



An Introduction to Tax-Exempt Financing



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An Introduction to Tax-Exempt Financing

Tax-exempt financing provides lower cost debt financing for state and local government agencies as well as qualified non-profit private entities. By making the interest earned on these bonds tax-free, investors are able to offer lower interest rates than are generally available. Bond issuances can be used for a variety of projects and can be used for both long- and short-term financing needs. As with any tax advantage, there are numerous regulatory requirements that must be complied with to ensure favorable tax treatment.

Who is eligible for Tax-Exempt Financing?

Tax-exempt financing was designed to provide state and local government agencies with low-cost borrowings for municipal improvements such as schools and hospitals. Tax-exempt financing is also available for nonprofit companies that fall under the provisions of Section 501(c)(3) of the Internal Revenue Code. In order to qualify, a company must have been issued a determination letter by the Internal Revenue Service that it qualifies as a charitable organization under Section 501(c)(3). This section of the Internal Revenue Code provides for favorable tax treatment for companies organized for charitable, religious, scientific, literary or educational purposes.

In order for a nonprofit to utilize tax-exempt bond financing they must utilize a state or local government agency as the conduit for the financing or the project financed by the issuance of tax-exempt bonds must be on behalf of a state or local governmental agency. The reason for this limitation is that the Internal Revenue Service requires that in order to receive tax-free treatment, the bonds must be issued by or on behalf of a state or local governmental unit. The limitations and requirements imposed on bond issuances on "behalf of" a state or local governmental can be burdensome. For that reason, the majority of projects financed with tax-exempt bonds utilize bonds issued by a state or local governmental unit. After the tax-exempt bonds are issued, the state or local governmental unit loans the bond proceeds back to the 501(c)(3) nonprofit.

Each state's laws will determine which governmental units can issue tax-exempt bonds. As a general rule, tax-exempt bonds can be issued by states, counties, special state agencies (such as Industrial Development agencies), cities, towns and counties. In many instances a nonprofit will have a number of different municipal agencies that could act as a conduit for a tax-exempt bond financing. However, each agency may have limitations on the use of bond proceeds. For instance, a county that issues tax-exempt bonds for a project might require that the proceeds only be used within their geographic boundaries. This limitation may be too restrictive for some nonprofits.

Use of Tax-Exempt Bond Proceeds.

The manner in which tax-exempt bond proceeds are used is determined by state and federal law. Under Section 145 of the Internal Revenue Code, any property financed by the issuance of tax-exempt bonds must be owned by the 501(c)(3) nonprofit. Also, at least 95 percent of the proceeds of the bond issuance must be used in connection with the exempt activities of a 501(c)(3). Use of tax-exempt bond proceeds for a private use is not permitted and doing so risks the tax exempt status of the bonds. A private use occurs when a private business, the federal government or a 501(c)(3) nonprofit uses the tax-exempt bond financed facilities in an unrelated trade or business. Further, if the use of the tax-exempt bond financed facility changes after issuance to a private use, the bonds risk losing their tax-exempt status.

Tax-exempt bond proceeds can also be used to acquire eligible assets. Tax-exempt bond proceeds can be used to acquire or construct capital assets, to pay interest on debt during construction, for debt service reserve fund, to cover certain costs of credit enhancements and cost of issuance. Bond proceeds used to finance the expense of bond issuance cannot exceed two percent of the total bond proceeds. If the amount of bond proceeds used to pay for credit enhancement exceeds two percent of the total bond proceeds, there are certain federal tax criteria that must be met. Tax-exempt bond proceeds can also be used to finance working capital, although the IRS' restrictive arbitrage requirements make this an unattractive option for most companies. When using tax-exempt bond proceeds to finance the cost of eligible assets, it is important to take into consideration the amount financed and the useful life of the assets to be financed. The IRS requires that the weighted average maturity of tax-exempt bonds cannot exceed 120 percent of the weighted average of the useful life of the capital assets being financed. The acquisition of land is exempt from this limitation.

Rules Relative to Private Use.

As previously stated, in order to maintain the tax-exempt status of a bond financing, at least 95 percent of the financed facility must be used in exempt activities. The private use of a facility is not measured on an annual basis, but rather is measured over the entire term of the bond issuance. A few particular situations can present difficulties related to the private use requirements. These situations include (1) unrelated trade or businesses and (2) leases, management contracts and service contracts.

Unrelated Trades or Businesses.

If more than five percent of a facility is used for a trade or business unrelated to the exempt activities of a 501(c)(3), the bond issuance may lose its tax-exempt treatment. Common examples of unrelated trades or businesses that regularly appear with respect to tax-exempt bond financed facilities include: gift shops and pharmacies in hospitals and summer camps or conferences sponsored by and held on college facilities. Even if these activities do not generate any net income, the activities will still be considered when calculating the 95 percent test.

Leases, Management Contracts, and Service Contracts.

