Important Change in Rules for Bank Qualified Tax-Exempt Obligations

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As part of the American Recovery and Reinvestment Act of 2009 (ARRA), Congress provided important, but temporary, modifications to the "bank qualified" rules that greatly expanded the ability of banks and other financial institutions to make loans to nonprofit organizations and governmental entities.

Under the Internal Revenue Code, financial institutions that acquire tax-exempt bonds or notes are subject to loss of a corresponding deduction for its interest carry expense unless the subject bonds or notes are designated as "qualified tax-exempt obligations" under Section 265(b)(2)(B) of the Code. If so designated and qualified, a financial institution is subject to only a 20% loss of its allocated interest deduction, the so-called "TEFRA penalty." Prior to the ARRA liberalization, an issuer could only designate a bond or note as a "qualified tax-exempt obligation" if (i) the bond or note was not a private activity bond other than a qualified 501(c)(3) bond, (ii) the issuer reasonably anticipated that it would not issue more than $10 million in tax-exempt bonds (other than non 501(c)(3) private activity bonds) in the calendar year in which the bond or note was issued and (iii) the issuer did not designate more than $10 million of bonds or notes as qualified tax-exempt obligations in that calendar year. Certain special rules apply for purposes of aggregating related issuers and dealing with refunding bonds and composite issues (i.e., issues for more than one purpose, such as a partial refunding and partial new money issue).

ARRA significantly expanded these bank-qualified limitations for obligations issued in calendar year 2009 and 2010 by (i) increasing the ceiling on the $10 million limits described above to $30 million and (ii) allowing the conduit 501(c)(3) borrower or governmental entity (if different from the actual issuer) to be treated as the "issuer" for purposes of the bank-qualified rules so that the expanded $30 million limits could be measured "by borrower" and not "by issuer." ARRA also created a safe harbor basket of tax-exempt bonds or notes that could be held by financial institutions in an amount up to 2% of their assets having the same tax effect as designated bank-qualified bonds. These changes greatly increased the capacity of a single issuer to issue, and ability of financial institutions to acquire and fund, bank-qualified tax-exempt obligations.

Regrettably, Congress failed to include in the year-end tax bill that was signed by President Obama on December 17, 2010 an extension of these special bank-qualified rules, including the 2% safe harbor, beyond December 31, 2010. Consequently, tax-exempt obligations that are issued after that date are once again subject to pre-ARRA

rules and limitations.

Other key provisions of ARRA that were similarly not extended beyond calendar year 2010 include (i) direct-pay and tax-credit Build America Bonds, (ii) Recovery Zone Economic Development Bonds, (iii) Recovery Zone Facility Bonds, (iv) the temporary special rules regarding exclusion of interest on private activity bonds from treatment as a preference item for purposes of the alternative minimum tax and (v) the temporary special rules exempting interest on certain tax-exempt bonds from “adjusted current earnings” of corporations for alternative minimum tax purposes.

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