
THE 501(c)(3) OPINION IN QUALIFIED 501(c)(3) BOND TRANSACTIONS

**BACKGROUND, OPINION FORMULATIONS
AND DUE DILIGENCE**



National Association
of Bond Lawyers

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National Association of Bond Lawyers
601 Thirteenth Street, NW, Suite 800 South
Washington, D.C. 20005-3875
Phone (202) 503-3300

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PREFACE AND ACKNOWLEDGMENTS

In March 2013, the Board of Directors (the “Board”) of the National Association of Bond Lawyers (“NABL”) noted the absence of published commentary on legal opinions typically rendered by borrower’s counsel and relied upon by bond counsel in qualified 501(c)(3) bond transactions as to the status of the borrower as an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”). Despite the central role that the 501(c)(3) opinion plays in relation to the tax-exempt status of qualified 501(c)(3) bonds, there is no uniform 501(c)(3) opinion standard. As discussed in this report, the phrasing and interpretation of opinion language, and the nature and degree of due diligence supporting the opinion, may vary depending on the lawyer or the firm delivering the opinion, and practices may vary from region to region.

The Board concluded that NABL should publish an educational resource regarding the 501(c)(3) opinion, presenting the background of qualified 501(c)(3) bond transactions and requirements for 501(c)(3) organizations in general, discussing the purpose and common formulations of the 501(c)(3) opinion, and providing commentary regarding the opinion language and due diligence that may be undertaken by counsel rendering and relying upon the 501(c)(3) opinion. In light of the considerable variations in existing 501(c)(3) opinion practice, however, the Board did not believe that it would be appropriate for NABL to publish a “model” 501(c)(3) opinion report at this point in time.

Allen K. Robertson, then President-Elect of NABL and the initial proponent of the project culminating in this report, prepared a detailed outline for the project which was reviewed and commented on by the Board during the summer of 2013. In September 2013, President Robertson appointed E. Tyler Smith to chair and form a special committee for the project (the “Committee”). The members of the Committee, which began work in earnest in December 2013, were:

Ginger P. Gaddy
Hand Arendall LLC
Mobile, Alabama

Peter H. Serreze
Ropes & Gray LLP
Boston, Massachusetts

R. Todd Greenwalt
Bracewell & Giuliani LLP
Houston, Texas

E. Tyler Smith
Haynsworth Sinkler Boyd, P.A.
Greenville, South Carolina

S. Roderick Kanter
Bradley Arant Boult Cummings LLP
Birmingham, Alabama

Stephen E. Weyl
Hinckley, Allen & Snyder LLP
Boston, Massachusetts

Antonio D. Martini
Edwards Wildman Palmer LLP
Boston, Massachusetts

The Committee received considerable support from members of the NABL Board including, in particular, President Robertson and President-Elect Antonio D. Martini, each of whom provided valuable guidance and contributions throughout the course of the project. The Committee also recognizes the significant time devoted to the project by Peter H. Serreze and Clifford M. Gerber in helping guide the report to its conclusion.

Lastly, the Committee acknowledges with appreciation the feedback and contributions of representatives of the National Association of Health and Educational Facilities Finance Authorities (“NAHEFFA”), coordinated by Charles A. Samuels.

The NABL Board has authorized the distribution of this report.

E. Tyler Smith
Chair

August 2014

Introduction

General

Under Section 145 of the Internal Revenue Code of 1986, as amended (the “Code”),¹ a governmental issuer (the “issuer” or the “conduit issuer”) may issue tax-exempt bonds for the benefit of an organization described in Section 501(c)(3) of the Code.² Such bonds are referred to in the Code as “qualified 501(c)(3) bonds.” Because the issuer usually lends the proceeds from the sale of the bonds to the 501(c)(3) organization to finance facilities that will be owned by the 501(c)(3) organization, the 501(c)(3) organization is usually referred to in such transactions as the “borrower” or the “conduit borrower.”³

