

Tax-Exempt Financing for 501(c)(3) Borrowers – Part I: Eligibility and Issuance

Description

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When borrowing for capital projects, 501(c)(3) borrowers often have various options to achieve their financing goals. Traditional financing through a bank or engaging in specific capital campaign fundraising efforts are well-known options. However, tax-exempt bond financing may also be available to certain non-profit borrowers.

While there are often many similarities and requirements that exist between these two financing methods, tax-exempt bonds will almost always result in lower interest costs due to the federal tax-exemption for such interest. However, there are several requirements for issuing tax-exempt 501(c)(3) bonds that will need to be adhered to prior to issuance. There are also several ongoing obligations that must be monitored post-issuance, in order to maintain the tax-exempt status of the bonds.

This article is the first in a two-part series, which will explore the benefits and requirements for 501(c)(3) entities to borrow through a tax-exempt bond issuance. The second article will discuss post-issuance compliance matters that are necessary to maintain the tax-exemption.

Tax Exemption

The main benefit that tax-exempt debt has over traditional financing is the lower interest costs that are (almost) always associated with tax-exempt bonds. In short, lenders or investors are generally willing to accept a lower interest rate on these bonds because the income derived from the interest payments will not be taxed by the federal government. This can lead to significant interest savings over the life of a loan. However, there are several requirements, under the Internal Revenue Code and accompanying Treasury Regulations, which must be met at issuance and throughout the life of the loan in order for the bonds to be tax-exempt.

Governmental Conduit Issuer

One important requirement is that tax-exempt bonds must be issued by a governmental conduit issuer on behalf of an entity qualified for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. The debt cannot be issued directly to a lender or investors, as is the case with a traditional loan. Typically, a financial institution (e.g., investment bank or a commercial bank) purchases the bonds and pays the purchase price to the governmental conduit issuer, who in turn, lends the bond proceeds received to a qualified 501(c)(3) borrower. The interest rate on tax-exempt bonds is based on the borrower's credit, and the governmental conduit issuer has no repayment or other obligations with respect to the bonds. The governmental conduit issuer assigns the repayment rights to the bond purchaser.

Project Ownership and Use

The Internal Revenue Code also requires that the financed project be entirely *owned* by a 501(c)(3) entity or a governmental unit. Moreover, no more than five percent (5%) of the bond proceeds may be *used* in a manner that constitutes an unrelated trade or business of the borrower. "Use" of the proceeds includes direct or indirect use of the financed project, or any arrangement in which there is a special legal entitlement to use the project. Common examples of arrangements which may run afoul of these rules include dining areas for educational or health care facilities where a private business contracts to manage dining services, or research agreements with an outside vendor, which utilize bond-financed space. Other types of leases for use of a project by unrelated entities could create issues and, when aggregated, could rise past the 5% threshold, thus rendering

the bonds taxable. While there are certain “safe harbor” guidelines which can be employed to assure that such arrangements do not impair the tax exemption of 501(c)(3) bonds, any private business issues should be analyzed by bond counsel in the light of detailed regulations.

Arbitrage and Rebate

Tax-exempt 501(c)(3) bonds are subject to tax rules intended to prevent 501(c)(3) borrowers from issuing bonds at favored tax-exempt rates, and investing those bond proceeds in obligations paying higher rates. The difference between the two rates is “arbitrage”. In certain limited circumstances and for certain temporary periods, the Treasury Regulations permit issuers to earn more than the yield on the bonds, and, in some instances, to keep those earnings. However, in other instances, even if earning such a higher yield is permitted, 501(c)(3) borrowers will be required to return or “rebate” the excess earnings to the federal government. The arbitrage and rebate rules are extremely complex and violation of these rules can cause bonds to be deemed taxable retroactively to the original issuance date. Therefore, potential 501(c)(3) borrowers should consult bond counsel early in the process to assist in assuring that the applicable legal requirements will be met.

Replacement Proceeds and Fundraising

An important consideration prior to issuance of bonds is the concept of “replacement proceeds,” which arise if funds exist that have a sufficiently direct nexus to the bond-financed project such that these funds would have been used to finance the project if the bonds were not issued. If replacement proceeds exist, they are considered proceeds of the bond issue, even if they were not obtained through the bond financing and are, therefore, subject to the arbitrage and rebate rules. For this reason, in a 501(c)(3) tax-exempt bond financing transaction it is especially important that any project specific capital campaign be examined for any replacement proceeds issues.

Reimbursement

501(c)(3) borrowers often advance their own funds to pay project costs prior to the issuance of bonds in anticipation of reimbursing themselves with bond proceeds upon bond issuance. Provided these expenditures qualify, the “reimbursement” monies to the 501(c)(3) borrower are considered spent and not subject to the arbitrage and rebate rules and other restrictions as to use of bond proceeds. There are detailed rules for determining whether a reimbursement qualifies as an expenditure for federal income tax purposes. Generally, however, a 501(c)(3) borrower may reimburse itself for project costs that were paid prior to issuance of the bonds only if a “declaration of official intent” to do so is passed by the borrower or the conduit issuer not later than 60 days after payment of the original expenditure. The tax-exempt 501(c)(3) bond must also be issued and the allocation made by the later of either (a) 18 months after the expenditure was made or (b) 18 months after the financed property was placed in service, but in no event later than 3 years after the date the expenditure was made. While “reimbursement resolutions” declaring official intent are not a requirement to access tax-exempt financing, they are often a strategic element of a financing plan. Therefore, 501(c)(3) entities considering tax-exempt financing are encouraged to engage counsel in the early stages of planning a financing transaction.

TEFRA Hearing

An additional procedural prerequisite to issuing tax-exempt 501(c)(3) bonds is a public hearing or “TEFRA” hearing, followed by approval by an appropriate elected representative of the governmental unit in which the project is located. There must be adequate public notice provided at least seven days prior to the hearing. The notice must include a description of the project, its location and the maximum stated principal amount of the bonds. At the TEFRA hearing members of the public are given a reasonable opportunity to express their views on the proposed issue of bonds and the location and nature of the proposed project to be financed.

Cost of Issuance Limitation

Costs of issuing tax-exempt 501(c)(3) bonds, such as fees paid to financial advisors, legal counsel, rating agencies and underwriters, can be paid out of the bond proceeds; however, the Internal Review Code caps this

amount at two percent (2%) of the par amount of the bonds. While costs of issuance are often somewhat higher than those incurred with traditional financing, they are usually offset by the lower interest rates on tax-exempt bonds. Importantly, any cost of issuance that is paid with bond proceeds is considered unrelated to the business of the borrower and counts against the 5% use threshold discussed above.

Conclusion

This article provides a brief overview of the benefits and requirements for tax-exempt financing. There are numerous rules governing each of the requirements discussed above, as well as others not mentioned. It is, therefore, crucial to engage counsel early in the process to guide the planning and documentation for a tax-exempt financing transaction.

The second article in this series will discuss post-issuance compliance matters and offer an overview of the areas which must be monitored in order to preserve the tax-exempt status of bonds after issuance.

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