-exempt securities. A computer match of a corporation's total assets from line 14 of Schedule L and tax-exempt state and local obligations owned from Schedule L could determine whether more than 2 percent of a corporation's assets might consist of tax-exempt securities. Revenue agents could then readily determine if only direct evidence of borrowing with the purpose to purchase or carrying tax-exempt securities need be evaluated.

As was also discussed in chapter 1, section 265(b) reduces the interest expense deduction of financial institutions according to the ratio of tax-exempt assets to total assets. If financial institutions reported the value of tax-exempt securities owned separately from taxable securities, the same computer match described above could calculate this ratio. The total interest expense of the financial institution can then be calculated as the amount of interest expense deducted adjusted by the amount disallowed. If the calculated total interest expense is very high relative to financial institutions of similar size, the mechanical rule may have been incorrectly applied, indicating that the tax return deserves further review. An IRS official familiar with the administration of section 265 agreed that this reporting would be helpful in the administration of the mechanical rule.

Along with providing administrative benefits, this change would provide policymakers—Congress and the Department of the Treasury—with information to evaluate the effects of the de minimis rule. Since a nonfinancial corporation can ordinarily avoid the "totality of facts and circumstances" test by having 2 percent or less of its assets tax-exempt, tax arbitrage profits can be made if loan proceeds are not directly used to purchase tax-exempt securities or if tax-exempt securities are not used as collateral for debt. Without data on the amount of tax-exempt assets held by nonfinancial corporations, policymakers cannot evaluate whether corporations are taking advantage of this opportunity and, if so, measure any possible loss in federal revenue from this provision.

IRS Audits Involving IRC Section 265

While more extensive information reporting would help IRS identify returns where IRC section 265 might be an issue, an audit would be needed to obtain the variety of information required by IRS rules to make a judgement on an individual's or a nonfinancial corporation's compliance with this code section. An IRS audit would be needed to determine if noncompliance can be shown with direct evidence; i.e., if a purchase of tax-exempt securities is directly traceable to a loan, or if tax-exempt securities were used as collateral for a loan. An audit of the taxpayer's investment-oriented financial transactions would also be needed if IRS believes indirect evidence, or the "totality of facts and circumstances," may show noncompliance with this code section.

We asked IRS officials in the Office of the Assistant Commissioner for Examination about the audit results for cases involving IRC section 265. These officials said they have no ongoing programs focusing specifically on IRC section 265, but such issues might be addressed as part of full-compliance audits. We were unable to quantify the number and results of all IRS audits involving IRC section 265 issues because IRS' computerized databases do not contain information on audit results by IRC section. To obtain information on the difficulty of auditing compliance with this provision, we asked IRS' national office to query all district offices for information on audits involving noncompliance. Revenue agents in 16 of IRS' 63 district offices responded that they had done, or were currently doing, audits that raised IRC section 265 as an issue. As shown in table 2.1, revenue agents identified 90 audits involving this code section. Several agents had worked on both individual and corporate audits. Although IRS has likely done more than 90 audits involving IRC section 265, the revenue agents' responses provide insight on the difficulties of these audits.

Table 2.1: Audits Involving Potential Noncompliance With Internal Revenue Code Section 265

Type of taxpayer	Number of taxpayers[a]	Number of audits[a]	Amount of interest expense deduction disallowed by IRS
Individuals	14	24	$5,030,897
Nonfinancial corporations	5	14	50,919,542[b]
Financial corporations[c]	23	52	20,364,268
Totals	**42**	**90**	**$76,314,707**

[a]The number of taxpayers is less than the number of audits because an audit may involve more than one tax period, and each tax period is considered a separate audit by IRS.

[b]$50 million of this total is due to several audits of the same company

[c]Because securities brokers and dealers are also subject to a mechanical disallowance rule, they are included with financial institutions.

Source: GAO analysis of information provided by revenue agents

Table 2.1 shows that of the 90 audits, 24 involved individual taxpayers. We interviewed eight revenue agents responsible for these 24 audits.

The revenue agents said that, generally, they had identified the IRC section 265 issue while reviewing documents the taxpayer provided in response to inquiries about other issues. Six of the eight revenue agents said that they identified noncompliance when the taxpayer provided a brokerage or bank statement to justify investment income and the statement also showed tax-exempt securities and interest expenses on a margin account. With these brokerage statements as evidence, the revenue agents said they followed up with questions about the taxpayer's borrowing to make these investments.

The remaining 66 audits identified by revenue agents involved corporations. The 19 revenue agents that responded to our inquiry said that they identified IRC section 265 issues by reviewing the Schedule M-1 on Form 1120, which, as previously mentioned, requires corporations to report tax-exempt interest income. In auditing a nonfinancial corporation for compliance with this code section, revenue agents said they ask the taxpayer questions and obtain and review documentation about the nature of the interest expenses reported and the relationship of such expenses to reported tax-exempt interest income to determine whether the subjective rule was properly applied. A variety of financial transactions may need to be explored to determine the taxpayer's purpose in borrowing money and trace the borrowed funds to investments in tax-exempt obligations. In auditing a financial institution for compliance with this code section, revenue agents said they ask questions to determine if the taxpayer applied the mechanical disallowance rule correctly (i.e., calculation of disallowed interest expenses based on the correct ratio of tax-exempt assets to total assets).