In a qualified 501(c)(3) bond transaction, the issuer and/or the borrower will engage bond counsel to provide an objective legal opinion with respect to the validity of the bonds and other subjects, particularly the tax treatment of interest on the bonds.⁴ This opinion is referred to as the “bond opinion” or the “approving opinion.”⁵ In a qualified 501(c)(3) bond transaction, bond counsel is expected to conclude in the approving opinion that interest on the bonds is excludable from gross income for federal income tax purposes.⁶

Because the excludability of interest on a qualified 501(c)(3) bond depends upon the status of the conduit borrower as a 501(c)(3) organization (assuming that the conduit borrower will be the owner or at least a significant “user” of the property financed by the bonds), bond counsel must be satisfied with respect to the status of the borrower as a 501(c)(3) organization in rendering its approving opinion.

In most qualified 501(c)(3) bond transactions, the borrower is represented (or also represented) by counsel other than bond counsel. Such counsel is referred to in this report as “borrower’s counsel.” The prevailing practice in qualified 501(c)(3) bond transactions is for bond counsel to rely upon an opinion of borrower’s counsel as to the borrower’s 501(c)(3) status

¹ Except as otherwise noted, references to the Code herein are to the Internal Revenue Code of 1986, as amended, and section references herein refer to Code sections.

² Organizations described in Section 501(c)(3) of the Code will, throughout this report, be referred to as “501(c)(3) organizations.”

³ In some qualified 501(c)(3) bond transactions, the issuer will own the facilities financed with the proceeds of the bonds and lease them to the 501(c)(3) organization. In those transactions, the 501(c)(3) organization is referred to as the “lessee” or the “conduit lessee.” The scope and formulation of the 501(c)(3) opinion should be the same in loan and lease structures; therefore, for the sake of simplicity, this report will assume that a loan structure is being used and refer to the 501(c)(3) organization as the “borrower.”

⁴ To learn more about the role of bond counsel, see National Association of Bond Lawyers, *The Function and Professional Responsibilities of Bond Counsel* (3d Ed. 2011) (“*Functions*”).

⁵ To learn more about bond opinions, see National Association of Bond Lawyers, *Model Bond Opinion Report* (4th Ed. 2003) (“*Model Bond Opinion Report*”).

⁶ See *Model Bond Opinion Report* at 26.

and related matters, and to expressly refer to such reliance in the approving opinion.⁷ This practice reflects that borrower's counsel is often likely to have the closest relationship with the borrower and have the most institutional knowledge about the borrower, placing it in the best position to render the 501(c)(3) opinion. This report focuses on the typical situation where borrower's counsel renders the 501(c)(3) opinion.

In some qualified 501(c)(3) bond transactions, the borrower is represented by bond counsel and does not engage separate borrower's counsel. In such transactions, bond counsel may render an express opinion as to the 501(c)(3) status of the borrower. And in other qualified 501(c)(3) bond transactions, no express opinion is given as to the borrower's 501(c)(3) status either by borrower's counsel or bond counsel, in which case bond counsel's opinion that interest on the bonds is excludable from gross income for federal income tax purposes necessarily subsumes a favorable conclusion as to the 501(c)(3) status of the borrower.

To ensure that the 501(c)(3) status of the borrower is appropriately evaluated, it is important that, as early as possible during the course of a qualified 501(c)(3) bond transaction, bond counsel, borrower's counsel and other applicable counsel (e.g., underwriter's counsel in a publicly offered bond issue, purchaser's counsel in a privately placed bond issue) allocate responsibilities for conducting due diligence and opining (either expressly or impliedly) on the 501(c)(3) status of the borrower.

Purpose and Goal of this Report

Despite the central role that the 501(c)(3) opinion plays in relation to the tax-exempt status of qualified 501(c)(3) bonds, there is no uniform 501(c)(3) opinion standard. The phrasing and interpretation of opinion language, and the nature and degree of due diligence supporting the opinion, may vary depending on the lawyer or the firm delivering the opinion, and practices may vary from region to region.

This report is intended as a resource for counsel when requesting, or rendering, a 501(c)(3) opinion in connection with a qualified 501(c)(3) bond transaction. It offers a general description of the background and salient features of a 501(c)(3) opinion, examples of and commentary regarding common opinion language, and commentary regarding the due diligence that may be conducted in support of the opinion and related matters. In light of the considerable variations in existing 501(c)(3) opinion practice, however, this report does not attempt to propose a "model" form of 501(c)(3) opinion to be rendered in a qualified 501(c)(3) bond transaction.

