Qualified 501(c)(3) Bonds

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Why Use Tax-Exempt Bonds

- Options Available to Fund Capital Projects
  - Pay as you go
  - Philanthropy*
    - Donations
    - Pledges
    - Endowment
    - Third party guarantees
  - Grants
  - Conventional taxable financing
  - New Market Tax Credits
  - Historic Tax Credits
  - Tax-Exempt Bonds

* For later discussion: Replacement proceeds, liquidity covenants and sinking funds.

Why Use Tax-Exempt Bonds, continued

- Tax-Exempt Bonds Compared to Taxable Debt
  - Lower Rates
  - Better Terms
  - Broader Market
- Balance Sheet Leverage
- “Cash is King” or “You don’t have to be ‘poor’ to borrow.”

501(c)(3) Status

- Qualified 501(c)(3) bonds are tax-exempt private activity bonds issued by a state or local government, the proceeds of which are loaned to and used by a Section 501(c)(3) organization in furtherance of its exempt purpose.
- What are the requirements to be a Section 501(c)(3) organization?
  - General Rule:
    - Organized and operated exclusively for exempt purposes **("No private benefit")**
    - No part of the organization's net earnings may inure to or for the benefit of any private shareholders or individuals **("No private inurement")**
    - Not engaged in substantial lobbying activity
    - Not engaged in political campaign activity
  - Evidence of 501(c)(3) status
    - IRS Determination Letter
    - Group Ruling Letter

Typical 501(c)(3) Organizations

Educational	Cultural	Recreational
Colleges and Universities Auxiliary Foundations Independent Schools Charter Schools Faith-Based Schools* Research Institutions	Museums Libraries Aquariums Cultural Venues Historical Preservation Public Broadcasting Stations Land and Open Space Conservation	Local Sports Facilities Community Centers YMCAs JCCs
Charitable Organizations	**Health Care**	**Housing**
Headquarter Facilities	Hospitals Clinics CCRCs	Non-Profit Housing Providers
Other—Lessen the burden of government		
Student Housing Hotels Parking Facilities Toll Roads		

* Consider Establishment Clause considerations.

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Eligible Uses of Tax-Exempt Bond Proceeds

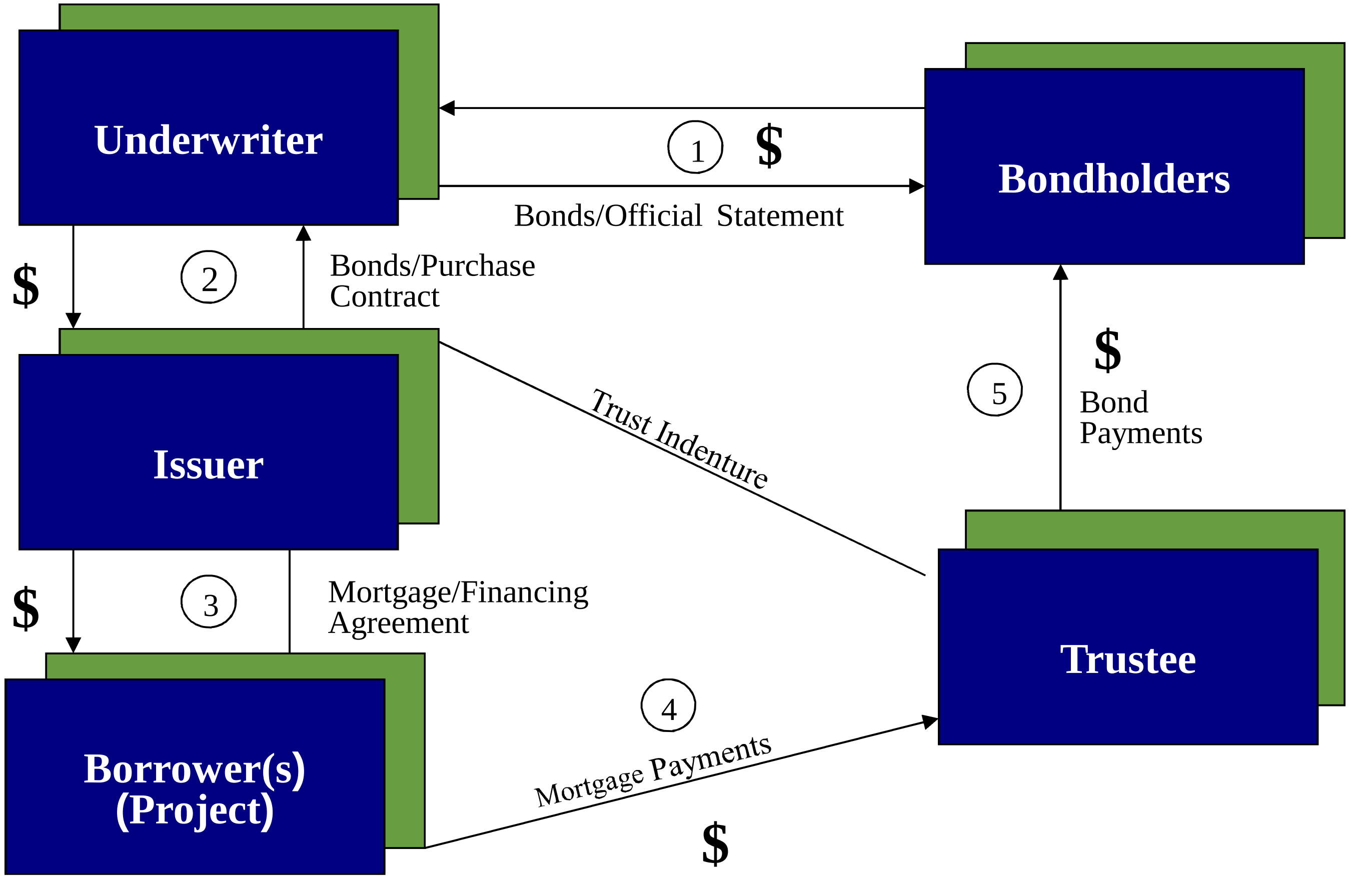
- ► Capital Expenditures
- ► Refinancing Prior Debt
- ► Reimbursing Prior Capital Expenditures
- ► Working Capital (up to 5%)
- ► Costs of Issuance (up to 2%)
- ► Capitalized Interest (up to 36 months)
- ► Debt Service Reserve Fund ("lesser of test")