Revenue agents who did audits involving this code section said that detecting potential noncompliance can be difficult, particularly in the case of individuals and nonfinancial corporations. For example, if an individual taxpayer had kept tax-exempt securities and taxable securities in separate accounts that generated separate brokerage or bank statements, the IRS audit would likely not detect the purchase or carrying of tax-exempt securities. Interest expense deductions that should be disallowed under IRC section 265 might appear to be legitimate if the holding of tax-exempt securities is undisclosed. The requirement in the Tax Reform Act of 1986 for individuals to report tax-exempt income should help revenue agents to identify the individual taxpayers to whom the code section may apply. However, because there is no information reporting for tax-exempt interest payments, IRS has no independent information with which to verify the tax-exempt income reported or to identify when such income should have been but was not reported.

Court Cases Involving IRC Section 265

Court cases involving IRC section 265 have further defined the parameters of the subjective disallowance rule in making determinations as to the taxpayer's purpose in borrowing funds. Two cases, Illinois Terminal Railroad Co. v. United States, 375 F.2d 1016 (Ct. Cl. 1967), and Wisconsin Cheeseman, Inc. v. United States, 385 F.2d 420 (7th Cir. 1968), are mentioned prominently in the applicable revenue procedures. The outcomes of these cases are summarized below to illustrate the complexity of IRC section 265 actions and the information needed by IRS to prove that a "sufficiently direct relationship" exists and therefore the interest deduction should be denied.

In Illinois Terminal, the taxpayer had borrowed money to purchase various assets, including a railroad bridge, from another corporation. The taxpayer later sold the bridge to a municipality for cash and tax-exempt municipal bonds. The taxpayer used the cash and the proceeds from the sale of a portion of the bonds to pay off some of the original loan. Although the taxpayer received an offer to purchase the remaining bonds, it chose not to liquidate its bondholdings and to continue its indebtedness.

While finding that the taxpayer had "good business reasons for holding the bonds apart from the favorable tax aspects," the court determined that the bonds could have been sold without harming the taxpayer's business, and therefore the taxpayer's dominant reason for continuing its indebtedness was to enable it to carry the tax-exempt bonds. IRS' denial of an interest deduction on the original loan was upheld, as the court found that a "sufficiently direct relationship" existed between the loan and tax-exempt bonds.

In Wisconsin Cheeseman, the taxpayer operated a seasonal business, receiving orders for its products before Christmas, and thus incurring large costs in the fall. The taxpayer made a practice of using short-term borrowing in the fall to finance these added costs. Tax-exempt securities were used as collateral for these loans. Upon receiving payment for its products, mostly in January and February, the taxpayer would repay the loans and invest remaining profit in tax-exempt securities. The taxpayer also borrowed to finance the building of a new plant, secured by a mortgage on its real estate. None of the taxpayer's tax-exempt securities were put up as collateral in this case. The mortgage proceeds were used solely to pay for the costs of the new plant.

The United States Court of Appeals for the 7th Circuit disallowed the deduction for interest expense on the short-term loans on two bases. Citing to Illinois Terminal, the court held that the use of the tax-exempt securities as collateral for the loans established the requisite "sufficiently direct relationship" between the tax-exempt securities and the debt. Additionally, the court articulated a "foreseeability test" in determining that a "deduction should not be allowed if a taxpayer could reasonably have foreseen at the time of purchasing the tax-exempts that a loan would probably be required to meet future economic needs of an ordinary, recurrent variety."

However, the court allowed the deduction of mortgage interest, finding that plant construction is "a major, non-recurrent expense," and that "[b]usiness reasons dominated the mortgaging of the property," since if the taxpayer had sold its bonds to pay for the construction costs, the taxpayer's liquid assets would have been reduced to a point where it would have been difficult for the taxpayer to borrow to meet its seasonal needs. The court concluded that these determinations precluded the establishment of a sufficiently direct relationship between the mortgage indebtedness and the holding of the tax-exempt securities needed to justify the denial of the deduction of the mortgage interest.

Illinois Terminal and Wisconsin Cheeseman demonstrate the complex legal and factual analyses courts will generally employ in making IRC section 265(a)(2) determinations. Courts will consider the taxpayer's purpose for borrowing. If the dominant purpose or reason is to purchase or carry tax-exempt securities, then a sufficiently direct relationship between the tax-exempt securities and the loan will be established and the interest deduction on the loan will be denied. Additionally, a sufficiently direct relationship will generally be inferred when the tax-exempt securities are used as collateral for the loan. Courts may also consider whether the taxpayer, when purchasing the tax-exempt securities, could have foreseen recurrent costs that would necessitate borrowing in the future. As held in Wisconsin Cheeseman, an IRS denial of an interest expense deduction will be upheld in situations where the taxpayer knew at the time of purchasing the tax-exempt securities that a loan would be needed to meet recurrent business costs.

In short, as noted by the United States Court of Claims in Illinois Terminal Railroad Co. v United States, 375 F.2d at 1022, "[t]his is an area of tax law in which it is more difficult to define the legal standard than it is to pass on a particular fact setting."