Overview

Part I of this report summarizes how an entity becomes, and maintains its status as, a 501(c)(3) organization. Part II covers the 501(c)(3) opinion itself, offering sample formulations and interpretations of the opinion's core phrases and related provisions. Part II also gives examples of ancillary opinions that from time to time are requested and rendered in connection with a 501(c)(3) opinion. Part III addresses due diligence, summarizing the documents and other items that counsel may review in order to support a 501(c)(3) opinion, with examples of specific

⁷ See *Model Bond Opinion Report* at 29 and 34.

due diligence inquiries that may be appropriate for particular borrower types (for example, hospital borrowers). Part III also describes other federal tax diligence matters that may be of particular significance in qualified 501(c)(3) bond transactions. Part IV discusses the additional due diligence, if any, that bond counsel may perform regarding 501(c)(3) status, depending on the phrasing of the 501(c)(3) opinion and the level of due diligence performed by borrower's counsel.

Part I.
501(c)(3) Organizations

Since the Internal Revenue Code was originally enacted in 1913, charitable organizations have been entitled to favorable treatment under various federal tax law provisions. Under the Code at present, 501(c)(3) organizations are, among other things, exempt from income taxes, eligible to receive tax-deductible contributions, and – of significance for this report – eligible to borrow on a tax-exempt basis through the receipt of proceeds of qualified 501(c)(3) bonds. This Part I summarizes how an entity becomes, and maintains its status as, an organization described in Section 501(c)(3) of the Code.

Qualification as a 501(c)(3) Organization

To qualify as a 501(c)(3) organization, an entity must meet a number of substantive requirements, including:

- the organization must be organized and operated exclusively for certain specified exempt purposes;
- no part of the organization's net earnings may inure to the benefit of a private shareholder or individual;
- no part of the organization's activities may constitute intervention or participation in a political campaign on behalf of or in opposition to any candidate for public office, and no substantial part of the organization's activities may consist of attempts to influence legislation; and
- the organization must meet certain information reporting requirements through the filing of Internal Revenue Service ("IRS") Form 990.

There may be additional requirements that apply to particular organizations such as, for example, organizations operating one or more hospital facilities, which organizations must comply with the new requirements imposed by the Patient Protection and Affordable Care Act.

The Organizational Test.

To qualify for exemption under Section 501(c)(3), an organization must be a corporation, community chest, fund, trust or foundation organized exclusively for exempt purposes.

Whichever legal form the organization takes, its articles of organization must, in most circumstances, explicitly limit its purposes to one or more exempt purposes specified in Section 501(c)(3). For this purpose, the term “articles of organization” refers to the written instrument used to formally create the organization, whether articles of incorporation, a trust instrument, articles of association, or other organizational documents. Exempt purposes include, among other things, religious, charitable, scientific, and educational purposes. Included within the category of charitable purposes are, among other things, relief of the poor, promotion of health, and lessening the burdens of government.

The organization must also permanently dedicate its assets to one or more exempt purposes. This is satisfied by providing in the articles of organization that, upon dissolution, such assets will be distributed for one or more exempt purposes, or to a government unit (federal, state or local) for public purposes. In certain states this requirement is automatically satisfied by operation of the law applicable to nonprofit corporations, but in other states, it must be explicitly provided for in the articles of organization.

The Operational Test.

As previously stated, to qualify for tax-exempt status under Section 501(c)(3), an organization must operate “exclusively” for one or more exempt purposes. Despite use of the term “exclusively,” under applicable regulations, an organization will meet this requirement if it engages “primarily” in activities that accomplish one or more exempt purposes set forth in Section 501(c)(3) and not more than an insubstantial part of its activities are in furtherance of non-exempt purposes.

An organization may meet the requirements of Section 501(c)(3) even where it operates an unrelated trade or business if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. An unrelated trade or business is defined in Section 513 as, in general, any trade or business regularly carried on the conduct of which is not substantially related (aside from the general need of the organization for funding) to the exercise or performance of the organization’s exempt purpose.

