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Internal Revenue Code Section 265

Expenses and interest relating to tax-exempt income

(a) General rule.

No deduction shall be allowed for-

(1) Expenses.

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

(2) Interest.

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

(3) Certain regulated investment companies.

In the case of a regulated investment company which distributes during the taxable year an exempt-interest dividend (including exempt-interest dividends paid after the close of the taxable year as described in section 855), that portion of any amount otherwise allowable as a deduction which the amount of the income of such company wholly exempt from taxes under this subtitle bears to the total of such exempt income and its gross income (excluding from gross income, for this purpose, capital gain net income, as defined in section 1222(9)).

(4) Interest related to exempt-interest dividends.

Interest on indebtedness incurred or continued to purchase or carry shares of stock of a regulated investment company which during the taxable year of the holder thereof distributes exempt-interest dividends.

(5) Special rules for application of paragraph (2) in the case of short sales.

For purposes of paragraph (2)-

(A) In general. The term "interest" includes any amount paid or incurred-

(i) by any person making a short sale in connection with personal property used in such short sale, or

(ii) by any other person for the use of any collateral with respect to such short sale.

(B) Exception where no return on cash collateral. If-

(i) the taxpayer provides cash as collateral for any short sale, and

(ii) the taxpayer receives no material earnings on such cash during the period of the sale,

subparagraph (A)(i) shall not apply to such short sale.

(6) Section not to apply with respect to parsonage and military housing allowances. No deduction shall be denied under this section for interest on a mortgage on, or real property taxes on, the home of the taxpayer by reason of the receipt of an amount as-

(A) a military housing allowance, or

(B) a parsonage allowance excludable from gross income under section 107 .

(b) Pro rata allocation of interest expense of financial institutions to tax-exempt interest.

(1) In general.

In the case of a financial institution, no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest.

(2) Allocation.

For purposes of paragraph (1), the portion of the taxpayer's interest expense which is allocable to tax-exempt interest is an amount which bears the same ratio to such interest expense as-

(A) the taxpayer's average adjusted bases (within the meaning of section 1016) of tax-exempt obligations acquired after August 7, 1986, bears to

(B) such average adjusted bases for all assets of the taxpayer.

(3) Exception for certain tax-exempt obligations.

(A) In general. Any qualified tax-exempt obligation acquired after August 7, 1986, shall be treated for purposes of paragraph (2) and section 291(e)(1)(B) as if it were acquired on August 7, 1986.

(B) Qualified tax-exempt obligation.

(i) In general. For purposes of subparagraph (A) , the term "qualified tax-exempt obligation" means a tax-exempt obligation-

(I) which is issued after August 7, 1986, by a qualified small issuer,

(II) which is not a private activity bond (as defined in section 141), and

(III) which is designated by the issuer for purposes of this paragraph .

(ii) Certain bonds not treated as private activity bonds. For purposes of clause (i)(II) , there shall not be treated as a private activity bond-

(I) any qualified 501(c)(3) bond (as defined in section 145) , or

(II) any obligation issued to refund (or which is part of a series of obligations issued to refund) an obligation issued before August 8, 1986, which was not an industrial development bond (as defined in section 103(b)(2) as in effect on the day before the date of the enactment [10/22/86] of the Tax Reform Act of 1986) or a private loan bond (as defined in section 103(o)(2)(A) , as so in effect, but without regard to any exemption from such definition other than section 103(o)(2)(A)).

(C) Qualified small issuer.

(i) In general. For purposes of subparagraph (B) , the term "qualified small issuer" means, with respect to obligations issued during any calendar year, any issuer if the reasonably anticipated amount of tax-exempt obligations (other than obligations described in clause (ii)) which will be issued by such issuer during such calendar year does not exceed \$10,000,000.

(ii) Obligations not taken into account in determining status as qualified small issuer. For purposes of clause (i) , an obligation is described in this clause if such obligation is-

(I) a private activity bond (other than a qualified 501(c)(3) bond, as defined in section 145),

(II) an obligation to which section 141(a) does not apply by reason of section 1312, 1313, 1316(g), or 1317 of the Tax Reform Act of 1986 and which would (if issued on August 15, 1986) have been an industrial development bond (as defined in section 103(b)(2) as in effect on the day before the date of the enactment of such Act) or a private loan bond (as defined in section 103(o)(2)(A) , as so in effect, but without regard to any exception from such definition other than section 103(o)(2)(A)), or

(III) an obligation issued to refund (other than to advance refund within the meaning of section 149(d)(5)) any obligation to the extent the amount of the refunding obligation does not exceed the outstanding amount of the refunded obligation.

(iii) Allocation of amount of issue in certain cases. In the case of an issue under which more than 1 governmental entity receives benefits, if-

(I) all governmental entities receiving benefits from such issue irrevocably agree (before the date of issuance of the issue) on an allocation of the amount of such issue for purposes of this subparagraph, and

(II) such allocation bears a reasonable relationship to the respective benefits received by such entities,

then the amount of such issue so allocated to an entity (and only such amount with respect to such issue) shall be taken into account under clause (i) with respect to such entity.

(D) Limitation on amount of obligations which may be designated.

(i) In general. Not more than \$10,000,000 of obligations issued by an issuer during any calendar year may be designated by such issuer for purposes of this paragraph .

