



## **SMALL BORROWER BANK-QUALIFIED TAX-EXEMPT OBLIGATIONS:**

### ***Supporting Small Local Governments and Non-Profits***

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When small local governments or health care organizations, education institutions, or other non-profits want to borrow for a new project, they often discover that the costs of issuance and delay involved in a public offering may outweigh the interest rate advantage of tax-exempt bonds. 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, so-called “bank-qualified” tax-exempt obligations may be the best alternative, allowing the government or non-profit to access tax-exempt rates more quickly and with reduced costs of issuance by using 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), a “bank-qualified” tax-exempt obligation is debt that is issued for state and local governments and 501(c)(3)’s by a “qualified small issuer” and which is formally designated by the issuer as “qualified tax-exempt obligation.” 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 million. Tax-exempt debt can be issued for 501(c)(3)’s only if a state or local government (a so-called “conduit issuer”) issues the debt and loans the proceeds to the 501(c)(3). The current rules require aggregating the total issuance by an issuer for all borrowers, making it practically impossible for state or other conduit 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,

resulting in thousands of dollars of savings each year that can be used for governmental and nonprofit purposes.

Small issuers and borrowers that proceed with public bond offerings also benefit from being able to designate the bonds as “bank qualified.” These bonds generally bear lower interest rates because of their relative attractiveness to bank purchasers in the primary and secondary markets. Again, these savings can be used for public and nonprofit purposes, benefitting local communities.

**Is the \$10 million threshold workable for small borrowers?**

No, the \$10 million limit was set in 1986 and in today’s dollars is not enough to fund most community projects. That is why we support legislation that would increase the exemption to \$30 million and index the limit to inflation.

**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 focus on whether the borrower is small, not on whether the issuer is small. 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.

**What Legislative Reform is Sought?**

The \$10 million limit in IRC Section 265(b)(3) 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.

In addition, 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 savings that can be used to benefit local communities.