



# The Essentials

# QUALIFIED 501(C)(3) BONDS



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## What are Qualified 501(c)(3) Bonds?

- **Qualified 501(c)(3) bonds are issued by a state or local government and the proceeds are used by a Section 501(c)(3) organization in furtherance of its exempt purpose.**
- **Qualified 501(c)(3) bonds are a special category of tax-exempt qualified private activity bonds issued under Section 145 of the Code.**

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## Determining 501(c)(3) Status

- **What are the requirements to be a Section 501(c)(3) organization?**
  - **General Rules:**
    - 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 Section 501(c)(3) organizations -- hospitals, colleges and universities, independent and charter schools, museums, social service organizations, nursing homes and senior living facilities**



## Private Inurement vs. Private Benefit

- **Who receives benefits?**
  - Private inurement involves “insiders” (e.g., *officers, directors, founders of the Section 501(c)(3) organization*)
    - Example – excessive compensation to CEO or loans for the personal benefit of a board member and his/her family
    - Note, however, that transactions between a Section 501(c)(3) organization and those who are “insiders” are allowed if transaction passes certain standards of reasonableness
  - Private benefit involves benefits to anyone other than the public served by the 501(c)(3) exempt purpose
    - A de minimis amount of private benefit is allowed so long as it is purely “incidental” to the 501(c)(3) organization’s exempt purpose



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## Due Diligence and 501(c)(3) Opinions

- **Items to review to determine 501(c)(3) status**
  - 1023 application (if available)
  - Determination letter
  - IRS Form 990 and 990-T
    - Schedule K regarding tax-exempt bonds
  - Organizational documents (e.g., articles of agreement and bylaws)
  - Corporate minutes
  - Agreements with employees, directors, etc.
  - Diligence questionnaire



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## Due Diligence and 501(c)(3) Opinions

- **501(c)(3) Counsel Opinion**
  - 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?
  - What are you willing to give as 501(c)(3) counsel and what must you see as bond counsel or underwriter's counsel?





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## Hybrid Status

- **Before 1986 Tax Act, Section 501(c)(3) organizations were treated as exempt entities, like governmental entities**
- **Now a special category for tax-exempt status, with some features like governmental bonds and some features like private activity bonds**



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## Basic Requirements of 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.





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## Ownership Requirement

- **What entity owns the property?**
  - Non-profit corporation
  - Limited liability company
  - Joint venture
  - Partnership
- **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
    - Qualified guarantee fees (bond insurance, LOC fees) and qualified hedge fees - allocated based on other uses of the proceeds



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## 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
  - Management contracts
  - Research contracts
  - Other actual or beneficial use



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## \$150 Million Limit on Non-hospital Bonds

- **501(c)(3) organization cannot have more that \$150 million of “non-hospital” bonds allocated to it**
  - Examples of “non-hospital” facilities include educational, cultural and social service facilities, as well as 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%

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## 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 (Sect. 142(d))
    - Requires meeting certain low-income set-aside minimums
  - Bonds finance property that will be substantially rehabilitated within a 2 year period beginning within 1 year after the date of acquisition of such property





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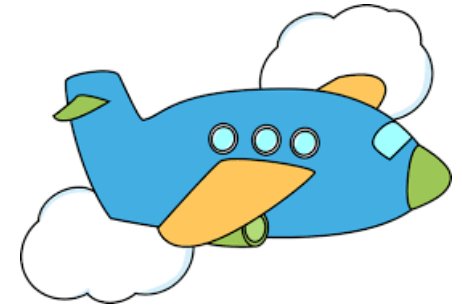
## Residential Rental Housing

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

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## Other Tax Requirements

- **Section 147(b)** – average maturity of the 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/refunding restrictions
- **Section 149(a)** – bonds must be in registered form
- **Section 149(b)** - no federal guarantee
- **Section 149(e)** - no hedge bonds
- **Section 149(g)** – timely filing of form 8038

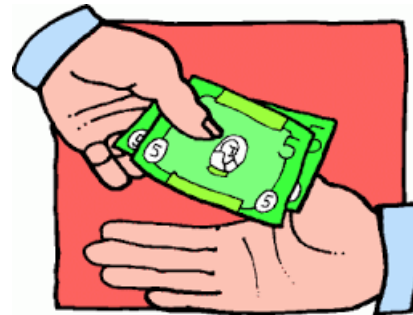




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## Other Tax Requirements

- **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
  - Pledged funds
  - Negative pledges



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## Other Tax Requirements

- A Section 501(c)(3) organization may spend money on a project in anticipation of a qualified 501(c)(3) bond issuance. If the following requirements are met, the borrower may be able 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 minimis” exception to official intent



## Other Tax Requirements

- Refunding restrictions of Section 148 apply
- “Acquisition financing” vs. “refunding” characterization may be critical, e.g.:
  - Advance refundings, which were permitted before the Tax Cuts and Jobs Act, are no longer allowed
  - Escrow yield
  - Carryover treatment of favorable tax laws
- Section 1.150-1(d) & (e) define “refunding issue” and “controlled group”



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## Common Financing Structures

- **Master Trust Indenture**
  - Designed to pool credit of multiple 501(c)(3) organizations and non-exempt entities (the “Obligated Group”)
  - Consolidates financial and operating covenants
  - Allows for issuance of taxable, as well as tax-exempt, debt
  - Obligated Group Representative
  - Master Trustee holds common security for all MTI obligations
  - Obligations issued under the MTI may have greater covenants/restrictions/security
- **“Corporate” style Master Indenture**



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## Financing Religiously Affiliated Facilities

- **Establishment Clause – part of 1<sup>st</sup> Amendment**
  - prohibits the government from making any law “respecting an establishment of religion”
- **Potential violation of Establishment Clause of US Constitution and similar provisions in state constitutions**
  - Tax-exempt bonds bestow benefit on entity sponsored by or affiliated with religious organization
  - Primarily a “validity” issue, not a tax issue

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## Financing Religiously Affiliated Facilities

- **Lemon v. Kurtzman, 403 U.S. 602 (1971)**
  - U.S. Supreme Court identified three main evils –
    - (i) sponsorship,
    - (ii) financial support and
    - (iii) active involvement of the government in religious activity
  - To pass the “Lemon Test”:
    - the statute must have a secular purpose;
    - its principal/primary effect must be one that neither advances nor inhibits religion; and
    - the statute must not foster an excessive government entanglement with religion
- **Trinity Lutheran Church of Columbia, Inc. v. Comer, 200 U.S. 32 (2017)**
  - State of Missouri violated Free Exercise Clause when it denied a state subsidy for playground resurfacing to a church affiliated pre-school
- **Additional cases are in the materials**

