

Time Running Out for 501(c)(3) Organizations to Take Advantage of Bank Qualified Designation to Reduce Borrowing Costs

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There is still time for 501(c)(3) organizations to borrow at reduced interest rates under temporary changes to the Internal Revenue Code (the "Code") that expire on December 31, 2010.

Background

Under the Code, banks are generally not eligible to receive an interest expense deduction for debt incurred to purchase or carry tax-exempt obligations. There is, however, an exception in the Code that allows banks to deduct 80% of the carrying cost of "qualified tax-exempt obligations," otherwise known as bank qualified bonds. Under this limited exception, a governmental issuer that issued no more than \$10 million in bonds per year could designate such bonds as bank qualified bonds. In most instances, few 501(c)(3) organizations could achieve bank qualified status on bonds issued for them (and thus attract bank purchasers) because most issuers either issued more than \$10 million in bonds per year or used the bank qualified designation for their own bonds.

ARRA and 501(c)(3)s

Under the American Recovery and Reinvestment Act of 2009 (the "ARRA"), several changes were made to the Code to encourage investment in tax-exempt bonds by banks. First, ARRA increased the annual aggregate amount of bonds that could be issued to \$30 million for each governmental issuer. In addition, the \$30 million limitation is separately applied to each 501(c)(3) organization without regard to the amount of bonds issued by the governmental issuer issuing such 501(c)(3) bonds.

ARRA and De Minimis Holding Exception for Banks

Prior to ARRA, banks were not allowed to deduct interest costs or other costs associated with carrying, acquiring or holding tax-exempt bonds unless the bonds were bank qualified. A second provision of ARRA designed to encourage bank investment in tax-exempt bonds creates a temporary "de minimis" rule giving banks the ability to deduct 80% of the cost of buying and carrying tax-exempt bonds to the extent their total tax-exempt holdings other than bank qualified bonds do not exceed 2% of their total assets. This provision gives banks an incentive to purchase not only bank qualified bonds but also tax-exempt bonds of all types (up to the 2% limitation).

The above incentives are limited to bonds issued in 2009 and 2010, including refunding bonds issued during this time period. These incentives are valid for the life of the bonds issued during this limited time period.

By expanding the ability of banks to buy bonds and hold them for their own portfolio, these provisions of ARRA have provided a viable source of financing and refinancing at a tax-exempt interest rate for 501(c)(3) organizations. 501(c)(3) organizations and banks looking to take advantage of these ARRA provisions should be aware that these provisions sunset 6 months from now, on December 31, 2010. Recently, legislation was introduced (the "American Jobs and Closing Loopholes Act") which would extend the \$30 million limitation for governmental issuers and 501(c)(3)

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organizations through 2011, but there is no guarantee that this legislation will be enacted. The proposed legislation does not contemplate an extension of the de minimis holding exception.

If you are interested in learning how you may take advantage of these incentives before December 31, 2010, please contact your Miller Canfield attorney.