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NATIONAL ASSOCIATION OF BOND LAWYERS

EXTENDING ARRA RELIEF FOR DEBT ISSUANCE OF

SMALL GOVERNMENTAL ENTITIES AND 501(C)(3) ORGANIZATIONS

The American Recovery and Reinvestment Act ("ARRA") contains two provisions which have been most beneficial to smaller issuers of governmental bonds as well as 501(c)(3) organization borrowers of tax-exempt bond proceeds in this recent period of market disruption. By expanding the ability of banks to "buy" bonds or make loans at a tax-exempt rate and hold them in their own portfolio, these provisions have provided a source of financing and refinancing for local governmental and 501(c)(3) organizations. These provisions of ARRA have saved smaller local governmental units as well as nonprofits such as colleges, schools, hospices, nursing homes, YMCA's and cultural arts facilities substantial interest expense as well as substantial costs of issuance. In many cases these smaller nonprofit issuers do not have established bond ratings due to their infrequent accessing of the market. Under ARRA, smaller issuers and 501(c)(3) organizations are directly evaluated by the bank purchaser, who in many cases is better able to assess the credit strength and monitor the borrower's financial condition.

Background. The 1986 Tax Act amended Section 265 of the Internal Revenue Code in a manner that made it less financially attractive for a bank to be a direct purchaser of tax-exempt bonds for its own loan portfolio. Section 265 generally denies an interest expense deduction for debt incurred to purchase or carry tax-exempt obligations. Since the 1986 Tax Act and prior to ARRA, banks lost their interest expense deduction in proportion to their assets that were tax-exempt obligations. Thus, a bank compared the adjusted basis of its tax-exempt bonds to the adjusted basis of all of its assets and applied that percentage to its total interest expense deduction to determine the amount that would be 100% disallowed. In enacting this 100% interest expense disallowance, Congress expressed concern about the effect that the harsher interest expense deduction rule would have on smaller localities which had traditionally depended on financial institutions to buy their tax-exempt bonds. [Tax Reform Act of 1985, House Report 99-426, p. 589.] To limit any potential increased borrowing costs to small issuers, Congress permitted a bank to subtract out from the numerator (thereby increasing its interest expense deduction) any so-called "qualified tax-exempt obligations," often referred to as bank-qualified or "BQ" bonds. Under this limited exception, an issuer (not the 501(c)(3) beneficiary) could issue and designate up to $10 million aggregate principal amount of its governmental obligations plus bonds it issues for 501(c)(3) organizations as BQ bonds each year. If the state or local government issued in the aggregate more than $10 million of governmental bonds, including bonds for 501(c)(3) organizations in any calendar year (with certain exceptions for current refundings), the BQ designation would not be available for *any* bonds issued in that year.

This $10 million amount had not been changed for 23 years and had not been indexed for inflation, so it had become increasingly harder for governmental issuers to finance their own governmental projects in a cost-effective manner through local banks. In most states, few 501(c)(3) organizations could achieve BQ status on bonds issued for them (and attract bank purchasers) because most statewide issuers of bonds and many local issuers always issued in the aggregate more than

$10,000,000 of bonds in a calendar year. 501(c)(3) organizations generally issue bonds through a governmental entity because the issuance of a bond directly by the 501(c)(3) entity is not sufficient to achieve tax-exempt interest for the purchaser. Banks could not offer a tax-exempt rate unless the bonds were designated BQ, leaving governmental issuers and 501(c)(3) organizations with the choice of paying effectively a taxable rate (when the bank took into account the interest expense disallowance) or going to the public market.

Following the 1986 Tax Act, many of the banks were able to continue to provide services to their 501(c)(3) customers by providing credit support in the form of letters of credit to secure tax-exempt bonds which then were sold into the public market as so-called variable rate demand obligations (VRDO). The VRDO structure allowed issuers and 501(c)(3) organizations to sell long-term debt, with the rate set for shorter intervals (weekly or monthly, for example) and the ability for holders to tender their bonds at those intervals, hence the need for a letter of credit. (*See Illustration 1 and Illustration 2 for comparison of VRDO structure and bank placement structure used in most BQ bonds).* This structure then led to a proliferation of interest rate hedges and other derivatives to manage this interest rate volatility.