Conclusions

IRC section 265(a)(2) is difficult for IRS to administer. The income tax forms now require individual taxpayers to report tax-exempt income, but since tax-exempt income is not subject to Form 1099 information reporting, IRS cannot readily verify the amount reported or detect if tax-exempt income has not been reported. With better information, IRS could identify returns to which IRC section 265(a)(2) might apply and target them for audits. The corporate tax form currently does not contain data on the amount of tax-exempt assets held by nonfinancial corporations, so IRS cannot determine if a nonfinancial corporation is subject to the de minimis rule for section 265(a)(2) or check whether a financial institution has correctly applied the mechanical disallowance rule. If corporations were required to report this information, audit procedures could be simplified, and policymakers could evaluate whether corporations are taking advantage of the de minimis rule to reduce tax liability through tax arbitrage and, if so, measure any loss in federal revenue due to this provision.

IRS has audited returns to determine compliance with this provision, but determining noncompliance given the lack of information concerning tax-exempt interest income and the subjectivity of the existing rules can be difficult. The experience of revenue agents making audits of individual taxpayers before the establishment of the reporting requirement indicates that IRS might not have found that a taxpayer received tax-exempt income, in which case IRC section 265(a)(2) would not become an issue. Court cases involving IRC section 265(a)(2) show that applying the subjective disallowance rule often requires a complex analysis of the facts and circumstances surrounding all related transactions.

Recommendations

GAO recommends that the Commissioner of Internal Revenue

- study the costs and benefits of requiring information reporting for tax-exempt interest income and
- consider changing Schedule L on the U.S. Corporation Income Tax Return to separately identify tax-exempt securities from other securities.

Agency Comments and Our Evaluation

IRS generally agreed with the report's recommendations. IRS stated that the 1987 and 1988 TCMP programs will contain questions on tax-exempt interest income received by corporations and individuals. IRS expressed some concern about the availability of other data needed to study the costs and benefits of information reporting. IRS also stated that the Tax

Forms Coordinating Committee will consider the recommended change in the corporate form when the 1989 form is developed. IRS' comments are included in appendix I.

We agree that TCMP studies on the accuracy of the reported amount of tax-exempt interest income received by taxpayers will be useful in accessing compliance with section 265. We would welcome the opportunity to discuss with IRS researchers how the TCMP study can provide information on compliance with section 265 and on the costs and benefits of information reporting. We would also welcome the opportunity to answer any questions on the recommendation that the Tax Forms Coordinating Committee might have.

Compliance With IRC Section 265 Is Unknown

The extent of individual and corporate taxpayer noncompliance with IRC section 265 is not known. Since audits are necessary to judge compliance with this IRC section and audit data regarding compliance are not compiled by IRC section, we were unable to assess taxpayer compliance. IRS tested individual taxpayer compliance with this section as part of a recent Taxpayer Compliance Measurement Program (TCMP) study, but IRS' methodology did not fully support its conclusion that no significant compliance problem exists. IRS has not studied corporate taxpayer compliance with this section.

IRS Data on Compliance With IRC Section 265 Is Limited

As discussed in the previous chapter, IRS data regarding taxpayer compliance with IRC section 265 is very limited. IRS has no ongoing examination programs focusing specifically on IRC section 265, although such issues might be addressed as part of full-compliance audits. We were unable to quantify the number and results of all IRS audits involving IRC section 265(a)(2) issues because IRS' computerized databases do not contain information on audit results by IRC section. Thus, the information we needed to assess taxpayer compliance was not available.

TCMP Assessment of Compliance With IRC Section 265

Concerns about compliance with IRC section 265(a)(2) have been raised by independent researchers and IRS' Research Division. As a result of these concerns, IRS agreed to investigate individual taxpayer compliance with this IRC section as part of a TCMP study.

Every 3 years, IRS does a TCMP study involving tax returns filed by individual taxpayers. TCMP studies are designed to measure taxpayer compliance with tax laws. IRS begins a TCMP study by randomly selecting a sample of tax returns. Revenue agents then make extensive line-by-line audits of those returns using controlled procedures and keeping detailed records. If concerns regarding compliance with particular code sections come to the attention of IRS, questions can be asked as part of the TCMP study in order to develop initial estimates of the extent of compliance problems. IRS projects the TCMP study results to the universe of taxpayers to determine the overall level of voluntary compliance with the tax laws.

IRS' most recent individual TCMP study, as of May 1988, was completed in 1985. In doing this TCMP study, IRS audited a random sample of 50,657 individual income tax returns filed for tax year 1982. The study's checklist included a question about taxpayer compliance with IRC section 265(a)(2): "Did the taxpayer deduct interest expenses from loans used to purchase tax-exempt securities?" According to an analyst on IRS' national office TCMP team, a negative response to this question indicated either that the taxpayer owned tax-exempt securities and was in compliance, or that the taxpayer did not own tax-exempt securities and consequently the question was not applicable. Table 3.1 shows that on the basis of answers to this question, IRS found 17 taxpayers in the TCMP sample not to be in compliance with IRC section 265. On the basis of these results, IRS estimated that 3,630 of a total of about 93 million taxpayers were not in compliance. IRS concluded that individual taxpayer compliance with IRC section 265(a)(2) was not a significant problem.

