

Bank Qualified Bonds

Philip H. Gleason | 23 February 2009

Lenders are occasionally asked by a potential borrower to provide tax exempt financing. Under federal tax law, 501(c)(3) entities, as well as certain kinds of projects, such as manufacturing facilities, are eligible for so-called “qualified private activity bonds.” The bonds are issued by a governmental conduit, such as the Maine Health and Higher Educational Facilities Authority (“MHHEFA”), the Finance Authority of Maine (“FAME”), or a local municipality.

A tax exempt financing may be structured in a number of different ways, but one of the simplest and most commonly used options is for one bond to be issued, and “purchased” by a bank, in a private placement scenario. The bank will typically hold the bond in its own portfolio. But for the fact that the interest rate is significantly lower than in a taxable financing, and that federal tax law requirements must be carefully observed, this structure is the same as any other commercial loan: the bank will typically take some or all of the borrower’s assets as collateral, there may be personal guaranties from the borrower’s principals, and financial and other customary loan covenants. The transaction costs for a private placement are considerably less than for a public issue involving an underwriter, bond trustee, remarketing agent and other parties.

One key issue which can be easily overlooked in a private placement financing is that in order for the bank to deduct the interest which is paid on deposits allocable to a tax exempt bond, the bond must be a “qualified tax exempt obligation,” which means, generally speaking, that the bond must be issued by a “qualified small issuer,” i.e., an issuer which does not issue or expect to issue tax exempt obligations in excess of \$10,000,000 in any particular calendar year. FAME, for obvious reasons, is not a qualified small issuer, nor are certain of Maine’s larger municipalities, such as the City of Portland. Accordingly, certain 501(c)(3) entities and certain worthy projects may be precluded from utilizing the private placement structure.

The question of whether a bond is “bank qualified” should be raised in the bank’s commitment letter, if not before. In addition, bond counsel or borrower’s counsel should be asked to provide a closing opinion on this issue.

For more information on this issue or on tax exempt financing generally, please contact Phil Gleason (pgleason@bernsteinshur.com, 207 774-1200) or Nelson Toner (ntoner@bernsteinshur.com, 207 774-1200).