Leases, management contracts, and service contracts may be considered a private use if the use or contract involves the use of tax-exempt bond financed facilities. In order to not be considered a private use:

- The compensation under the contract cannot be based on a share or percentage of net profits.
- The relationship with the 501(c)(3) can't limit the rights of the 501(c)(3) to exercise its rights under the contract.

The IRS rules and regulations have created a safe harbor for service contracts. If a contract meets the requirements of the safe harbor, the services provided will not be considered a private use. To meet the safe harbor requirements, the service contract must meet one of the following criteria:

- At least 95 percent of the total annual compensation must be based on a periodic fixed fee and the term of the contract cannot exceed 85 percent of the reasonably expected useful life or 15 years, whichever is less. These contracts may include a one-time incentive award.
- At least 80 percent of the total annual compensation must be based on a fixed fee and the term of the contract cannot exceed 80 percent of the reasonably expected useful life or 10 years, whichever is less. These contracts may include a one-time incentive award.
- At least 50 percent of the total annual compensation must be based on a periodic fixed fee or all the services must be based on a capitation fee or a combination of capitation fee and periodic fixed fee. Under this safe harbor provision, the term of the contract cannot exceed five years and, at the end of year three of the contract, the 501(c)(3) must be able to terminate the contract on reasonable notice without cause or penalty.
- All compensation must be based on a per-unit fee or a combination of periodic fixed fee and per-unit fee. The term of the contract cannot exceed three years and must be terminable by the 501(c)(3) without cause or penalty at the end of the second year of the contract.
- All compensation must be based on a percentage of fees charged or a combination of per-unit fee and percentage of revenue or expenses. The term of the contract cannot exceed two years and the 501(c)(3) must have the opportunity to terminate the contract after year one without cause or penalty.

Agents and Employees.

For purposes of calculating private use, the IRS has specifically stated that use of a tax-exempt bond financed facility by agents of a 501(c)(3) do not constitute a private use. While the IRS rules and regulations are silent as to employees, the IRS has publicly stated that employees of a 501(c)(3) are also its agents and, therefore, any employment contracts with employees do not need to fall under any of the service contract safe harbors. This is an important distinction because the lack of flexibility in contract length, the inability to regularly offer incentive awards and the one-sided contract termination rights, could make hiring suitable executives very difficult. This would make it difficult for nonprofits that have or may seek tax-exempt bond financing to compete with the private sector for high level managers and executives.

Use of Tax-Exempt Bond Financed Facilities for Research.

The use of tax-exempt bond financed facilities for scientific research presents special concerns for a 501(c)(3) company. Scientific research is frequently a collaborative effort between private and public-sector companies. In other instances, scientific research is funded by private or quasi-private entities. These arrangements present unique challenges for 501(c)(3) companies that have utilized tax-exempt bonds to finance their operations. Specifically, research conducted in a tax-exempt bond financed facility may be considered a private use if a private company or enterprise funds the scientific research and benefits from the results of that research. Fortunately, the IRS has provided specific guidance relative to research agreements and private use. Specifically, in a published Revenue Procedure, the IRS created two safe harbors under which private enterprises can fund and collaborate on scientific research conducted in a tax-exempt bond financed facility without risking the tax-exempt treatment afforded to the bonds. The requirements of the safe harbor are:

- The research and any technology that results from the research must be available to or licensed to the research sponsor on the same terms and conditions that it will be offered to other entities that did not sponsor or were not involved with the research. In addition, the sponsor must pay a reasonable and competitive price for the research or technology. To determine whether a price is reasonable or competitive, the IRS will look at what would have been a reasonable price for the research or technology at the time the technology was available for use.
- In circumstances where there are multiple, unrelated research partners or sponsors, the use will qualify for a safe harbor if the 501(c)(3) controls the scope and performance of the research. In addition, the 501(c)(3) must have title to any technology or intellectual property rights that arise out of the research. Lastly, the sponsors may be granted a non-exclusive, royalty-free license to use the technology.

If one of these safe harbors is met, the research arrangement will be considered a qualified use and will not endanger the tax-exempt status of the issued bonds. It is important to note that the safe harbors for research agreements and arrangements extend only to basic research and does not include clinical testing.

Limits Placed on Non-Hospital Tax-Exempt Bond Issuances.

The beneficiary of a tax-exempt bond financing cannot be the beneficiary of more than \$150 million of outstanding tax-exempt, non-hospital bonds. This limitation does not apply to bonds issued after August 5, 1997 as part of a bond issuance where 95 percent or more of the bond proceeds were used to finance capital expenditures that were incurred after August 5, 1997. If bond proceeds are used to pay for working capital, the bond issuance may not meet this 95 percent threshold and the bonds would count towards the \$150 million limit. When determining the outstanding amount of tax-exempt non-hospital bonds, any nonprofits under common management or control will be treated as one 501(c)(3) for purposes of calculating the \$150 million limit. Further, once the bond proceeds have been allocated to a 501(c)(3), they will always be allocated to that 501(c)(3) for purposes of the \$150 million limit even if the 501(c)(3) no longer uses the tax-exempt bond financed facility.