Table 3.1: Results of IRS' 1985 TCMP Study of Individual Taxpayer Compliance With IRC Section 265

	Number of returns—tax year 1982	
IRS audit findings	**TCMP sample tax returns audited by IRS**	**IRS projection to the universe of individual returns**
Taxpayer in compliance with IRC section 265 or issue not applicable	50,640	92,572,022
Taxpayer in noncompliance with IRC section 265	17	3,630[a]
Totals	**50,657**	**92,575,652**

[a]According to IRS officials, the projected audit results regarding noncompliance with IRC section 265(a)(2) are subject to variability ranging from 30 to 40 percent. Thus, the projected number of taxpayers in noncompliance may be as low as 2,178 or as high as 5,082.

Source: GAO analysis based on IRS' 1985 TCMP study.

We do not believe that IRS' conclusion that no significant compliance problem exists with IRC section 265(a)(2) is fully supported. As previously discussed, this IRC section disallows interest deductions for funds borrowed to purchase or carry tax-exempt securities. Since the TCMP question did not address the carry provision, compliance with IRC section 265(a)(2) was not fully measured; rather, compliance with only the purchase provision of this code section was measured.[1] Further, in doing these audits IRS revenue agents had no prior evidence showing that the taxpayer owned tax-exempt securities. Thus, the taxpayer could have answered "no" to the TCMP study question, and IRS might not have found evidence to prove otherwise.

We also believe that by only projecting the results of its survey to the universe of all taxpayers, IRS does not obtain a complete indication of noncompliance. While it is important to know the percentage of the general population not in compliance with a part of the tax code, it is also

[1]Many of the court cases we identified involving corporations dealt with potential violations of the carry provision.

important to identify the percentage of the individuals to whom the section might apply that are not in compliance. Without this additional information, compliance problems would not be found for any code section that is applicable to a small percentage of taxpayers, and cost-effective methods of identifying noncompliance might be overlooked. The 1983 Survey of Consumer Finances[2] reported that 3 percent of families held nontaxable securities. IRS should also have separately identified the subset of taxpayers for whom IRC section 265(a)(2) might apply (i.e., those taxpayers who own tax-exempt securities and deduct interest expenses) and measured the extent of compliance for those taxpayers. This could have been done by recording whether the taxpayer said that he held tax-exempt securities, regardless of how the purchase was financed, and had interest expense deductions on his tax return. If this information had been recorded, IRS would be able to evaluate whether a computer match of tax-exempt interest income and interest deductions from Form 1040 would readily target those returns not in compliance with section 265(a)(2).

We discussed taxpayer compliance with section 265(a)(2) with IRS officials responsible for this portion of the TCMP study. These officials concurred that the TCMP study did not fully test compliance with IRC section 265, but they did not believe that the results of the study would have changed substantially had the carry provision been explicitly mentioned. They believed that the question as stated was sufficient to raise the issue of borrowing to purchase or carry, and revenue agents familiar with the IRC section would also have probed for information relating to the carry provision. However, they did not know whether or how often this might have been done.

IRS also does TCMP studies for tax returns filed by corporations with less than $10 million in assets. However, an analyst on the IRS national office TCMP team said none of these studies have attempted to measure corporate compliance with IRC section 265(a)(2).

Conclusion

The extent of individual and corporate taxpayer noncompliance with IRC section 265(a)(2) is not known. A recent TCMP study concluded that compliance with this section was not a significant problem, but we believe

[2]The Survey of Consumer Finances collected data on the balance sheets of 3,824 families through personal interviews. The survey was carried out by the Survey Research Center at the University of Michigan. It was sponsored by the Board of Governors of the Federal Reserve System; the Departments of Health and Human Services, Labor, and Treasury; the Federal Deposit Insurance Corporation; the Comptroller of the Currency; and the Federal Trade Commission.

IRS' methodology did not fully support this conclusion. IRS has not studied corporate taxpayer compliance.

Chapter 4

Effect of Establishing a Mechanical Disallowance Rule for All Corporate Taxpayers

In this chapter we discuss two effects of extending the mechanical disallowance rule to all corporate taxpayers—the effect on administration of IRC section 265 and the effect on the market for tax-exempt securities. From an administrative standpoint, IRS revenue agents believe that extending the mechanical rule to all corporate taxpayers would make administering IRC section 265 easier.

To assess the effect of extending the mechanical rule on the tax-exempt securities market, we obtained data from the Federal Reserve Board on the share of the market held by different types of investors. These data indicate that the share of tax-exempt securities held by financial institutions has fallen since the imposition of the mechanical disallowance rule. Among nonfinancial corporations, property and casualty insurance companies hold the largest share of tax-exempt securities. Since there are existing tax rules regarding how insurance companies are required to treat tax-exempt income, the effect of extending the rule to nonfinancial corporations would depend on whether the mechanical rule replaced or was added to these existing provisions. If the mechanical rule replaced these existing provisions, insurance companies might have an incentive to increase their holdings of tax-exempt securities.