(ii) Certain refundings of designated obligations deemed designated.- Except as provided in clause (iii) , in the case of a refunding (or series of refundings) of a qualified tax-exempt obligation, the refunding obligation shall be treated as a qualified tax-exempt obligation (and shall not be taken into account under clause (i)) if-

(I) the refunding obligation was not taken into account under subparagraph (C) by reason of clause (ii)(III) thereof ,

(II) the average maturity date of the refunding obligations issued as part of the issue of which such refunding obligation is a part is not later than the average maturity date of the obligations to be refunded by such issue, and

(III) the refunding obligation has a maturity date which is not later than the date which is 30 years after the date the original qualified tax-exempt obligation was issued.

Subclause (II) shall not apply if the average maturity of the issue of which the original qualified tax-exempt obligation was a part (and of the issue of which the obligations to be refunded are a part) is 3 years or less. For purposes of this clause, average maturity shall be determined in accordance with section 147(b)(2)(A) .

(iii) Certain obligations may not be designated or deemed designated. No obligation issued as part of an issue may be designated under this paragraph (or may be treated as designated under clause (ii)) if-

(I) any obligation issued as part of such issue is issued to refund another obligation, and

(II) the aggregate face amount of such issue exceeds \$10,000,000.

(E) Aggregation of issuers. For purposes of subparagraphs (C) and (D) -

(i) an issuer and all entities which issue obligations on behalf of such issuer shall be treated as 1 issuer,

(ii) all obligations issued by a subordinate entity shall, for purposes of applying subparagraphs (C) and (D) to each other entity to which such entity is subordinate, be treated as issued by such other entity, and

(iii) an entity formed (or, to the extent provided by the Secretary, availed of) to avoid the purposes of subparagraph (C) or (D) and all entities benefiting thereby shall be treated as 1 issuer.

(F) Treatment of composite issues. In the case of an obligation which is issued as part of a direct or indirect composite issue, such obligation shall not be treated as a qualified tax-exempt obligation unless-

(i) the requirements of this paragraph are met with respect to such composite issue (determined by treating such composite issue as a single issue), and

(ii) the requirements of this paragraph are met with respect to each separate lot of obligations which are part of the issue (determined by treating each such separate lot as a separate issue).

(G) Special rules for obligations issued during 2009 and 2010.

(i) Increase in limitation. In the case of obligations issued during 2009 or 2010, subparagraphs (C)(i), (D)(i), and (D)(iii)(II) shall each be applied by substituting "\$30,000,000" for "\$10,000,000".

(ii) Qualified 501(c)(3) bonds treated as issued by exempt organization. In the case of a qualified 501(c)(3) bond (as defined in section 145) issued during 2009 or 2010, this paragraph shall be applied by treating the 501(c)(3) organization for whose benefit such bond was issued as the issuer.

(iii) Special rule for qualified financings. In the case of a qualified financing issue issued during 2009 or 2010-

(I) subparagraph (F) shall not apply, and

(II) any obligation issued as a part of such issue shall be treated as a qualified tax-exempt obligation if the requirements of this paragraph are met with respect to each qualified portion of the issue (determined by treating each qualified portion as a separate issue which is issued by the qualified borrower with respect to which such portion relates).

(iv) Qualified financing issue. For purposes of this subparagraph, the term "qualified financing issue" means any composite, pooled, or other conduit financing issue the proceeds of which are used directly or indirectly to make or finance loans to 1 or more ultimate borrowers each of whom is a qualified borrower.

(v) Qualified portion. For purposes of this subparagraph, the term "qualified portion" means that portion of the proceeds which are used with respect to each qualified borrower under the issue.

(vi) Qualified borrower. For purposes of this subparagraph, the term "qualified borrower" means a borrower which is a State or political

subdivision thereof or an organization described in section 501(c)(3) and exempt from taxation under section 501(a) .

(4) Definitions.

For purposes of this subsection-

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

(B) Tax-exempt obligation. The term "tax-exempt obligation" means any obligation the interest on which is wholly exempt from taxes imposed by this subtitle. Such term includes shares of stock of a regulated investment company which during the taxable year of the holder thereof distributes exempt-interest dividends.

(5) Financial institution.

For purposes of this subsection , the term "financial institution" means any person who-

(A) accepts deposits from the public in the ordinary course of such person's trade or business, and is subject to Federal or State supervision as a financial institution, or

(B) is a corporation described in section 585(a)(2) .

(6) Special rules.

(A) Coordination with subsection (a) . If interest on any indebtedness is disallowed under subsection (a) with respect to any tax-exempt obligation-

(i) such disallowed interest shall not be taken into account for purposes of applying this subsection , and

(ii) for purposes of applying paragraph (2) , the adjusted basis of such tax-exempt obligation shall be reduced (but not below zero) by the amount of such indebtedness.

(B) Coordination with section 263A . This section shall be applied before the application of section 263A (relating to capitalization of certain expenses where taxpayer produces property).

(7) De minimis exception for bonds issued during 2009 or 2010.

(A) In general. In applying paragraph (2)(A) , there shall not be taken into account tax-exempt obligations issued during 2009 or 2010.

(B) Limitation. The amount of tax-exempt obligations not taken into account by reason of subparagraph (A) shall not exceed 2 percent of the amount determined under paragraph (2)(B) .

(C) Refundings. For purposes of this paragraph, a refunding bond (whether a current or advance refunding) shall be treated as issued on the date of the issuance of the refunded bond (or in the case of a series of refundings, the original bond).