BROOKINGS

The Double Benefit Myth: Disallowed Interest Expense and Inefficiency in the Municipal Bond Market

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Outline

- What is IRC 265?
- How the formulaic application of 265 to banks forced them out of the muni market
- Debunking double benefit myth
- The consequences of 265 for efficiency in the muni market
- Policy options

IRC 265: NO INTEREST DEDUCTIONS FOR TAX-EXEMPT INVESTMENTS

- “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.”
  - Why? “a taxpayer could accrue a double benefit by deducting interest paid on money borrowed to invest in tax-exempt securities.” (GAO 1988)
- TEFRA 1982: 15% of formulaic allocation disallowed.
- TRA 1986: 100% disallowed.

Formulaic application of 265 caused an exodus of banks from muni market

Commercial Bank Holdings of Municipal Securities

Percent of Total Outstanding Municial Securities

60%
50%
40%
30%
20%
10%
0%

TEFRA 1982

TRA 1986

1945 1950 1955 1960 1965 1970 1975 1980 1985 1990 1995 2000 2005 2010 2015 2020

The Double Benefit Myth

- “a taxpayer could accrue a double benefit by deducting interest paid on money borrowed to invest in tax-exempt securities.” GAO 1988.

“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…if the $5,000 interest expense is allowed as a deduction, no tax would be due on the $5,000 in taxable dividends.”

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The Double Benefit Myth

- Arbitrage requires that $r_t(1-t) = r_e$, where

  r_t is the yield on taxable bonds

  r_e is the yield on tax-exempt bonds

  t is the marginal tax rate

- If the bank deposit rate is r_d then banks earn the same after-tax return if and only if they get the tax benefit from deducting interest, when:

$$(r_t - r_d)(1-t) = r_e - r_d(1-t)$$
$$= (r_e - r_d) + r_d t$$

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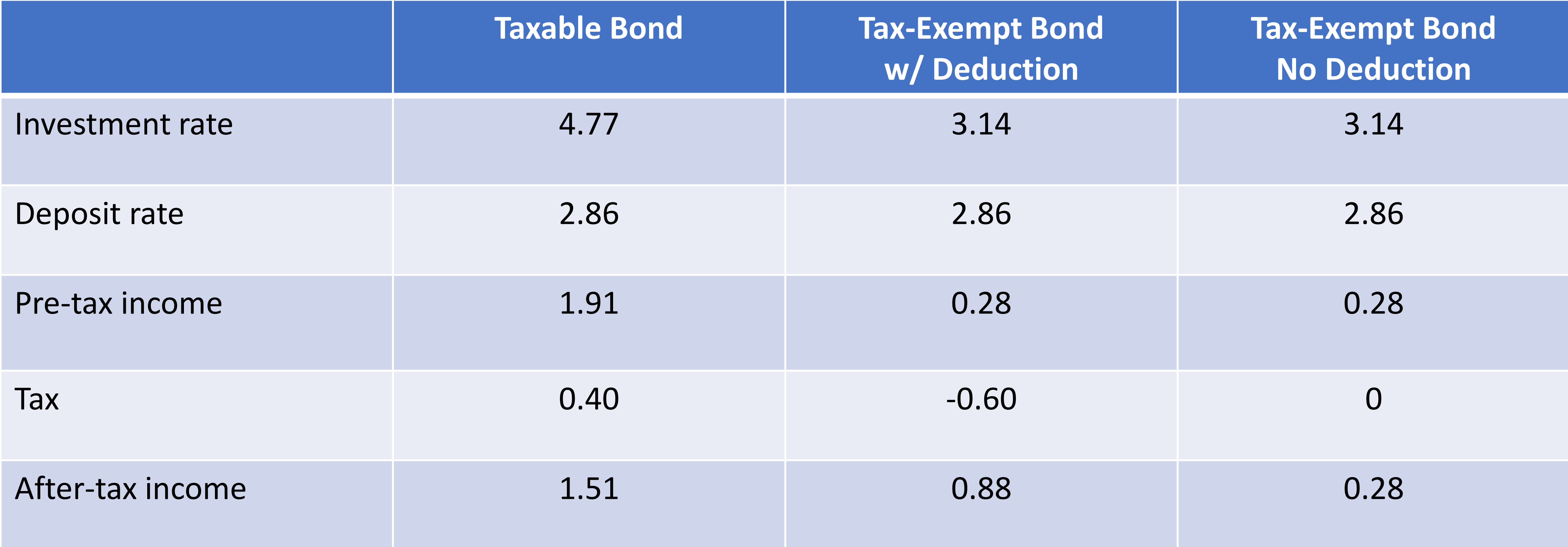
- Disallowing interest expense imposes tax penalty, drives return on exempt debt below that of taxable debt.

Numerical example



	Taxable Bond	Tax-Exempt Bond w/ Deduction	Tax-Exempt Bond No Deduction
Investment rate	4.77	3.14	3.14
Deposit rate	2.86	2.86	2.86
Pre-tax income	1.91	0.28	0.28
Tax	0.40	-0.60	0
After-tax income	1.51	0.88	0.28

Numerical example: Sensitivity of After-Tax Income

	Taxable Bond	Tax-Exempt Bond w/ Deduction	Tax-Exempt Bond No Deduction
Original	1.51	0.88	0.28
Investment yield +1%	2.30	1.88	1.28
Expense cost -1%	2.30	1.67	1.28
Spread -0.5%	1.31	1.13	0.53
Tax rate 34% (vs 21%)	1.26	1.25	0.28

Consequences of 265 Disallowance

- Exodus of banks → now a retail market
- High tax-adjusted spreads, high transaction costs. Why?
  - Illiquidity (e.g. Ang et al 2010, 2014)
  - Excessive risk premia (Schwert 2017)
- Absence of banks surely contributes
  - Bring pools of risk-bearing capital; expertise in local underwriting; financial sophistication and trading capacity.

Consequences of 265 Disallowance

- Bank participation reduces spreads and increases liquidity
- Build America Bonds (Treasury 2011)
- Dagostino 2022 & St. Clair 2022: Bank qualification reduces yields, increases issuance, boosts local activity.

Policy options

- Repeal IRC 265’s 1980s pro-rata disallowances.
- Increase small issuer thresholds
  - Adjusted for inflation $10m in 1986 would be ~$30m
- Make permanent ARRA’s 2% de-minimus rule
- Changes would reduce yields, increase liquidity, improve delivery of municipal subsidy.

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