

First, all expenses (other than interest) otherwise deductible as an expense for the production of income are not deductible if allocable to tax-exempt income.<sup>7</sup> This rule is generally applicable only to investment expenses, and not to trade or business expenses. Thus, if the exempt interest is income of a trade or business, such as a bank, the expenses of earning that interest are not subject to disallowance under this rule.

Second, the code provides that interest on indebtedness incurred or continued to purchase or carry obligations, the interest on which is exempt, is not deductible.<sup>8</sup> This is so regardless of whether the exempt income is investment income or income of a trade or business.

Obligations of State and local governments are not accorded any preferential treatment for purposes of estate and gift taxation. In each case, tax is generally imposed on the fair market value of the obligation at the time it is transferred or bequeathed.

The foregoing rules are rules of general applicability, regardless of whether the taxpayer is an individual, a trust, or a corporation. Significant departures, however, result in the case of the following holders of tax-exempt obligations, classified by institutional group. The following analysis, however, does not treat of situations where the municipal bonds are held as inventory by dealers in such obligations.

#### 1. COMMERCIAL BANKS

While State and local obligations held by commercial banks may qualify as capital assets, gains on disposition of which are taxed at 25 percent if held for more than 6 months, net losses on the sale or exchange of such obligations which are capital assets may, in effect, be deducted against ordinary income. Ordinarily, capital losses of corporations may not be used to offset ordinary income, but may be used to offset capital gains of the taxable year or future years. The bank, rule, however, applies only if the losses of the taxable year from sales or exchanges by banks of obligations issued by corporations, including municipal corporations, exceed the gains for the taxable year from such sales or exchanges.<sup>9</sup>

With respect to interest expense paid or accrued by commercial banks on indebtedness incurred or continued to earn tax-exempt interest, interest is not disallowed on deposits. The general disallowance rule has not obtained in the case of interest on deposits of commercial banks for historical reasons but is, of course, applicable to interest on other obligations of banks such as notes and debentures.

#### 2. MUTUAL SAVINGS BANKS

Mutual savings banks which meet specified tests of similarity to national banks may, as in the case of commercial banks, deduct their net losses on sales or exchanges of obligations, including municipal obligations, for the taxable year against ordinary income.<sup>10</sup>

<sup>7</sup> Internal Revenue Code, sec. 265(1).

<sup>8</sup> Internal Revenue Code, sec. 265(2).

<sup>9</sup> Internal Revenue Code, sec. 582(c).

<sup>10</sup> Internal Revenue Code, sec. 582(c).