Effect on IRS' Administration of IRC Section 265

As previously discussed, Congress has established two different rules for determining how much of a taxpayer's interest expenses should be disallowed under this IRC section. Since the percentage disallowed for financial institutions was raised to 100 percent, the deduction for interest expense is reduced according to the following formula:

$$\text{disallowed interest expense} = \left(\text{total interest expense}\right) \times \frac{\text{tax-exempt assets}}{\text{total assets}}$$

For individuals and nonfinancial corporations, IRC section 265(a)(2) requires that a determination be made as to whether the taxpayer's purpose in borrowing was to purchase or carry tax-exempt obligations. Thus, interest expenses disallowed are those IRS can determine to have a sufficiently direct relationship to tax-exempt investments.

IRS revenue agents who have worked audit cases involving IRC section 265 and who are familiar with the mechanical and subjective disallowance rules said that the mechanical rule is generally easier to administer. The revenue agents explained that a mechanical disallowance rule basically requires application of a single ratio to calculate the appropriate amount of disallowed interest expenses. The subjective disallowance rule, however, is harder to administer because it requires IRS to make a complex analysis of the taxpayer's purpose in borrowing money and to trace the borrowed funds to investment in tax-exempt obligations. Also, some tax experts have argued that extending the mechanical disallowance rule to all corporate taxpayers would be a way to ease the burden of administration and ensure tax equity.

Extending the mechanical disallowance rule to individuals would present administrative difficulties for IRS and the taxpayer. To extend the rule, IRS would need to require that individuals prepare a balance sheet listing total assets and tax-exempt assets for use in the formula. To evaluate compliance with such a provision, IRS would need to verify the asset values declared by the taxpayer or require that taxpayers be able to verify them. Consequently, any administrative benefits of extending the mechanical rule to individuals might be outweighed by the administrative costs in verifying asset values and in additional burden to the taxpayer.

Effect of the Mechanical Disallowance Rule on Holdings of Tax-Exempt Securities

As agreed with the Joint Committee, we did not attempt to estimate the revenue effects of extending the mechanical disallowance rule to all corporate taxpayers. We obtained and analyzed data from the Federal Reserve Board of Governors' Flow of Funds Accounts to identify who holds the outstanding stock of tax-exempt securities. We also reviewed the sections of the tax code regarding the treatment of tax-exempt income. With this background, we analyzed the direction of change in holdings that would likely follow an extension of the 100 percent mechanical disallowance rule.

Federal Reserve Board Data

Overall investment in tax-exempt securities has grown significantly, and the proportions of these securities held by different sectors of the market have changed substantially over the last 10 years. Table 4.1 shows that overall investment in tax-exempt securities grew from $290 billion in 1978 to $721 billion in 1987. The table also shows that financial institutions held about 25 percent of the outstanding stock of tax-exempt securities at the end of 1987 compared to 45 percent at the end of 1978. This decrease continues a trend that started in the early 1970s, when commercial banks alone held over 50 percent of the outstanding tax-exempt securities. Although their share of tax-exempt securities decreased, financial institutions remained net buyers of tax-exempt debt from 1978 through 1985.

Households and money funds appear to have taken up the share of the market given up by financial institutions. Table 4.1 shows that the percentage of tax-exempt securities held by households increased from about 25 percent at the end of 1978 to about 39 percent at the end of 1987. The percentage of tax-exempt securities held by money funds increased from about 1 percent at the end of 1978 to about 18 percent by the end of 1987.

Table 4.1 shows that the share of tax-exempt securities held by nonfinancial corporations decreased from about 25 percent at the end of 1978 to about 16 percent at the end of 1985, but has remained constant since then. The table also shows that insurance companies hold most of the tax-exempt securities held by nonfinancial corporations. The percentage of tax-exempt securities held by other nonfinancial corporations has been about 1 percent since the end of 1978.

Table 4.1: Tax-Exempt Security Holdings by Type of Investor - Years, 1978-87

Dollars in millions

	4th Qtr. of Calendar Year	
	1978	**1979**
Households	**$71,195**	**$81,691**
Percent of total holdings	24.6	25.5
Financial corporations		
Commercial banking	$126,205	$135,583
Savings & loan associations	1,275	1,150
Mutual savings banks	3,335	2,930
Brokers & dealers	864	1,046
Subtotal	**$131,679**	**$140,709**
Percent of total holdings	45.4	44.0
Money funds		
Money market funds	$0	$0
Mutual funds	2,683	4,039
Subtotal	**$2,683**	**$4,039**
Percent of total holdings	0.9	1.3
Nonfinancial corporations		
Life insurance co.	$6,402	$6,428
Other insurance co.	62,931	72,811
Insurance subtotal	$69,333	$79,239
Percent of total holdings	23.9	24.8
Other nonfinancial corporations	$3,658	$3,687
Percent of total holdings	1.3	1.2
Subtotal	**$72,991**	**$82,926**
Percent of total holdings	25.2	25.9
State & local govt.		
General funds	$7,238	$6,788
Retirement funds	3,951	3,910
Subtotal	**$11,189**	**$10,698**
Percent of total holdings	3.9	3.3
Total holdings	**$289,737**	**$320,063**

