SMALL BORROWER EXCEPTION –April 8 ,2019

Banks can be a major source of the funds necessary to finance needed infrastructure improvements. Some banks currently have a limited appetite for the purchase of tax-exempt bonds because of limitations imposed on the bank's interest deductions. Tax-exempt bonds qualifying as "small issuer bank qualified bonds" attract a greater interest from banks and bear correspondingly lower interest rates. Currently such qualifying bonds are limited to issuers that issue no more than $10 million in a calendar year. We propose increasing this limit (and related limits) to $30 million for years beginning in calendar year 2019. This would provide a significant increase in the ability of local governmental units to take advantage of bank financing. We also recommend that bonds be tested at the borrower level regardless of the quantity of bonds issued by the bond issuer. This will greatly enhance the ability of smaller governments and 501(c)(3) organizations to reduce borrowing costs.

Modification of Small Issuer exception to tax-exempt interest expense allocation rules for financial institutions (sec. 265(b)).

Current Law

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax. In general, an interest deduction is disallowed if the taxpayer has a purpose of using borrowed funds to purchase or carry tax-exempt obligations; a determination of the taxpayer's purpose in borrowing funds is made based on all of the facts and circumstances.

Financial institutions

In the case of a bank or other financial institution, the Code generally disallows a proportionate share of all of the taxpayer's interest expense based on a ratio of its basis in tax-exempt investments to its basis in all its assets. Tax-exempt obligations acquired on or before August 7, 1986, are not treated as tax-exempt investments for this purpose.

Exception for certain obligations of qualified small issuers

The general rule in section 265(b), denying financial institutions' interest expense deductions allocable to tax-exempt obligations, does not apply to "qualified tax-exempt obligations." Instead, only 20 percent of the interest expense allocable to "qualified tax-exempt obligations" is disallowed. A "qualified tax-exempt obligation" is generally a tax-exempt obligation that (1) is issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond other than a qualified 501(c)(3) bond as defined in section 145, (3) is designated by the issuer as qualifying for the exception from the general rule of section 265(b), and (4) generally is not part of an issue larger than $10 million.

A "qualified small issuer" is an issuer that issues $10 million or less of tax-exempt obligations during a calendar year. The Code specifies the circumstances under which separate issuers are aggregated. An issuer is not allowed to designate more than $10 million of tax-exempt bonds in a calendar year.

Composite issues qualify for the "qualified tax-exempt obligation" exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue), and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue). Thus, a composite issue may qualify for the exception only if the composite issue itself in the aggregate does not exceed $10 million. Bonds that are not part of the same issue under the formal regulatory definition of an issue may nonetheless be treated as part of a composite issue if the sales of such bonds are related.

When bank qualified bonds are issued to benefit governmental or 501(c)(3) borrowers, the bonds are tested for compliance with the bank qualification rules by reference to the conduit issuer of the bonds.

Reasons for Change

The $10 million limitation has not been increased since the provision was enacted in 1986, except temporarily in 2009 and 2010. Banks have increasingly become important lenders to local units of government, and reducing the expense of lending will encourage local government infrastructure financing.

501(c)(3) organizations often have difficulty borrowing from banks via bank qualified bonds because the actual issuer (often a state agency) is not a qualified small issuer. Some otherwise qualified small issuers refrain from issuing tax-exempt bonds for 501(c)(3) organizations located in their jurisdiction because the issuance of such bonds might prevent the local government from being a qualified small issuer. Essentially, current law does not recognize that bonds issued for conduit borrowers are accessing the capital markets for the conduit borrower.

Proposal

The proposal increases from $10 million to $30 million the annual limit for qualified small issuers and indexes the limit for inflation.