Conduit Bond Issuers

- The bonds are issued by a state or local governmental entity. The proceeds of the bonds are loaned to the nonprofit organization.
  - cities
  - counties
  - CHFA, CECFA & COHFA
  - PFA
- The bonds will be special limited obligations of the issuer secured solely by loan payments made by the borrower and collateral pledged by the borrower.
- Documentation will vary based upon who the purchaser of the bonds will be.
  - public offerings
  - private placements
  - limited offerings
  - direct placements

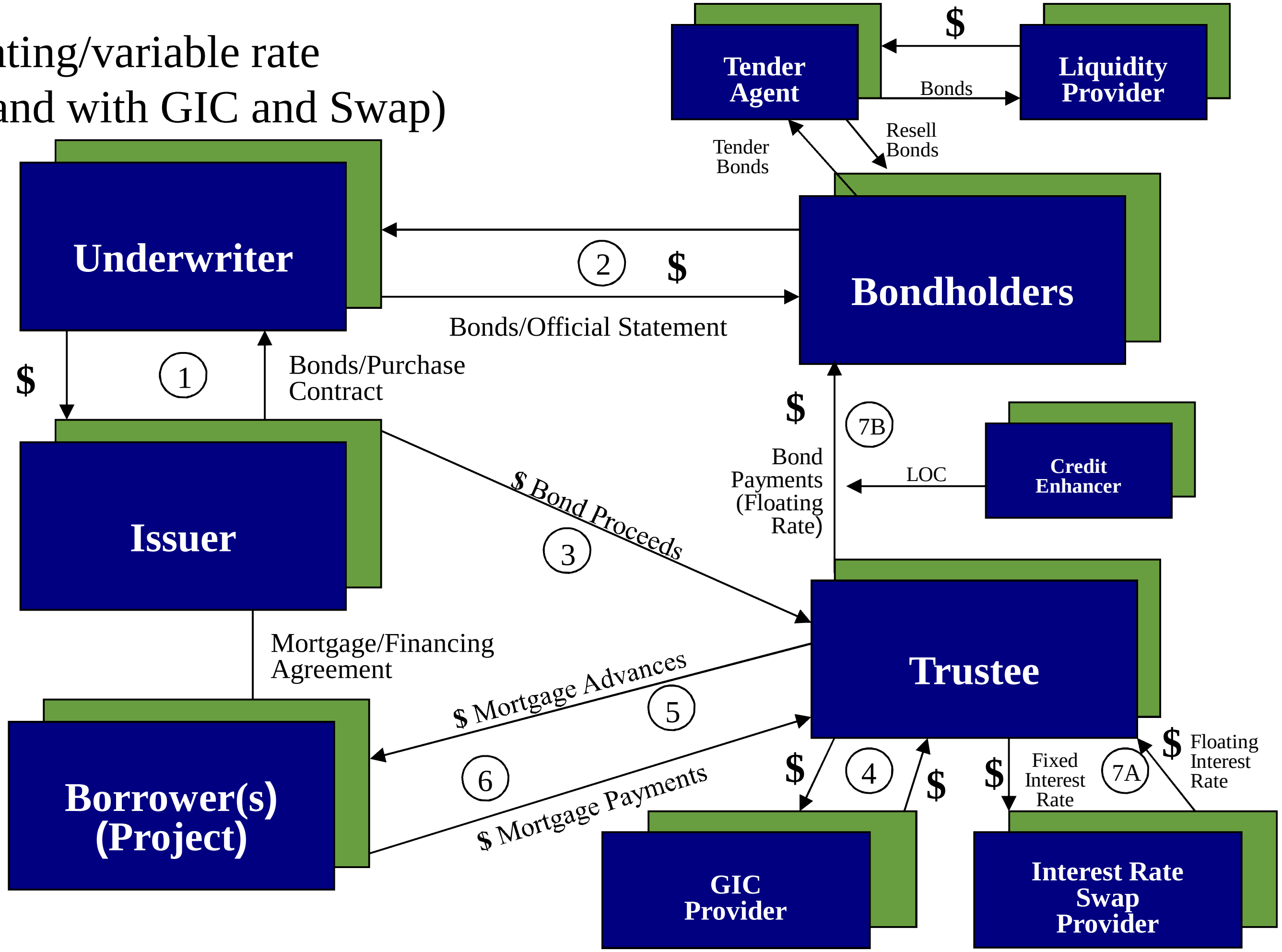
Bond Issue Structure & Parties

(Simple fixed rate)



Bond Issue Structure & Parties

- (Floating/variable rate demand with GIC and Swap)



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Basic Requirements of IRC Section 145

- Section 145(a)(1) - Ownership Requirement
  - All property financed by the net proceeds of a qualified 501(c)(3) bond issue must be owned by a 501(c)(3) organization or a state or local government throughout the term of the bonds.

- Section 145(a)(2) - Use Requirement
  - At least 95% of net proceeds of bonds must be used by (i) a 501(c)(3) organization engaged in exempt activities or (ii) a state or local governmental unit.

Ownership Requirement

- What entity owns the property?
  - Non-profit corporation
  - Governmental Unit
  - Limited liability company (single member vs. multiple member)
  - Joint venture (restrictions apply)
  - Partnership (restrictions apply)
- Legal title vs. ownership for tax purposes

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Use Requirement

- ► 95% of net proceeds of the bonds must be used for “good” use
  - Use of property = use of proceeds
  - Net proceeds
    - Net of DSRF
    - Include investment earnings
  - “Soft costs” included in financing
    - Costs of issuance - not treated as a “good” use; 501(c)(3) bonds treated differently than other tax-exempt bonds
    - Qualified guarantee fees (bond insurance, LOC fees) and qualified hedge fees - allocated based on other uses of the proceeds (“neutral cost”)