1980	1981	1982	1983	1984	1985	1986	1987
$88,358	**$99,828**	**$123,816**	**$162,871**	**$192,206**	**$240,124**	**$231,929**	**$278,993**
25.2	26.7	29.6	34.5	36.8	36.5	33.7	38.7
$149,199	$154,174	$158,490	$163,240	$174,151	$231,323	$202,800	$180,044
1,190	1,305	838	907	676	1,073	910	1,049
2,390	2,288	2,470	2,177	2,077	2,323	2,174	2,004
1,064	1,220	1,047	1,400	2,000	3,000	2,507	486
$153,843	**$158,987**	**$162,845**	**$167,724**	**$178,904**	**$237,719**	**$208,391**	**$183,583**
43.9	42.5	39.0	35.6	34.3	36.1	30.2	25.5
$1,914	$4,248	$13,230	$16,844	$23,822	$36,267	$63,763	$61,420
4,420	5,102	7,972	13,424	19,068	33,523	65,288	70,696
$6,334	**$9,350**	**$21,202**	**$30,268**	**$42,890**	**$69,790**	**$129,051**	**$132,116**
1.8	2.5	5.1	6.4	8.2	10.6	18.7	18.3
$6,701	$7,151	$9,047	$9,986	$8,713	$9,708	$11,659	$11,800
80,533	83,923	86,968	86,667	84,742	87,248	91,869	94,620
$87,234	$91,074	$96,015	$96,653	$93,455	$96,956	$103,528	$106,420
24.9	24.4	23.0	20.5	17.9	14.7	15.0	14.8
3,490	$3,470	$3,536	$4,201	$4,066	$4,902	$7,968	$10,532
1.0	0.9	0.8	0.9	0.8	0.7	1.2	1.5
$90,724	**$94,544**	**$99,551**	**$100,854**	**$97,521**	**$101,858**	**$111,496**	**$116,952**
25.9	25.3	23.8	21.4	18.7	15.5	16.2	16.2
$7,008	$7,139	$7,383	$7,955	$9,016	$7,822	$7,557	$8,084
4,059	3,856	3,131	2,000	1,534	1,128	809	775
$11,067	**$10,995**	**$10,514**	**$9,955**	**$10,550**	**$8,950**	**$8,366**	**$8,859**
3.2	2.9	2.5	2.1	2.0	1.4	1.2	1.2
$350,326	**$373,704**	**$417,928**	**$471,672**	**$522,071**	**$658,411**	**$689,233**	**$720,503**

Source: Federal Reserve Board, Flow of Funds Accounts. 1987 data should be regarded as preliminary.

In order to highlight the changes in tax-exempt securities holdings that occurred during 1985 through 1987, table 4.2 shows the most recent data on a quarterly basis. The table shows that the total value of tax-exempt securities increased from $530 billion to $720 billion, or by 36 percent, in this period. Aside from a temporary increase in the percentage of tax-exempt securities held in the fourth quarter of 1985, financial institutions held about 33 percent of total tax-exempt securities outstanding. However, the percentage of tax-exempt securities held by financial institutions decreased after the third quarter of 1986, when new holdings became subject to the 100 percent mechanical disallowance rule. By the end of the fourth quarter of 1987, the value of financial institutions' tax-exempt securities holdings was 18 percent less than in the third quarter of 1986.

Table 4.2 shows the rapid development of money funds as major owners of tax-exempt securities in 1985 and 1986. Mutual fund holdings tripled and money market holdings nearly doubled in this 2-year period. This growth seems to have stopped in 1987. The tax-exempt interest income earned by these funds is in certain cases passed through as tax-exempt to the owners of the funds. Federal Reserve Flow of Funds data indicate that an average of 87 percent of mutual fund shares were held by households over this time period.

Table 4.2 also shows that while the share of tax-exempt securities held by nonfinancial corporations other than insurance companies has remained small, holdings more than doubled from the beginning of 1985 to the end of 1987. The Tax Reform Act of 1986 contained both incentives and disincentives for other nonfinancial corporations to hold tax-exempt securities. The reduction in corporate tax rates and the inclusion of certain tax-exempt interest income in the base of the alternative minimum tax decreased the incentive for nonfinancial corporations to hold tax-exempt securities. However, the elimination of both the investment tax credit and the preferential treatment of capital gains and the scaling back of accelerated depreciation made tax-exempt securities one of the few remaining methods to shelter income, thus increasing the incentive to hold tax-exempt securities. The net effect then depends on the relative magnitudes of these changes.

Table 4.2: Tax-Exempt Security Holdings, by Type of Investor - Quarters, 1985-1987

Dollars in millions

	1985			
	I	II	III	IV
Households	**$192,730**	**$208,785**	**$207,846**	**$240,124**
Percent of total holdings	36.4	37.7	36.5	36.5
Financial corporations				
Commercial banking	$169,255	$171,349	$182,275	$231,323
Savings & loan associations	683	648	626	1,073
Mutual savings banks	2,092	2,093	2,107	2,323
Brokers & dealers	1,600	2,200	2,200	3,000
Subtotal	**$173,630**	**$176,290**	**$187,208**	**$237,719**
Percent of total holdings	32.8	31.8	32.9	36.1
Money funds				
Money market funds	$34,292	$35,279	$36,891	$36,267
Mutual funds	21,291	25,393	28,565	33,523
Subtotal	**$55,583**	**$60,672**	**$65,456**	**$69,790**
Percent of total holdings	10.5	10.9	11.5	10.6
Nonfinancial corporations				
Life insurance co.	$8,891	$8,914	$9,044	$9,708
Other insurance co.	84,943	85,523	86,176	87,248
Insurance subtotal	$93,834	$94,437	$95,220	$96,956
Percent of total holdings	17.7	17.0	16.7	14.7
Other nonfinancial corporations	$4,139	$4,187	$4,286	$4,902
Percent of total holdings	0.8	0.8	0.8	0.7
Subtotal	**$97,973**	**$98,624**	**$99,506**	**$101,858**
Percent of total holdings	18.5	17.8	17.5	15.5
State & local govt.				
General funds	$8,650	$8,735	$8,025	$7,822
Retirement funds	1,550	1,278	1,225	1,128
Subtotal	**$10,200**	**$10,013**	**$9,250**	**$8,950**
Percent of total holdings	1.9	1.8	1.6	1.4
Total holdings	**$530,116**	**$554,384**	**$569,266**	**$658,441**