Private Inurement and Private Benefit.

An organization will not qualify under Section 501(c)(3) as operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals, i.e., persons having a personal and private interest in the activities of the organization.

- This rule, known as the prohibition on “private inurement,” focuses primarily on the benefits and compensation provided to organizational insiders and related parties, such as officers, directors, substantial contributors, and their family members. Such persons are not strictly prohibited from receiving such benefits or payments, but the transaction must be reasonable and reflect an exchange of fair value.

- The existence of any private inurement, however modest relative to the organization's exempt activities, can be the basis for revocation of the organization's 501(c)(3) status. Because of the disproportionate nature of this remedy, Congress added Section 4958 to the Code in July 1996 as an alternative to revocation, commonly referred to as "intermediate sanctions." These rules impose excise taxes on "disqualified persons" and "organization managers" who benefit from or approve "excess benefit transactions."⁸

An organization also will fail to qualify for 501(c)(3) status unless the benefits provided by the organization flow principally to the general public (or one or more classes of persons intended to benefit from the organization's activities, such as the sick or the elderly) and only incidentally to private interests, such as the creator of the organization or his or her family.

Political Campaign Activities and Legislative Activities.

501(c)(3) organizations are prohibited from participating in, or intervening in (including the publishing or distributing of statements) any political campaign on behalf of, or in opposition to, any candidate for public office. In addition, 501(c)(3) organizations are not permitted to advocate the adoption or rejection of legislation, by propaganda or otherwise, unless such activities are not more than an insubstantial part of their activities, which, with an election by the organization, may be determined under the quantitative test provided by Section 501(h) of the Code.

Annual Information and Reporting Requirements.

Most 501(c)(3) organizations are required to file an annual information return on Form 990 with the IRS and, if they have any unrelated business taxable income, to file Form 990-T and pay any taxes due. An organization's tax-exempt status is automatically revoked if the organization is required to file Form 990 but fails to do so for three consecutive years. The IRS also has the authority to revoke the tax-exempt status of an exempt organization that, without reasonable cause, does not file complete and accurate Forms 990. Whenever a 501(c)(3) organization makes a material change in its character, purposes or operations, the organization is required to notify the IRS, which can be accomplished in the organization's annual information return.

⁸ The term "excess benefit transaction" includes any transaction in which an economic benefit is provided by a 501(c)(3) organization (or certain other organizations) directly or indirectly to or for the use of any "disqualified person," if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. For this purposes, an economic benefit is not treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit. *See generally* 26 U.S.C. § 4958.

Recent Legislative Changes Applicable to Hospitals.

The Patient Protection and Affordable Care Act added Section 501(r) to the Code, which imposes requirements on 501(c)(3) organizations that operate one or more hospital facilities and that are more particularly described below. Each such organization is required to meet four general requirements on a facility-by-facility basis:

- establish written financial assistance and emergency medical care policies;
- limit amounts charged for emergency or other medically necessary care to individuals eligible for assistance under the hospital's financial assistance policy;
- make reasonable efforts to determine whether an individual is eligible for assistance under the hospital's financial assistance policy before engaging in extraordinary collection actions against the individual; and
- conduct a community health needs assessment and adopt an implementation strategy at least once every three years.

Application for 501(c)(3) Status

Most charitable organizations formed after October 9, 1969 must apply to the IRS for recognition of their 501(c)(3) status. Churches are generally exempt from this requirement,⁹ and certain religiously-affiliated organizations, such as hospitals and schools, may derive their exemption from a group ruling.¹⁰ To apply, the organization must file Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code."

In response to the application, the IRS may issue a ruling or determination letter recognizing the 501(c)(3) status of the organization. The ruling or determination letter is usually effective as of the date of the organization's formation. If an organization is required to alter its activities or substantially amend its charter to qualify for exemption, or if the organization fails to timely file its Form 1023 following its formation, recognition of the organization's 501(c)(3) status generally will not be effective until the date specified in the determination letter.