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Use Requirement

- Use by a 501(c)(3) organization in an "unrelated trade or business" is *<u>not</u>* "good" use.
  - Unrelated trade or business (Section 513(a) of the Code) is:
    - any trade or business
    - regularly carried on
    - no substantial causal relationship to furthering the exempt purpose

Use Requirement

- Types of use
  - Ownership
  - Leases - both lessor and lessee are users
  - Partnerships and Joint Ventures
  - Management contracts
  - Research contracts
  - Other actual or beneficial use

Management Contracts

- Rev. Proc. 97-13 (as later modified by Rev. Proc. 2001-39 and Notice 2014-67) provide safe harbors for service and other management contracts
  - Management contract - agreement between exempt person and service provider under which services for all or a portion of, or any function of, a facility are provided.

Management Contracts

- Safe Harbors
  - No portion of compensation based on a share of net profits
  - Length of contract will depend on type of compensation (fixed vs. variable payments)
  - For some safe harbors, exempt person must have rights to terminate after a set period without penalty and without cause
  - Appropriate treatment of manager's employee expenses

Research Agreements

- Rev. Proc. 2007-47 (formerly 97-14) provides safe harbors for research agreements
- A research agreement with a corporate or government sponsor to sponsor research performed by a 501(c)(3) charitable organization or a state or local government unit conducted with property financed by qualified 501(c)(3) bonds may create private business use.
- Safe Harbors exist for corporate / industry sponsors and the federal government.
  - In general, the sponsor is allowed a non-exclusive license or use of the research product after paying a competitive fair market value price.
  - Allows research governed by Bayh-Dole Act procedures so long as safe harbor is met.