While these VDRO structures were expected to provide a lower cost of capital than the taxable rate banks were otherwise able to offer, they greatly increase the complexity of the financing and bring the bond offerings into the public offering arena with its attendant securities laws and tax information reporting regimes. Few 501(c)(3) conduit borrowers could have foreseen the financial risks that emerged, such as the freezing of the auction rate market, downgrading of banks providing letters of credit, the decrease in the number of banks providing letters of credit, substantial increases in letter of credit fees for those banks still in the market, and the demise of interest rate hedge counterparties. Under the current credit conditions, banks, if offering letters of credit at all, are raising fees and shortening the term of the letter of credit. Issuance of VRDO's accounted for 9% of total municipal issuance in the first three quarters of 2009, down from 30.4% in the same year – earlier period. Securities Industry and Financial Markets Association, Research Report, Third Quarter 2009.

In response to the turmoil in the tax-exempt market, NABL submitted a paper entitled "Options for Coordinating Tax-Exempt Financing with Stimulus and Economic Recovery" (January 8, 2009), including the recommendation to amend Section 265 to bring banks back into the tax-exempt market for small issuers. NABL is appreciative of the responsiveness of Congress and Treasury in including these stimulus provisions in ARRA.

Relief Provided By ARRA-Bank Qualified Bonds. ARRA increased the $10 million BQ limit to $30 million, and in recognition of the lack of access to an important market segment, essentially gave each 501(c)(3) organization "for whose benefit the bonds are issued" its own $30 million of BQ bonds that it can designate. Each of these incentives is currently limited to bonds issued in 2009 and 2010, including refunding bonds issued during this time period. Once issued, these bonds will be able to keep that BQ status throughout the life of the bonds. Under prior law, Section 265 treated pooled bond or composite issues rather harshly. Both the pool issue and the individual loans were subject to the $10 million size limit. ARRA provides relief for pooled bond issuances by eliminating the limitation on the total size of the pooled issue, applying the new $30 million limit only to the governmental or 501(c)(3) conduit borrower.

Despite the need for certain technical corrections, which the National Association of Bond Lawyers believes could clarify some practical concerns in implementation, ARRA nonetheless provides in many cases the only viable opportunities to many 501(c)(3) organizations and smaller governmental issuers that otherwise would find going to the public market uneconomical if not impossible.

De Miminis Holding Exception for Banks. The second provision designed to encourage banks to provide a market for tax-exempt bonds gives banks the ability to hold a 2% de minimis amount of tax-exempt bonds issued in 2009 and 2010 outside of the general proportionate interest expense disallowance rule. Thus, banks are given the same ability to hold up to 2% of their total assets in tax-exempt bonds that corporations have had for decades under Service administrative practice. The 2% rule is in addition to the traditional BQ bonds, now with the $30 million limit. That means a bank can use its 2% de minimis limit to purchase bonds that cannot be designated by the issuer as a BQ bond. For example, a bank could enter into a 3-way financing agreement with a local Industrial Development Agency and a company to do a small issue manufacturing bond or one of the new Recovery Zone Facility Bonds included in the ARRA under the 2% de minimis rule. In addition, the bank could directly purchase within its 2% de minimis rule a $10 million bond for fire trucks or for energy conservation improvements for a 501(c)(3) organization that is not BQ eligible because the issuer or 501(c)(3) organization has already issued bonds in excess of $30 million in that same year.

Conclusion. We believe that the ARRA changes to Section 265 have accomplished their goals and could have a continued beneficial impact if extended beyond the December 31, 2010 sunset date. These two provisions of ARRA addressing Section 265 have given small issuers and 501(c)(3) organizations access to capital at a time when they needed to exit from a VRDO because the rating on the bank providing the letter of credit declined enough to greatly increase interest rates or to cause a failed remarketing of bonds. Without the ARRA provisions, these entities often had to draw upon taxable bank loans to purchase the bonds that were tendered, often increasing the overall borrowing by 3.00-4.00%. Some banks who have seen their letters of credit no longer accepted by the public markets have offered to buy the bonds as long as they can be designated as BQ. This restructuring should be encouraged because this BQ structure is often the only alternative available. Financings to meet new money needs face similar problems of market access. Upon expiration of the ARRA provisions, the pre-ARRA regime comes back into play with smaller issuers losing the banks as purchasers and the advantages to small borrowers of having a much less complex and risky financing.