⁹ Neither churches, their integrated auxiliaries, nor conventions or associations of churches are required to file IRS Form 1023 and receive a determination letter from the IRS to be classified as a 501(c)(3) organization. 26 U.S.C. § 508(c)(1)(A). Nor is any organization which is not a private foundation and the gross receipts of which in each taxable year are normally not more than \$5,000. *Id.* § 508(c)(1)(B).

¹⁰ For example, most Catholic organizations do not have a separate 501(c)(3) determination letter, but rather evidence their exempt status by inclusion in the Official Catholic Directory, which is published annually, with the local diocese responsible for ensuring that only qualified organizations are listed. See "Issues relating to group exemptions" in Part II below for a discussion pertaining to group exemptions.

Upon recognition, the name of the organization historically was included in IRS Publication 78.¹¹ The IRS no longer publishes Publication 78, but the Publication 78 data about tax-exempt organizations, including those eligible to receive tax-deductible charitable contributions, is now available as part of the “Exempt Organizations Select Check” on the IRS website.¹² A ruling or determination letter recognizing 501(c)(3) status may be revoked or modified by a subsequent ruling or determination letter addressed to the organization or by a revenue ruling or other statement published in the *Internal Revenue Bulletin*.

Part II. The 501(c)(3) Opinion

For the bonds to be “qualified 501(c)(3) bonds” under Section 145(a) of the Code, the property financed by the bonds must be owned by a 501(c)(3) organization (or a state or local governmental unit), and the issue must not have excessive private business use and private payments or security (treating, for this purpose, use by a 501(c)(3) organization other than in an unrelated trade or business as use by a governmental unit). Thus, assuming that the conduit borrower will be the owner or at least a significant “user” of the property financed by the bonds, a conclusion that the conduit borrower is a 501(c)(3) organization is fundamental to the tax-exempt status of the bond issue.

More specifically, the conduit borrower generally must qualify as an organization described in Section 501(c)(3) of the Code on the date the bonds are issued (and for as long as the bonds are outstanding, although the 501(c)(3) opinion will speak only as of its date, i.e., the date the bonds are issued). However, at the time the bonds are issued, the IRS’s determination of the borrower’s 501(c)(3) status may be quite dated, and there may not have been a recent examination in which the IRS reviewed that status.

Accordingly, to cover the applicable legal issues, the 501(c)(3) opinion letter should address two points:

- whether the borrower has been determined to be a 501(c)(3) organization by the IRS as of the date of the 501(c)(3) opinion (which implies that such determination has not been revoked by the IRS as of the date of the 501(c)(3) opinion); and
- whether, since that determination, the borrower has continued to be organized and operated in a manner to qualify as a 501(c)(3) organization through the date of the 501(c)(3) opinion (which implies that such

¹¹ Note that organizations that derive their exempt status from a group ruling were generally not included in IRS Publication 78. Nor are such organizations generally included in “Exempt Organizations Select Check” on the IRS website. See footnote 12 and accompanying text.

¹² See <http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check>.

determination should not be revoked if the IRS conducted an examination of the borrower's status as of the date of the 501(c)(3) opinion).

The simplest one-sentence formulation of the opinion is:

- “The Borrower is an organization described in Section 501(c)(3) of the Code.”¹³

This formulation should be interpreted as subsuming the first point, because a borrower would not be a 501(c)(3) organization in the absence of having been determined to be such by the IRS with such determination not having been subsequently revoked.¹⁴ In addition, the wording suggests coverage of the second point (i.e., by stating that the borrower is a 501(c)(3) organization as of the date of the 501(c)(3) opinion, the opinion giver has concluded that, based on the facts and circumstances that exist as of the date of the 501(c)(3) opinion, the borrower has continued to be organized and operated in a manner to qualify as a 501(c)(3) organization through the date of the 501(c)(3) opinion). However, the description in the 501(c)(3) opinion letter of the due diligence undertaken by the opinion giver in rendering the 501(c)(3) opinion should be considered as well. For example, if the 501(c)(3) opinion states that the opinion giver has examined such facts and law that are necessary to render the opinions contained therein, many counsel would be comfortable concluding that this formulation addresses the second point. On the other hand, if the 501(c)(3) opinion describes the examination that the opinion giver has undertaken with respect to the 501(c)(3) opinion (e.g., the opinion giver has relied solely on the borrower's IRS determination letter or a certificate from an officer of the borrower in rendering the opinion), then bond counsel would need to consider whether the scope of examination is too limited to address the second point.

