Federal Housing Finance Board

Memorandum

July 1, 1991

TO: Beth L. Climo
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SUBJECT: FHLBank Letter of Credit Enhancements of Tax-Exempt Bonds Under Section 149 of Internal Revenue Code

Issue: Whether the issuance by a Federal Home Loan Bank ("FHLBank") of a standby letter of credit ("LOC") enhancing a tax-exempt bond issue would cause the bonds to lose their tax-exempt status under section 149 of the Internal Revenue Code ("IRC") which prohibits federal guarantees of tax-exempt bonds.

Conclusion: The plain language of section 149 prohibiting tax-exempt status for federally guaranteed bonds would appear to cover FHLBank standby LOC enhancements of tax-exempt bonds. However, the Congressional purpose underlying the federal guarantee provision -- i.e., to prevent double federal subsidies -- is not served where FHLBank LOCs are involved, because their issuance in conjunction with tax-exempt bonds would not result in double subsidies. In addition, even assuming a federal guarantee exists, section 149 sets forth a number of exceptions to the tax-exemption denial, including exceptions for certain housing and federally insured bond issues, that may be applicable to the specific bond deal in question.

This memorandum identifies a number of legal issues affecting the determination of whether a federal guarantee is involved, as well as other possible obstacles to issuance by the FHLBanks of LOC enhancements of tax-exempt bonds. This memorandum is not a definitive legal opinion providing conclusive answers to the issues raised herein. Because of the open legal questions involved, and the fact that statutory exceptions may apply depending on the specifics of the particular bond deal, bond counsel (and possibly the Internal Revenue Service ("IRS") should be consulted regarding application of section 149 before proceeding with a bond transaction enhanced by a FHLBank standby LOC.

1. Background

The Tax Reform Act of 1984 amended section 149 of the IRC to provide that "federally guaranteed" bonds are not tax-exempt. 26 U.S.C. § 149. At the time the statute was enacted, the FHLBanks were not engaging in credit enhancing of--tax-exempt bonds. This was because Federal Home Loan Bank Board ("FHLBB") policy prohibited such LOC transactions. The FHLBB changed its policy in 1989, authorizing the FHLBanks to issue or confirm standby LOCs satisfying specific conditions "on behalf of member institutions in conjunction with tax-exempt bonds or notes when the issues are designed to promote housing development." No legal or other FHLBB opinions analyzing the application of the federal guarantee provision in section 149 of the IRC to the amended FHLBB policy have been located.

II. Discussion

A. Threshold Issue -- Direct Issuance of FHLBank LOCs to Bond Issuer

A threshold issue arises as to whether the FHLBanks have the authority to issue standby LOCs directly enhancing tax-exempt bonds where the account party requesting the LOC is not a member institution. The FHLBanks' authority to issue standby LOCs is derived from their authority under the FHLBank Act to make advances to members. The LOC is viewed as another form of an extension of credit to members. Thus, where the account party to the LOC is not a member, the FHLBanks arguably do not have the authority to issue the LOC. See Memorandum from Beth L. Climo to J. Stephen Britt, dated May 3, 1991 ("May 3 Memorandum").

On the other hand, the argument could be made that the FHLBanks may issue such LOCs if a member is otherwise involved in the transaction (e.g., as a loan servicer), or pursuant to the FHLBanks' incidental powers under the FHLBank Act. See FHLBank-NY Memorandum from Paul S. Friend to Leslie Bogen, datedarch 19, 1991; May 3 Memorandum. In addition, where there is no member involvement in the bond deal, the FHLBanks arguably can issue LOCs supporting the bonds if the bond issuer is a nonmember mortgagee, pursuant to section 10b of the FHLBank Act, 12 U.S.C. § 1430b.

B. Federal Guarantee of Tax-Exempt Bonds

Assuming the FHLBanks can issue standby LOCS supporting the tax-exempt bond issue, the question arises whether such credit enhancements constitute "federal guarantees" of the bonds, thereby prohibiting tax-exempt status for the bonds under section 149 of the IRC.