1986				1987			
I	II	III	IV	I	II	III	IV
$220,366	**$216,286**	**$227,286**	**$231,929**	**$234,199**	**$251,519**	**$270,575**	**$278,993**
34.2	33.3	33.2	33.7	33.5	35.7	37.8	38.7
$213,672	$208,412	$217,084	$202,800	$192,011	$185,027	$179,461	$180,044
903	798	861	910	888	855	1,016	1,049
2,306	2,281	2,407	2,174	2,041	2,059	2,023	2,004
2,500	2,500	3,763	2,507	4,701	3,299	2,240	486
$219,381	**$213,991**	**$224,115**	**$208,391**	**$199,641**	**$191,240**	**$184,740**	**$183,583**
34.0	33.0	32.7	30.2	28.6	27.2	25.8	25.5
$51,494	$56,086	$60,637	$63,763	70,232	66,705	64,923	61,420
41,289	48,260	56,246	65,288	73,881	72,946	72,836	70,696
$92,783	**$104,346**	**$116,883**	**$129,051**	**$144,113**	**$139,651**	**$137,759**	**$132,116**
14.4	16.1	17.1	18.7	20.6	19.8	19.3	18.3
$10,023	$10,791	$11,648	$11,659	$10,860	$11,485	$11,086	$11,800
88,265	89,281	90,538	91,869	92,496	93,107	93,720	94,620
$98,288	$100,072	$102,617	$103,528	$103,356	$104,592	$104,806	$106,420
15.2	15.4	15.0	15.0	14.8	14.9	14.7	14.8
$5,482	$6,173	$5,980	$7,968	$8,837	$8,581	$8,445	$10,532
0.9	1.0	0.9	1.2	1.3	1.2	1.2	1.5
$103,770	**$106,245**	**$108,597**	**$111,496**	**$112,193**	**$113,173**	**$113,251**	**$116,952**
16.1	16.4	15.9	16.2	16.1	16.1	15.8	16.2
$7,562	$7,254	$7,342	$7,557	$7,740	$7,739	$7,908	$8,084
938	1,196	1,070	809	709	775	767	775
$8,500	**$8,450**	**$8,412**	**$8,366**	**$8,449**	**$8,514**	**$8,675**	**$8,859**
1.3	1.3	1.2	1.2	1.2	1.2	1.2	1.2
$644,800	**$649,318**	**$684,862**	**$689,233**	**$698,595**	**$704,097**	**$715,000**	**$720,503**

Source: Federal Reserve Board, Flow of Funds Accounts. 1987 data should be regarded as preliminary.

Existing Tax Rules Regarding Tax-Exempt Income of Insurance Companies

Life insurance and property and casualty insurance companies are subject to special rules regarding tax-exempt income. Life insurance companies must allocate all investment income, including tax-exempt interest income, between the company and their policyholders on a pro rata basis. Since policyholder income is not taxed at the corporate level and can be deferred from individual tax, the tax exemption is useful only on that fraction of interest income allocated to the company. Given the usual yield differential between taxable and tax-exempt securities, life insurance companies have found that taxable securities usually offer a higher after-tax yield than tax-exempt securities. As a consequence, life insurance companies have held relatively few tax-exempt securities, as seen in table 4.2.

Property and casualty insurance companies, who hold the largest percentage of tax-exempt securities among nonfinancial corporations, are not required to allocate investment income between policyholders and the company as do life insurance companies. Unlike banks, whose payments to customers are characterized as interest payments, expected insurance payments are credited to a loss reserve and are deductible from underwriting income as a cost of business. Prior to the Tax Reform Act of 1986, while property and casualty companies were subject to IRC section 265(a)(2), no reduction in the loss reserve was required to offset tax-exempt income. According to the Joint Committee on Taxation staff,[1] Congress believed that it was not appropriate to fund deductible loss reserves with income that might be tax-exempt. The Tax Reform Act amended IRC section 832(b)(5), which now reduces the deduction for losses incurred by 15 percent of property and casualty company tax-exempt interest income and certain dividends received or accrued after August 7, 1986. This provision is similar to the mechanical disallowance rule for banks. If the premium payments of insurance company customers are considered analogous to bank deposits, and if payments for losses by insurance companies to their customers are seen as analogous to interest payments made by banks to their customers, then disallowing a portion of the loss deduction is similar to disallowing a portion of the interest expense deduction.