Some borrower's counsel are uncomfortable with the formulation described above, or simply prefer to use the following limited formulation:

- “The Borrower has been determined by the Internal Revenue Service to be an organization described in Section 501(c)(3) of the Code.”

This formulation (referred to below as the “limited formulation”) would generally be interpreted as addressing the first point, but not the second point, and therefore, when taken alone, is generally viewed as inadequate.

Some bond counsel will accept the limited formulation if it is coupled with some form of negative assurance to the effect that the 501(c)(3) opinion giver has no knowledge, based on due diligence, of any circumstances that would cause the organization to fail to meet the

¹³ At times, this opinion may be amplified by language as to the effect of such status, such as, “and as a result thereof is exempt from federal income taxation under Section 501(a) of the Code, with the exception of any taxes imposed by the provisions of (a) Subtitle A, Chapter 1, Subchapter F, Part III of the Code or (b) Section 527(f) of the Code.”

¹⁴ This is subject to the caveat that certain organizations may not be required to have their own determination letter. See footnotes 9 and 10 above and accompanying text.

requirements for 501(c)(3) status.¹⁵ There does not appear to be any standard phrasing of this sort of negative assurance, although the following is a list of certain examples:

- “Based on a certificate of the Chief Financial Officer of the Borrower, our examination of certain records of the Borrower, discussions with the above-referenced officer of the Borrower and factual representations made by other senior officers of the Borrower (in each instance as to those issues that would, in our experience, most likely affect the Borrower’s status as an organization described in Section 501(c)(3) of the Code), nothing has come to our attention that would cause us to believe that the Borrower (1) has not conducted its operations in a manner necessary to maintain its status as such an exempt organization, (2) has not made all filings necessary to maintain its status as such an exempt organization, or (3) has done anything known to it to impair its status as such an exempt organization.”
- “To our knowledge, based on our review of the Exempt Status Documents and any Exempt Status Discussions, the Borrower has not failed to file a return with the IRS which is required to be filed to maintain its status as an exempt organization described in Section 501(c)(3) of the Code or engaged in conduct inconsistent with its status as an exempt organization described in Section 501(c)(3) of the Code.”
- “To our knowledge, after due inquiry, the Borrower has conducted its operations and has made all necessary filings so as to maintain its status as an exempt organization described in Section 501(c)(3) of the Code and has done nothing to impair its status as an exempt organization. To our knowledge, after due inquiry, the Borrower has not received notice or any other communication from the Internal Revenue Service questioning, directly or indirectly, its status as an exempt organization under Section 501(c)(3) of the Code.”

Some bond counsel may conclude, however, that even with such assurance, the limited formulation of the 501(c)(3) opinion falls short of full coverage of the second point discussed above (i.e., that the borrower has continued to be organized and operated in a manner to qualify as a 501(c)(3) organization through the date of the 501(c)(3) opinion), leaving bond counsel at least partially responsible for the ultimate conclusion on this point. In such circumstances, bond counsel may consider increasing the amount of due diligence it would otherwise perform as discussed in Part IV below.

Note that the preceding discussion assumes a simple transactional structure in which a single, unaffiliated nonprofit wishes to borrow the proceeds of qualified 501(c)(3) bonds. If a borrower is part of an affiliated group of 501(c)(3) organizations which will share in the

¹⁵ Some bond counsel also request this negative assurance when borrower’s counsel opines that the borrower “is” a 501(c)(3) organization.

ownership and use of the bond-financed assets, it generally will be necessary to address the 501(c)(3) status of each affiliate in the 501(c)(3) opinion. By contrast, if a group of affiliated nonprofit entities pools its resources as an “obligated group” and pledges those resources as security for an issue of qualified 501(c)(3) bonds (for example, in a financing for a hospital system or for a nonprofit organization and its related foundations), it may not be necessary to address the 501(c)(3) status of those obligated group members that are only providing security and do not otherwise own or use any of the bond-financed assets or have any significant control over the use or operation of those assets.