1. Definition of **"Federal Guarantee"**

Section 149(b)(l) of the IRC provides that a state or local bond that is "federally guaranteed" is not tax-exempt under section 149(b)(2), a bond is "federally guaranteed" generally where:

(a) the payment of principal or interest on the bond is directly or indirectly "guaranteed" by the "United States (or any agency or instrumentality thereof)'; **or**

(b) 5 percent or more of the bond proceeds is to be (i) used in making loans the payment of principal or interest of which is "guaranteed" by the "United States (or any agency or instrumentality thereof)", or (ii) invested in federally insured deposits or accounts.

Section 149(b)(4) defines an "instrumentality" of the United States as "any entity with statutory authority to borrow from the United States." The definition apparently does not rest *on* whether the entity is federally funded. No relevant IRS regulations, opinions or rulings further defining these terms have been located.

The FHLBanks have the statutory authority under the FHLBank *Act* to borrow from the U.S. Treasury. 12 U.S.C. § 1431(i). Accordingly, the FHLBanks appear to meet the definition of "instrumentality" under the plain language of section 149 of the IRC, even though they are not federally funded. (See discussion in 3. below).

On the other hand, an argument could be made that FHLBank standby LOCs arguably are not "guarantees" because they are primary rather than secondary obligations. The common law historically has distinguished between standby LOCs and guarantees because of their differing legal consequences. However, LOCs are in a sense guarantees in that they "guarantee" the performance of a third party (i.e., the member, if such institution is the account party), and therefore look something like "indirect" guarantees, which are covered by section 149(b)(2).

We have consulted informally with outside bond counsel who were involved in a proposed standby LOC tax-exempt bond deal with one of the FHLBanks. Bond counsel has advised us informally that in their view, the FHLBanks are "instrumentalities" under section 149. In addition, they believe that the IRS would view FHLBank LOCs as "guarantees," notwithstanding the common law distinction between LOCs and guarantees, where the bondholders have recourse against the FHLBank in the event of the account party's nonperformance. Where no recourse lies against the FHLBank, such as perhaps for certain types of FHLBank confirming or back-to-back LOCS, a guarantee would not exist.

2. Exceptions to Denial of Tax-Exemption

Section 149(b)(3) of the IRC sets forth a number of exceptions to the prohibition on tax-exempt status for federally guaranteed bonds where the bonds are insured pursuant to certain federal insurance programs, or are issued under certain housing programs. For example, the section specifically exempts guarantees by the FHA, VA, FNMA, FHLMC or GNMA, as well as certain private activity housing bonds, qualified mortgage bonds, and qualified veterans' mortgage bonds. Arguably, if Congress had intended to exclude the- FHLBanks from coverage under section 149, it would have listed the FHLBanks as well in this section. However, as mentioned earlier, the FHLBanks were not involved in credit enhancements of tax-exempt bonds back in 1984, and therefore, Congress would have had no reason at the time to exempt them from coverage.

A tax-exempt bond issuance backed by FHLBank standby LOCs may fall within one of the exceptions identified in section 149(b)(3), depending on the facts of the specific deal. Accordingly, bond counsel should be consulted to determine whether any of these exceptions would preserve the tax-exemption for the bond issuance.

3. Legislative Purpose of Section 149

Although the plain language of section 149 appears to cover FHLBank credit enhancements of tax-exempt bonds, section 149 arguably was not intended to prohibit such credit enhancements. The Congressional purpose underlying section 149 was to prevent double subsidies and competitive advantages for such bonds over taxable U.S. Treasury securities and other state and local obligations lacking federal guarantees. Specifically, Congress was concerned about transactions where tax-exempt bond proceeds were being deposited in federally insured accounts or deposits in financial institutions, to be loaned by the institutions to the ultimate borrowers. Bondholders in these deals thus had the benefit both of the federal tax exemption and federal insurance.

Use of FHLBank funds to credit enhance tax-exempt bonds would not result in a double subsidy or double-dipping into the U.S. Treasury because the FHLBanks' funds are not appropriated by or derived from the U.S. Treasury. The IRS has conceded that the FHLBanks' funds are not federal funds in its proposed rule on the low income housing tax credit. Thus, the argument could be made that prohibiting tax-exempt status to bonds backed by FHLBank standby fails to serve the underlying Congressional intent in enacting section 149.