In addition, in the case of a "qualified financing issue," the proposal applies the $30 million annual volume limitation at the conduit borrower level (rather than at the level of the conduit issuer). Thus, for the purpose of applying the requirements of the section 265(b)(3) qualified small issuer exception, the portion of the proceeds of a qualified financing issue that is lent to a "qualified borrower" that participates in the issue is treated as a separate issue with respect to which the qualified borrower is deemed to be the issuer. In addition to giving each qualified borrower its own $30 million limit, this rule would permit an issuer to issue bonds on a non-conduit basis to finance its own projects without having to count bonds issued for the benefit of a conduit borrower.

A "qualified financing issue" is any composite, pooled or other conduit financing issue the proceeds of which are used directly or indirectly to make or finance loans to one or more ultimate borrowers all of whom are qualified borrowers. A "qualified borrower" means (1) a state or political subdivision of a state, or (2) an organization described in section 501(c)(3) and exempt from tax under section 501(a). Thus, for example, a $100 million pooled financing issue could qualify for the section 265(b)(3) exception if the proceeds of such issue were used to make four equal loans of $25 million to four qualified borrowers. However, if (1) more than $30 million were lent to any qualified borrower, (2) any borrower were not a qualified borrower, or (3) any borrower would, if it were the issuer of a separate issue in an amount equal to the amount loaned to such borrower, fail to meet any of the other requirements of section 265(b)(3), the entire $100 million pooled financing issue would fail to qualify for the exception.

To determine whether qualified 501(c)(3) bonds are bank qualified, such bonds are treated as if issued by the conduit borrower and not the conduit issuer. In addition, in the case of a 501(c)(3) organization, the requirements for "qualified financing issues" shall be applied as if the section 501(c)(3) organization were the issuer. Thus, an organization described in section 501(c)(3) and exempt from taxation under section 501(a) shall be limited to the $30 million per issuer per calendar year cap for qualified tax exempt obligations described in section 265(b)(3).

The proposal would be effective for bonds issued on or after the date of enactment.

Proposed statutory language amending Section 265(b)(3) of the Code:
PERMANENT MODIFICATION OF SMALL ISSUER EXCEPTION TO TAX-EXEMPT INTEREST EXPENSE ALLOCATION RULES FOR FINANCIAL INSTITUTIONS.

(a) Permanent Increase in Limitation. – Subparagraphs (C)(i), (D)(i), and (D)(iii)(II) of section 265(b)(3) of the Internal Revenue Code of 1986 are each amended by striking "$10,000,000" and inserting "$30,000,000."

(b) Permanent Modification of Other Special Rules. – Section 265(b)(3) of such Code is amended —

(1) by redesignating clauses (iv), (v), and (vi) of subparagraph (G) as clauses (ii), (iii), and (iv) of such subparagraph, respectively, and

(2) by striking so much of subparagraph (G) as precedes such clauses and inserting the following:

"(G) Qualified 501(c)(3) bonds treated as issued by exempt organization. — In the case of a qualified 501(c)(3) bond (as defined in section 145), this paragraph shall be applied by treating the 501(c)(3) organization for whose benefit such bond was issued as the issuer.

"(H) Special rule for qualified financings. –

"(i) In general. – In the case of a qualified financing issue —

"(I) subparagraph (F) shall not apply, and

"(II) any obligation issued as a part of such issue shall be treated as a qualified tax-exempt obligation if the requirements of this paragraph are met with respect to each qualified portion of the issue (determined by treating each qualified portion as a separate issue that is issued by the qualified borrower with respect to which such portion relates)."

(c) Inflation Adjustment. – Section 265(b)(3) of such Code, as amended by subsection (b), is amended by adding at the end the following new subparagraph: "(I) Inflation adjustment. – In the case of any calendar year after 2016, the 30,000,000 amounts contained in subparagraphs (C)(i), (D)(i), and (D)(iii)(II) shall each be increased by an amount equal to —

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year, determined by substituting 'calendar year 2016' for 'calendar year 1992' in subparagraph (B) thereof. Any increase determined under the preceding sentence shall be rounded to the nearest multiple of $100,000."

(d) (d) Effective Date. — The amendments made by this section shall apply to obligations issued after the date of the enactment of this Act.