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

<table>
<thead>
<tr>
<th>Educational</th>
<th>Cultural</th>
<th>Recreational</th>
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<tbody>
<tr>
<td>Colleges and Universities</td>
<td>Museums</td>
<td>Local Sports Facilities</td>
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<td>Auxiliary Foundations</td>
<td>Libraries</td>
<td>Community Centers</td>
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<tr>
<td>Independent Schools</td>
<td>Aquariums</td>
<td>YMCAs</td>
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<td>Charter Schools</td>
<td>Cultural Venues</td>
<td>JCCs</td>
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<td>Faith-Based Schools*</td>
<td>Historical Preservation</td>
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<td>Research Institutions</td>
<td>Public Broadcasting Stations</td>
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<td></td>
<td>Land and Open Space Conservation</td>
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<tr>
<th>Charitable Organizations</th>
<th>Health Care</th>
<th>Housing</th>
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<tr>
<td>Headquarter Facilities</td>
<td>Hospitals</td>
<td>Non-Profit Housing Providers</td>
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<td>Clinics</td>
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<td>CCRCs</td>
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<th>Other—Lessen the burden of government</th>
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<tr>
<td>Student Housing</td>
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<td>Hotels</td>
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<td>Parking Facilities</td>
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<td>Toll Roads</td>
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* Consider Establishment Clause considerations.
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”)

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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)

Underwriter

Issuer

Borrower(s) (Project)

Bondholders

Trustee

1. Bonds/Official Statement

2. Bonds/Purchase Contract

3. Mortgage/Financing Agreement

4. Mortgage Payments

5. Bond Payments

Trust Indenture

Bonds/Purchase Contract

Mortgage/Financing Agreement

Mortgage Payments

$
Bond Issue Structure & Parties

(Floating/variable rate demand with GIC and Swap)

1. Bonds/Purchase Contract

2. Bonds/Official Statement

3. Bond Payments (Floating Rate)

4. Fixed Interest Rate

5. $ Mortgage Advances

6. $ Mortgage Payments

7. $ Floating Interest Rate

Underwriter

Issuer

Borrower(s) (Project)

Tender Agent

Bondholders

Trustee

Credit Enhancer

Liquidity Provider

GIC Provider

Interest Rate Swap Provider

Mortgage/Financing Agreement

$ Bond Proceeds

Bonds/Purchase Contract

Resell Bonds

Tender Bonds

Bonds
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
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”)
Use Requirement

Use by a 501(c)(3) organization in an “unrelated trade or business” is not “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


– 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 **not** 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 not later than 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
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.
5. Lobbying/Political Campaigns.
6. Unrelated Business Activity.
7. Reporting Obligations.
9. General Compliance Hygiene.
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