[1]Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, May 4, 1987, pp. 598 to 600.

Effect of Extending the Mechanical Disallowance Rule

The effect of extending the 100 percent mechanical disallowance rule to all corporations on the proportions of securities held by various sectors of the market would depend on whether such a provision replaces or is added to the provisions already in effect for insurance companies. If the rule is added to the provisions already in effect, tax-exempt securities would become in effect more expensive relative to taxable investments, so insurance companies and other nonfinancial corporations would have less incentive to own tax-exempt securities than had the rule not been extended. As nonfinancial corporations find tax-exempt securities less attractive, and assuming no changes in supply, the rate of return on tax-exempt securities would have to increase relative to the rate of return on taxable securities in order to attract buyers. The rate of return on tax-exempt securities would increase until households and financial institutions find tax-exempt securities attractive relative to taxable investments.

If the mechanical disallowance rule replaced the existing provisions for insurance companies, insurance company holdings of tax-exempt securities may increase rather than decrease. Since insurance companies do not borrow to the extent firms in other industries do, they have relatively little interest expense to disallow.[2] Therefore, the mechanical rule would have a smaller effect on the effective rate of return on tax-exempt securities held by insurance companies. If the current provisions lower effective rates of return to a greater extent, the replacement of these provisions with the mechanical disallowance rule would increase insurance companies' demand for tax-exempt securities rather than decrease demand. Extending the rule would decrease demand by other nonfinancial corporations since they would lose some fraction of their interest deductions by owning tax-exempt securities. Also, with a 100 percent mechanical disallowance rule, the 2 percent de minimis rule would no longer apply. The net effect on the market would depend on the relative magnitudes of the possibly increased demand of insurance companies and the decreased demand of other nonfinancial corporations.

Conclusions

IRS revenue agents familiar with both the subjective disallowance rule and the mechanical disallowance rule for corporations told us that the mechanical rule is an easier policy to administer. On the other hand, we

[2]According to IRS' Statistics of Income, the insurance industry's ratio of interest expense to total assets has been substantially lower than the ratio for all other industries. The most recently available data, for 1985, show the two ratios differing by 3.4 percentage points (1.1 percent versus 4.5 percent). A similar differential occurred for the years 1982-84.

believe that extending the mechanical rule to individuals might not reduce administrative costs and would increase taxpayer burden.

Federal Reserve Board data indicate that the proportions of tax-exempt securities held by different sectors of the market have changed over the last 10 years. The share owned by households and money funds has grown, while the share owned by financial institutions has declined. Since the third quarter of 1986, when the mechanical rule became effective, financial institutions have been net sellers of tax-exempt securities.

The effect on the tax-exempt securities market of extending the mechanical disallowance rule depends on whether the rule would replace or be added to existing provisions dealing with how insurance companies are allowed to treat tax-exempt income. If the mechanical rule is added to existing provisions, nonfinancial corporations would likely hold fewer tax-exempt securities. If the rule replaces the existing provisions, nonfinancial corporations as a group might increase rather than decrease holdings of tax-exempt securities.

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

SEP 23 1988

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Policy: Deducting Interest on Funds Borrowed to Purchase or Carry Tax-Exempt Bonds". We generally agree with the report's recommendations and our detailed comments are enclosed.

We hope you find these useful.

With kind regards,

Sincerely,

Charles H. Brennan

Acting

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"TAX POLICY: DEDUCTING INTEREST ON FUNDS BORROWED TO
PURCHASE OR CARRY TAX-EXEMPT BONDS"

Now on page 22.

Recommendation 1 (Page 38):

Study the costs and benefits of requiring information reporting for tax-exempt interest income.

See page 23.

Comment:

Our tax year 1987 TCMP program for corporations contains a question asking if the taxpayer received tax-exempt interest. We also intend to develop such a question for our tax year 1988 TCMP program for individuals. This should provide some information on the usefulness of information reporting as well as compliance with section 265.

However, the data we get from these programs will not enable us to fully evaluate the costs and benefits of requiring information reporting for tax-exempt interest income. In order to determine the costs and benefits, it would be necessary to identify the potential universe of payors and the number of individuals and corporations that receive tax-exempt interest. It would also be necessary to obtain a representative sample of payees in order to determine if they had reported this information and, if not, the compliance effect of the omission.

The appropriate source of a sample would be the financial institutions that pay this income. However, it is unlikely that these institutions would be willing to provide IRS with names and SSNs of owners of tax-exempt securities and amounts paid since there is no legal requirement to report these amounts to IRS. IRS does not believe that it could successfully summon such information from banks and other payors for purposes of conducting a study.

Now on page 22.

Recommendation 2 (Page 38):

Consider changing the corporate tax forms to provide for reporting separately the value of (1) federal and taxable state and local securities and (2) tax-exempt state and local securities. Changing line 4 of Schedule L into two line items is a way to do this.

See page 23.

Comment:

We agree that revising the balance sheet on corporate tax returns could assist us in determining the interest deduction subject to the IRC section 265 limitations. Because we are so far along in our 1988 tax forms development cycle, we do not anticipate that any changes to the corporate return could occur until a tax year beginning after 1988. During development of the 1989 form, we will present GAO's recommendations to the Tax Forms Coordinating Committee.

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