

PUBLIC FINANCE LAW

Update

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

More favorable tax treatment under Stimulus Act for financial institution investment in tax-exempt bonds

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The American Recovery and Reinvestment Act of 2009 (Stimulus Act), signed into law by President Obama on February 17, 2009, includes several changes to Section 265(b) of the Internal Revenue Code of 1986 (Code) that heighten the attractiveness of tax-exempt municipal bonds to banks and other financial institutions.

Background

Prior to the Stimulus Act, Section 265(b) of the Code disallowed the deduction of the portion of a financial institution's interest expense deemed attributable to interest on tax-exempt bonds, with the amount not deductible determined by multiplying the financial institution's total interest expense by the percentage obtained by dividing the basis of its tax-exempt bonds acquired after August 7, 1986, by the basis of all of the financial institution's assets. In calculating the disallowance, tax-exempt bonds issued by a "qualified small issuer" (i.e., an issuer who reasonably expected to issue no more than \$10 million of tax-exempt obligations in a particular calendar year) that met certain other requirements were treated as acquired on August 7, 1986, regardless of the actual acquisition date, and therefore these bonds—generally referred to as "bank qualified" bonds—were not included in the numerator of the disallowance percentage and did not reduce the amount of the interest deduction under Section 265(b) of the Code. Section 291 of the Code, however, provided for the reduction of a financial institution's interest deduction in the amount of 20% of the interest attributable to tax-exempt bonds acquired before August 8, 1986 (including all bank qualified bonds), calculated in a similar manner to the adjustment under Section 265(b) of the Code. To summarize, under prior law a financial institution lost all of its interest deduction attributable to bonds acquired after August 7, 1986, other than bank qualified bonds, and 20% of its interest deduction attributable to bonds treated as acquired before August 8, 1986, including all bank qualified bonds. Because of this favorable treatment, bank qualified bonds have generally borne lower interest rates than non-bank qualified bonds.

Stimulus Act Changes

The Stimulus Act made four changes to Section 265(b) of the Code applicable to bonds issued in 2009 and 2010:

- **Increase in qualified small issuer limit from \$10 million to \$30 million.** The Stimulus Act increased the \$10 million limit on issuers of bank qualified bonds to \$30 million for bonds issued during 2009 and 2010, thereby significantly increasing the number of issues that can be designated as bank qualified bonds.
- **Treatment of 501(c)(3) organizations as issuers.** Prior to the Stimulus Act, qualified 501(c)(3) bonds (i.e., tax-exempt bonds issued for the benefit of 501(c)(3) organizations by conduit governmental authorities such as health and educational facilities boards) could be designated as bank qualified bonds if the municipality (e.g., a city or county) that formed the conduit issuer met the \$10 million qualified small issuer limitation, with all qualified 501(c)(3) bonds issued by all conduit issuers formed by the municipality counting against the \$10 million limit. Qualified 501(c)(3) bonds also counted against a municipality's \$10 million limit in determining whether the municipality's own bonds could be designated as bank qualified. Thus, a large and active municipal issuer could prevent a moderately-sized 501(c)(3) organization from benefiting from bank qualified bonds and a large 501(c)(3) borrower could adversely affect a small municipality's ability to issue bank qualified bonds.

The Stimulus Act addresses this situation by providing that both new money and refunding bonds issued in 2009 and 2010 for the benefit of a 501(c)(3) organization will be treated as issued by the 501(c)(3) organization rather than the municipality. As the issuer, the 501(c)(3) organization has its own \$30 million limitation without any aggregation with the municipality's bonds and, therefore, can benefit from the issuance of bank qualified bonds (including direct loans structured as bond issues) as long it does not expect to issue more than \$30 million of bonds in that year. Treating qualified 501(c)(3) bonds as issued by the benefited 501(c)(3) organization rather than the sponsoring municipality should also increase the number of municipalities eligible to issue bank qualified bonds.

- **Relaxation of pool and composite issue limitations.** Under prior law, it was difficult for bonds issued as part of a pool or composite issue to be designated as bank qualified because the size limitation applied at both the issuer and borrower levels. The Stimulus Act amends Section 265(b) of the Code to apply the bank qualification requirements to pool and composite issues at the borrower level for bonds issued in 2009 and 2010 and provides that a pool or composite issue may be deemed bank qualified if each of the borrowers meets the requirements separately.
- **2% de minimis exception.** Under a long-standing Internal Revenue Service position, a non-financial institution investor in tax-exempt bonds does not risk losing a portion of its interest deduction as long as its tax-exempt bonds do not exceed 2% of its total assets. The Stimulus Act extends a similar exception to financial institutions by amending Section 265(b) of the Code to provide that tax-exempt bonds issued in 2009 and 2010 up to a limit of 2% of the financial institution's total assets are excluded from the numerator in the disallowance percentage referred to above. For purposes of this exception, refunding bonds are treated as issued on the date the refunded bonds were issued or, if there has been a series of refundings, the refunding bonds are treated as issued on the issue date of the original bonds in the series. The Stimulus Act also amends Section 291 of the Code to clarify that a financial institution will lose 20% of the interest deduction with respect to bonds subject to this 2% de minimis exception. The addition of the de minimis exception permits a

financial institution to acquire non-bank qualified bonds, including both bonds of issuers too large to meet the qualified small issuer requirements or bonds that are ineligible for bank qualified status (e.g., qualified small issue bonds for manufacturing facilities and exempt facility bonds) in an amount up to 2% of its total assets and achieve the tax treatment that applies to bank qualified bonds—loss of 20% of the interest deduction attributable to such bonds rather than the loss of 100% that would otherwise apply to such bonds.

Conclusion

The changes to Code Section 265(b) in the Stimulus Act should increase substantially the amount of bank qualified bonds available for purchase by financial institutions and thereby reduce the spread by which the interest rates borne by non-bank qualified bonds generally exceed the interest rates on bank qualified bonds.

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