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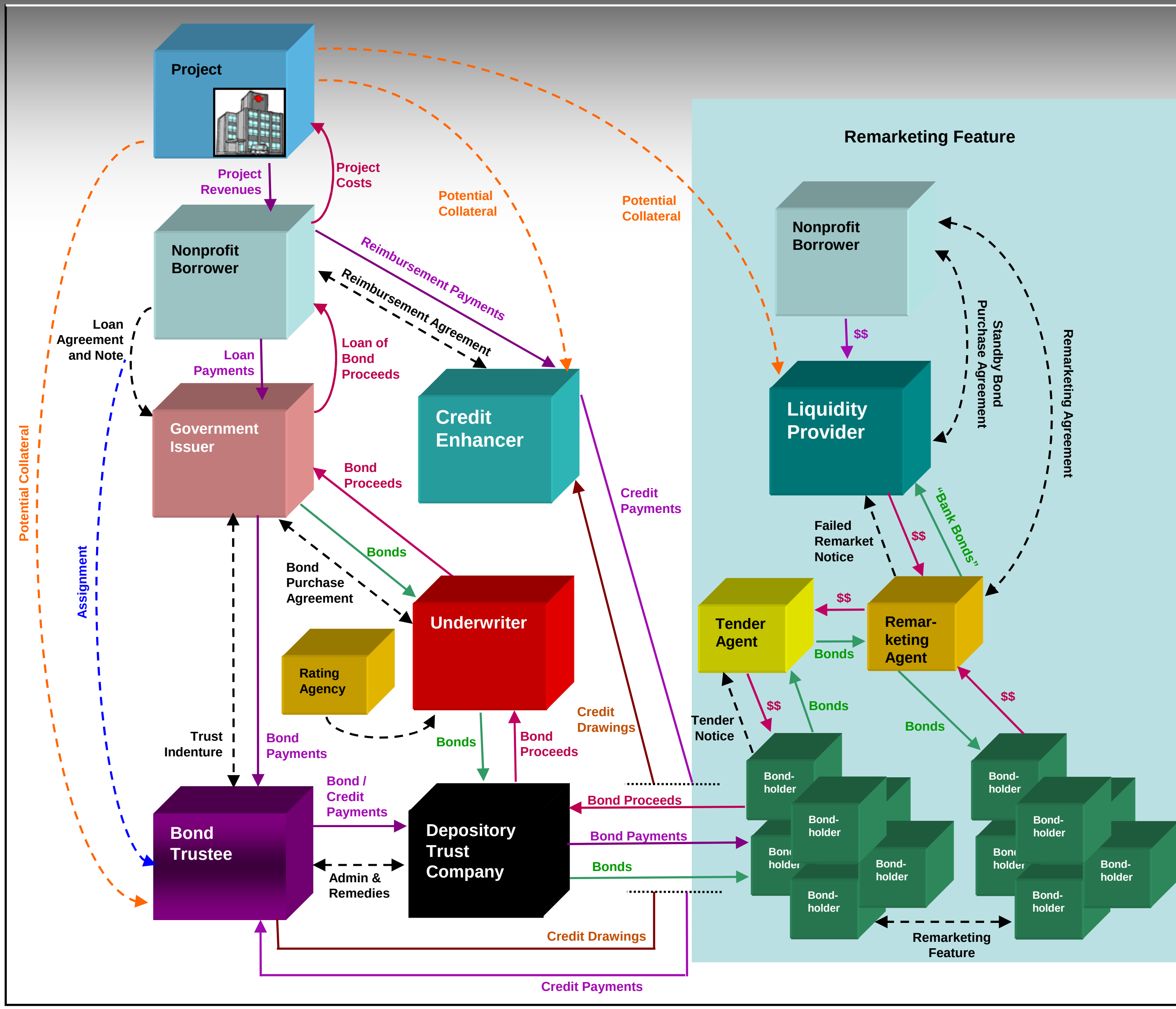
Attachments: Illustration 1 (VRDO Structure)
Illustration 2 (BQ Structure)

