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SMALL BORROWER BANK-QUALIFIED TAX-EXEMPT OBLIGATIONS:

Supporting Small Local Governments and Non-Profits

When small local governments, health care and education institutions, or other non-profits want to borrow several million dollars for a new project they often discover that they are not sufficiently creditworthy to access the public markets at attractive rates and/or that the costs of issuance and delay involved in a public offering may outweigh the interest rate advantage of tax-exempt debt. Often, a local bank, familiar with the government or non-profit, is prepared to lend the institution money. However, the conventional loan rates offered by the bank are high. In certain cases, bank-qualified tax-exempt obligations may be the best alternative, allowing an institution to access tax-exempt rates more quickly and with reduced costs of issuance. In effect, this involves a private placement of tax-exempt bonds with a bank — no underwriting fees, no offering document, and substantially reduced costs of issuance.

What are "small borrower" bank-qualified tax-exempt obligations?

Under IRC Section 265(b) they are tax-exempt obligations that are issued for and state and local governments and 501(c)(3)'s by a "qualified small issuer" and which are formally designated by the issuer as "qualified tax-exempt obligations." Currently, a qualified small issuer is defined, with respect to obligations issued during any calendar year, as any issuer if the reasonably anticipated amount of tax-exempt obligations (with certain exclusions) to be issued during such calendar year does not exceed $10,000,000. The current rules require aggregating the total issuance by an issuer for all borrowers, making it practically impossible for state issuers to issue such debt for small borrowers.

Why are small borrower bank-qualified tax-exempt obligations better than other tax-exempt obligations?

Banks are often not interested in purchasing tax-exempt obligations because banks are not allowed to deduct the "carrying costs" (interest paid on borrowed funds to purchase bonds) of such tax-exempt obligations. In contrast, banks are allowed to deduct 80% of their carrying costs associated with bank-qualified tax-exempt obligations. As a result, banks are more eager to purchase bank-qualified tax-exempt obligations. In other words, the carrying cost treatment of bank-qualified bonds creates a market for tax-exempt bonds (banks) that might not otherwise exist for a particular small borrower. This translates into lower costs for the borrower, as much as 30 to 50 basis points, thousands of dollars of savings each year that can be put into the governmental and institutional missions and new jobs.

Are there qualified small issuers in every jurisdiction for charities and non-profits?

No. Unfortunately, many borrowers of small amounts are not able to benefit from bank-qualified tax-exempt obligations because there are no qualified small issuers in their jurisdiction. In many states, there is a single or several statewide issuers who issue bonds for health care and educational institutions but issue in excess of 10 million per year over many transactions and borrowers. Borrowers in these states are therefore deprived of access to this lower cost alternative. This is why we support legislation that would increase the exemption to $30 million and only require a small borrower — not a small issuer. Applying the exemption at the borrower level would allow access to bank-qualified tax-exempt obligations for all small 501(c)(3) borrowers with capital needs, not just those that happen to have a qualified small issuer in their jurisdiction.

Are pools a satisfactory alternative?

An alternative offered by some issuers to small borrowers is the ability to borrow through a pool, whereby the issuer issues bonds, the proceeds of which will be loaned to a number of different borrowers. These pools can be effective in reducing borrowing costs, but because they are more difficult to structure and there are underwriting fees involved, they are often more costly than private placements. There are other reasons why pools may not be a better alternative. First, pools are not regularly available in all states, particularly in smaller rural ones. Second, there is often a delay involved while the issuer identifies a critical mass of other institutions interested in borrowing from a pool. Third, pools are sometimes insured or otherwise credit enhanced, and some borrowers may not meet the credit criteria of the credit enhancers.

What Legislative Reform is Sought?

The Congress should revise IRC Section 265(b)(3) to increase the "bank qualified" debt limit from $10 million to $30 million and allow it to be applied on a borrower-by-borrower basis. The $10 million limit was created in The Tax Reform Act of 1986, and is an amount, if indexed to inflation, that is worth only $5.4 million today.

The Congress should set the bank qualified debt limit at $30 million and provide for indexing of the limit for future years. The small borrower bank qualified debt limit should be applied on a borrower-by-borrower basis, rather than aggregating all bank qualified bonds issued by a conduit issuer. Under this proposal, thousands of local governments, schools, hospitals, colleges and other entities will be able to more easily access the capital markets, and sell debt in an efficient, less costly manner, which will ultimately result in a savings for taxpayers.