Bank Qualification

Facility Financing Policy Series
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Prior to 1982, banks could deduct all carrying costs (the cost of borrowing money) associated with tax-exempt bonds making them an attractive investment. The Tax Reform Act of 1986 eliminated that policy and banks could no longer deduct the carrying costs. An exception though are bank-qualified bonds (BQB). If a financial institution invests in a bank-qualified bond, then the institution is eligible to deduct 80% of associated carrying cost. What qualifies a bond is that the issuer (conduit) issues a PAB and less than $10 million worth of bonds in a given calendar year. Since most issuers (conduit) issue on behalf of multiple entities, the $10 million cap is easily surpassed thereby disqualifying bonds.

A hypothetical solution to attract banks to invest in 501(c)(3) bonds has two changes. First, the wording in the policy must change from issuer to borrower to state that the borrower issues less than $10 million. Second, the issuance amount should be raised from $10 million to $30 million. This would qualify more bonds, thus allowing more banks to be eligible for the tax credit.

Executive Summary

501(c)(3) organizations raise capital through the issuance of a private activity bond (PAB). Governmental agencies (issuer/conduit) issue the bond on behalf of the 501(c)(3) organizations. For example, the Indiana Finance Authority (IFA) issues PABs on behalf of private educational entities that are 501(c)(3) organizations. However, banks are hesitant to invest their money in these bonds due to the lack of tax and interest benefits in relationship to their perceived risk. Thus, educational entities struggle to raise the appropriate capital to fund their projects.
Prior to 1982, banks could deduct any carrying costs related to tax-exempt bonds. However, the Tax Reform Act of 1986 eliminated the allowance of banks to deduct any carrying costs. One exception to the rule is a bank-qualified bond. A bank-qualified bond is a PAB that is issued by a small issuer. An issuer is deemed small if it issues less than $10 million per calendar year. In 2009, the amount was increased to $30 million to help stimulate the economy. Today, the limit is now back to the 1986 $10 million amount, not accounting for any inflation. A timeline of laws is outlined on the following page.

It is important to note the issuer amount capped at $10 million. When a 501(c)(3) wants to issue a bond, it must go through a conduit such as the IFA. The problem is the issuer(conduit) normally issues more than $10 million worth of bonds in a given calendar year. Thus, the issued bonds by the issuer(conduit) are not considered “qualified” deterring banks from investing in these bonds due to the lack of tax benefits. This creates a funding problem for 501(c)(3) organizations like educational entities because banks are not interested in lending money to them. However, if the law changes then another market is opened for banks to invest in.

*Source: https://www.irs.gov/pub/irs-tege/teb1_lesson13.pdf*
**TEFRA of 1982**
Banks are allowed to deduct 85% of carrying cost associated with tax-exempt obligations

**Tax Reform Act of 1984**
Banks are allowed to deduct 80% of carrying cost associated with tax-exempt obligations

**Tax Reform Act of 1986**
Banks cannot deduct any carrying cost associated with tax-exempt obligations

**Tax Reform Act of 1986 EXCEPTION**
Banks are allowed to deduct 80% of carrying cost related to "qualified obligations" such as:
- a 501(c)(3) bond issued by a small issuer that issues less than $10 million per calendar year

**American Recovery and Reinvestment Act of 2009**
The small issuer amount is raised from $10 million to $30 million for bonds issued in 2009 and 2010

**Today**
The issuer amount is set back to $10 million
A hypothetical optimal scenario would be the following two changes: one: change phrasing from an issuer issuing $10 million to the borrower issuing $10 million. Two: the amount should increase from $10 million to $30 million to account for inflation from the 1986 amount and other costs.

Raising the issuance amount to $30 million and limiting the borrower, not the issuer, will create more bank-qualified bonds. This will be an attractive investment for banks because banks will be able to deduct carrying costs associated with these bonds and earn a tax credit. Ultimately, banks will compete for these bonds and shift capital towards 501(c)(3), like educational entities, giving them the necessary funding. See Appendix B for mathematical example.
The following math assumes the new 21% federal tax rate.

**Step 1**
Calculate TEFRA haircut (disallowed portion). Assume a 3% carrying cost. TEFRA haircut: Cost of funds x disallowance x federal tax rate

\[0.03 \times 0.20 \times 0.21 = 0.00126\text{ or }12.6\text{ basis points}\]

**Step 2**
Calculate the actual Bank Qualified yield:
Assume a 5% BQ yield = bank qualified yield - TEFRA haircut (as calculated above)

\[0.05 - 0.00126 = 0.0487\text{ or }4.87\%\]

**Step 3**
Calculate the taxable equivalent yield: = actual bank qualified yield (as calculate above) / (1-federal tax rate)

\[0.0487 / (0.79) = 0.0616\text{ or }6.16\%\]

Compare 6.16% rate to the options in the Treasury market

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1 TERFA: Tax and Equity Fiscal Responsibility Act. It outlines tax rules for tax-exempt bonds
2 Carrying Cost: the cost to borrow money; interest expense
3 Bank qualified yield: the amount to be amount on a bank-qualified bond
Appendix B

Capital Flows to 501(c)(3) Educational Entities

Assume $100,000 of borrowed money. Carrying cost of 2%. Interest rate from loans of 2.5%.

Bank-qualified bonds (Policy Recommended):
   a. Spread: (.025-.02) x $100,000 = (.005) x $100,000 = $500 profit
   b. This spread is not taxed so banks keep all $500
   c. The bank can also deduct 80% of carrying cost
      Carrying cost = (.02) x (100,000) = 2,000
      80% of carrying cost = (.8) x 2,000 = 1,600
      Banks can deduct $1600 of carrying cost, a tax benefit

All bond options have a spread, creating profit for the banks. Only the bank-qualified bond, following the policy change, creates spread and allows the bank to deduct carrying cost. Thus, this is a profitable and beneficial tax-break investment option for banks. Therefore, banks will gravitate toward the options where the benefits outweigh the cost. Although the interest rate is consistent among the options in this example, it is important to note realistically that PABs offer higher interest rates because there is more risk associated with them. Thus, banks investing in PABs will recognize not only a tax break, but also a larger spread.

<table>
<thead>
<tr>
<th>Options</th>
<th>b. Is the spread tax exempt?</th>
<th>c. Can the bank deduct 80% of carrying cost?</th>
</tr>
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<tr>
<td>Taxable Bonds</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>Tax-Exempt Bonds</td>
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</tr>
<tr>
<td>Bank-qualified Bonds</td>
<td>✓</td>
<td>✓</td>
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</tbody>
</table>
Appendix C
S&P Charter School Sector 2018
Outlook- Rising Interest rates statement

Rising interest rates

With the expected rise in interest rates and elimination of advanced refundings through the recently passed Tax Cuts and Jobs Act, we believe the sector will likely face decreased capital market activity in 2018. However, we believe this reduction will be somewhat limited, since even with slightly increased rates, bond financing can still provide significantly lower rates than many other forms of capital financing for charter schools, and we suspect with a decrease in market activity overall, there will be significant demand for low investment grade or high yield paper.