$150 Million Limit on Non-hospital Bonds

- 501(c)(3) organization cannot have more than $150 million of "non-hospital" bonds allocated to it
  - Examples of "non-hospital" entities include nursing homes, day care centers, medical school facilities, research labs, and urgent care facilities.
  - Amended on 8/5/97
    - Most new money bonds will <u>not</u> be subject to limitation
    - Still may need to address limitation for refunding bonds and some new money deals with non-capital expenditures exceeding 5%

Residential Rental Housing

- 501(c)(3) bonds may not finance "residential rental property for family units" unless:
  - Bonds finance new residential rental property (first use rule)
  - Bonds finance "qualified" residential rental property (Section 142(d))
    - Requires meeting certain low-income set –aside minimums
  - Bonds finance property that will be substantially rehabilitated within a 2 year period beginning 1 year after the date of acquisition of such property (substantial rehabilitation means an amount equal to the total amount of bond proceeds used to acquire the buildings and improvements – but not the land)

Residential Rental Housing

- What is “residential rental property”?
  - Housing units not used on transient basis and provide complete facilities for living, sleeping, eating, cooking and sanitation
  - Rev. Rul. 98-47 - How do you treat facilities providing different levels of service?

    1 - Is all or any part of the facility comprised of complete living units?

    - Yes – go to step 2
    - No – the facilities are NOT residential rental property

    2 - If so, does the facility make available continual or frequent nursing, medical or psychiatric services?

    - Yes – the facilities are NOT residential rental property
    - No – the facility is residential rental property

Other Tax Requirements

- Section 147(b) – average maturity of qualified 501(c)(3) bonds cannot exceed 120% of the average reasonably expected economic life of the property financed or refinanced with the proceeds of the bond issue
- Section 147(e) – no skyboxes, airplanes, gambling facilities and liquor stores (but health club facilities are allowed for qualified 501(c)(3) bonds)
- Section 147(f) – TEFRA hearing and approval
- Section 147(g) – 2% limit on cost of issuance
- Section 148 - arbitrage/rebate
- Section 149(a) – registered form
- Section 149(b) – no federal guarantee
- Section 149(e) – timely file IRS Form 8038
- Section 149(g) – no hedge bonds

Other Tax Requirements

- A 501(c)(3) organization may spend money on a project in anticipation of a qualified 501(c)(3) bond issuance and then wish to reimburse itself from bond proceeds for these expenditures when the bonds are issued
- Reimbursement issues (Treasury Regulations Section 1.150-2; see also Section 148) –
  - Declaration of "official intent" within 60 days after the payment of the original expenditures to be reimbursed
    - Can be by 501(c)(3) entity, rather than issuer of bonds
  - Time periods covered:
    - Reimbursement must be made <u>not later than</u> 18 months after the later of:
      - The date the original expenditure is paid OR
      - The date that the financed project is placed in service or abandoned
    - BUT in no event later than 3 years after the date of the original expenditure
  - "Preliminary expenditures" exception to official intent
  - "De minimus" exception to official intent

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Other Tax Requirements

- Section 148 arbitrage and rebate requirements
  - Arbitrage restrictions on earnings above the bond yield apply to gross proceeds, which include replacement proceeds
  - Replacement proceeds
    - Endowment funds
    - Fundraising campaigns (pledge cards)
    - Pledged funds
    - Negative pledges
    - Liquidity covenants

501(c)(3) Counsel Legal Opinion

- 501(c)(3) status and no unrelated trade or business income with respect to the financed facilities
  - Reliance on IRS Determination Letter
  - Borrower’s counsel should perform a “due inquiry” – has there been anything since the 1023 application that might jeopardize the 501(c)(3) status?
  - Section 513 Opinion
  - Section 509(a) Opinion
  - Section 7701 Opinion
  - Group Exemptions
- Documents are valid and binding obligations, properly approved and executed, duly organized and existing, no litigation, no contravention

501(c)(3) Due Diligence

- Items to review to verify 501(c)(3) status
  - IRS Form 1023 Application
  - IRS Determination Letter
  - IRS Forms 990 and 990-T
    - Schedule K regarding tax-exempt bonds
  - Articles of Incorporation and Bylaws
  - Corporate Minutes
  - Organizational Chart
  - Agreements with employees, directors, officers, etc.
  - Audited Financial Statements
  - Annual Report
  - Fund raising materials
  - Accreditation self studies

501(c)(3) Diligence Issues

1. *Organizational Test.*
2. *IRS Determination.*
3. *Operational Test.*
4. *Private Benefit/Inurement.*
5. *Lobbying/Political Campaigns.*
6. *Unrelated Business Activity.*
7. *Reporting Obligations.*
8. *Community Health Needs Assessments and Policies.*
9. *General Compliance Hygiene.*

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