To determine whether the \$150 million limit has been reached, it is necessary to determine the aggregate outstanding amount of tax-exempt non-hospital bonds for each Test Period Beneficiary. A Test Period Beneficiary is any 501(c)(3) that is an owner or principal user of a tax-exempt bond financed facility at any point during the three year test period. The three year test period begins on the date the tax-exempt bonds are issued or the date the tax-exempt bond financed facility is placed in service, whichever is later.

Use of Tax-Exempt Bond Proceeds for Reimbursement.

As a general rule, federal tax law does not permit 501(c)(3) nonprofits to use tax-exempt bond proceeds to reimburse itself for capital expenditures made before bond issuance. However, reimbursement with tax-exempt bond proceeds will be permitted if, prior to making the expenditure, the 501(c)(3) filed a declaration of official intent to use bond proceeds for reimbursement. This filing must occur prior to bond issuance and no later than sixty days after the expenditure to be reimbursed is paid. The declaration of official intent must include:

- A statement that the 501(c)(3) has a reasonable expectation that it will reimburse planned expenses with tax-exempt bond proceeds.
- A general description of the project under which reimbursement will be sought or a description of the fund or account from which the expense is to be paid along with a description of the purpose of such fund or account.
- The maximum principal amount of debt issued for the project.

A declaration of official intent is not required for reimbursement of preliminary expenditures that do not exceed twenty percent of the total tax-exempt bond proceeds. Preliminary expenditures include, but are not limited to, bond issuance costs, architectural, engineering and surveying fees. The cost of land acquisition and site preparation are not considered preliminary expenses and the costs of such must be included in the declaration of official intent if reimbursement of these expenses will be sought. In addition, a declaration of official intent is not required for the costs associated with issuance of the tax-exempt bonds or other expenses that, in the aggregate do not exceed certain thresholds. In order to use tax-exempt bond funds for reimbursement of capital expenditures, the reimbursement must occur less than 18 months after the expenditure date or date of service, whichever is later. In no event may tax-exempt bond proceeds be used to reimburse expenses that are more than three years old.

Remedial Actions Necessary if Use of Facility Changes.

In the event a tax-exempt bond financed facility ceases to be used for exempt activities after the bonds are issued, the bonds may lose their favorable tax treatment under the Internal Revenue Code. In the event this happens, the IRS has developed remedial actions that, if taken, can preserve the tax-exempt status of the bonds. These remedial actions include:

- Redemption of the bonds.
- Using the facility financed by the bond issuance for an alternate exempt use.
- Using the bond proceeds for an alternate exempt use.

Even if the remedial actions are taken, the 501(c)(3) may suffer financial implications as well. These implications may include paying a penalty or reimbursing the IRS for any lost tax revenue.

IRS Concerns with Arbitrage.

Tax-exempt bonds are intended to encourage state and local governmental units and nonprofits to invest in and build and improve facilities and businesses that benefit the general public. The lower interest rates makes these investments affordable and encourages outside investors to purchase the bonds.

Unfortunately, the lower interest rates afforded by tax-exempt bonds also creates an opportunity for investors to profit by capitalizing on the spread or margin between the interest rate on tax-exempt bonds and current market interest rates. To discourage this practice, the IRS controls the amount of profit or arbitrage that investors can realize. With few exceptions, the IRS requires that investors rebate to the government the amount of any interest earned on investment of tax-exempt bonds.

Arbitrage and Replacement Proceeds.

The IRS specifically states that replacement proceeds will be subject to the arbitrage rules. Replacement proceeds are monies that the 501(c)(3) acquires or solicits that are used for a purpose similar to that for which the bonds were issued. The IRS' concern is that nonprofits will obtain pledges or donations to complete the bond project and then instead of using the bond proceeds for the project or for debt service obligations, the 501(c)(3) will invest the funds in higher interest bearing investments. In this scenario, the 501(c)(3) would be arbitraging the bonds. In many instances, this arbitrage transaction can happen unintentionally, especially in situations where the 501(c)(3) is running a simultaneous fundraiser for a project.

A typical scenario where this unintentional arbitrage transaction might occur is if a 501(c)(3) is soliciting gifts or pledges in connection with a particular project, program or facility. To avoid any classification of funds as replacement proceeds and any accusations of engaging in arbitrage transactions, 501(c)(3)'s should avoid funds, pledges, gifts or donations that:

- Have a restricted purpose.
- Are reasonably expected to pay debt service on the issued bonds.
- Are provided as security for the bonds.
- Are closely related to or have a significant nexus to the bond project.

If a 501(c)(3) wants to secure bond financing and solicit pledges and donations on the same project, it is important to make sure the solicitation is open-ended and that any invitations, letters, advertisements and solicitation materials do not reference a specific capital project.

Tax-exempt bond financing provides state and local governments and nonprofits with significant low interest financing for projects that have the potential to significantly impact the health, welfare and economy in that area. A thorough understanding of the project to be financed as well as the legal requirements for obtaining and maintaining tax-exempt status is necessary at the outset of the transaction.

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