Traditional Variable Rate Demand Structure Illustration 1



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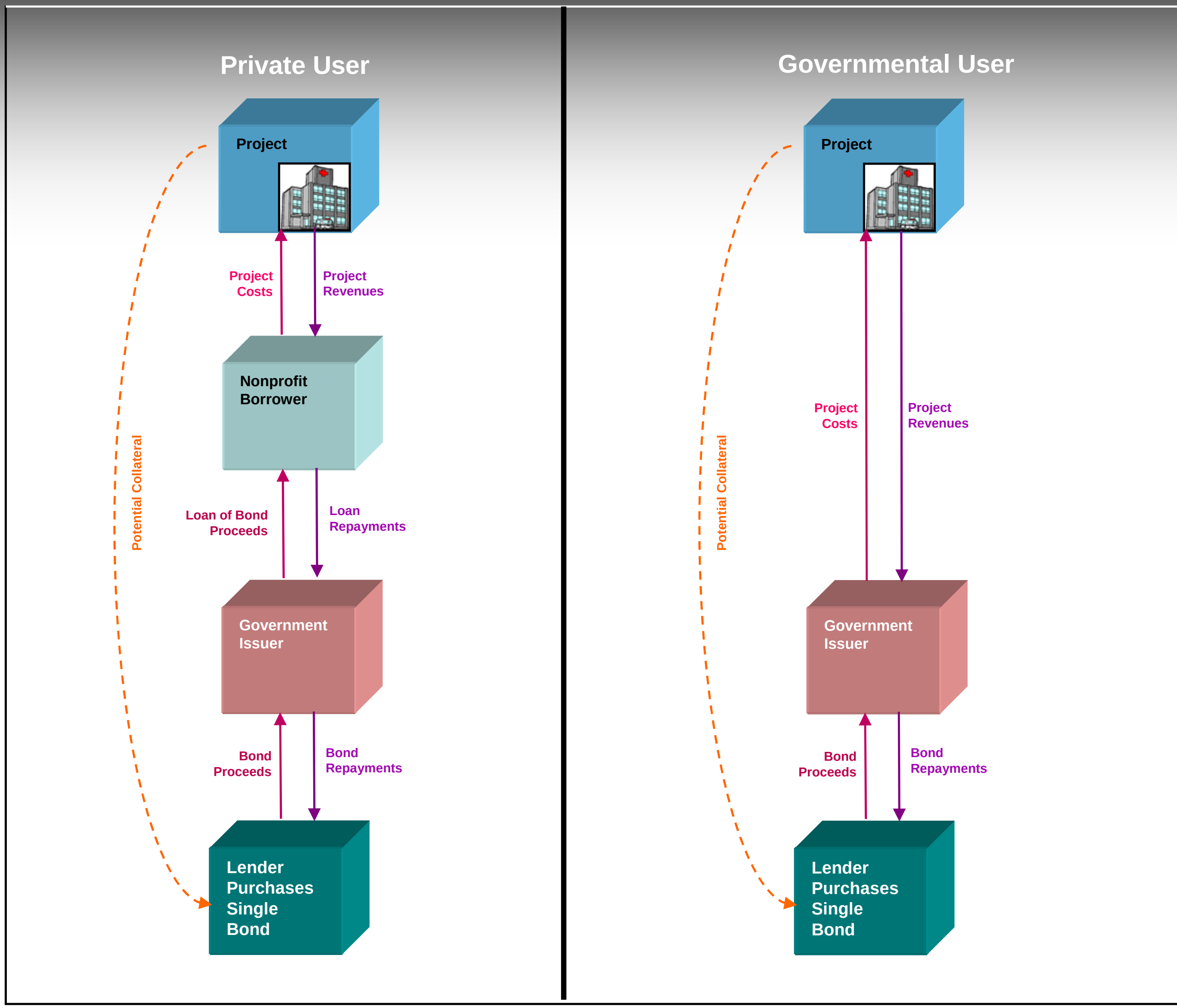
Typical Bank-Placed Bond (two types shown) Illustration 2



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