In addition to the 501(c)(3) opinion, borrower’s counsel also may be asked to render certain related opinions, including:

- *The Section 513 opinion:* Because use of property financed by qualified 501(c)(3) bonds in an unrelated trade or business results in private business use, borrower’s counsel is often asked to render an opinion regarding the existence of an unrelated trade or business. This request may come in various forms. In its broadest form, borrower’s counsel may be asked to opine that the bond-financed project is not, or will not be, used in an unrelated trade or business of the borrower. Borrower’s counsel may be reluctant to provide an opinion in this form, given its factual nature and expansive scope. In particular, providing such an opinion would require borrower’s counsel to identify the bond-financed project and the current and expected uses thereof, which it may regard as a task more appropriately handled by bond counsel, considering the overlap with bond counsel’s private business use due diligence. However, in circumstances involving unusual facts or legal issues, it may be appropriate for borrower’s counsel to render a Section 513 opinion, drawing upon its expertise or special knowledge of the borrower, particularly if the opinion is limited to a specifically identified use of the bond-financed property, for example a use described in the offering document or tax regulatory agreement for the issue.
- *The “private foundation” opinion:* Borrower’s counsel is at times asked to opine that the borrower is not a “private foundation” as defined in Section 509(a) of the Code or to affirmatively opine that the borrower is a public charity. However, there does not appear to be any statutory or regulatory prohibition against a 501(c)(3) organization that is a private foundation using the proceeds of qualified 501(c)(3) bonds (in particular, public charity status is irrelevant for purposes of private business use analysis). Accordingly, the “private foundation” opinion is not a critical element for purposes of issuing qualified 501(c)(3) bonds.
- *The Section 7701 opinion:* 501(c)(3) organizations often establish wholly-owned limited liability companies (“LLCs”) to engage in a particular activity. The establishment of the LLC is typically driven by non-tax concerns. Treasury Regulations under Section 7701 of the Code provide

that a wholly-owned LLC may be disregarded for federal income tax purposes. If the conduit borrower is an LLC that is wholly-owned by a 501(c)(3) organization, bond counsel may request that borrower’s counsel render an opinion to the effect that the sole owner of the LLC is a 501(c)(3) organization, that the LLC is disregarded pursuant to those regulations for federal income tax purposes, that neither the LLC nor its 501(c)(3) parent has made an election to treat the LLC as a separate entity and that, as a result, the bond-financed property is deemed to be owned and operated by the 501(c)(3) organization.

- *Issues relating to group exemptions:* In some circumstances, a borrower may not have its own IRS determination letter but rather may be covered under a parent entity’s group exemption. Borrower's counsel in these situations may be asked to opine that the parent is a 501(c)(3) organization and that all necessary actions have been taken to include the borrower under the parent's group exemption.

Part III. Due Diligence Underlying the 501(c)(3) Opinion

This Part III describes the due diligence that may be undertaken by borrower’s counsel (or, if bond counsel is explicitly or implicitly opining as to the borrower’s 501(c)(3) status, by bond counsel) to support a 501(c)(3) opinion.

501(c)(3) Issues Reviewed - Generally

In its due diligence process for 501(c)(3) organizations of all types, borrower’s counsel should investigate the following fundamental 501(c)(3) issues:

- Organizational Test. Do the organizational documents set forth the charitable purpose and make appropriate provision for distribution of assets in the event of the organization’s dissolution?
- IRS Determination. Has the organization been recognized and is it currently recognized by the IRS as a 501(c)(3) organization?¹⁶
- Operational Test. Has the organization operated in furtherance of the exempt purpose for which it was granted tax-exempt status?

¹⁶ As mentioned above, upon recognition of an entity as a 501(c)(3) organization, the name of the organization historically was placed in IRS Publication 78, although organizations that derive their exempt status from a group ruling are generally not included in IRS Publication 78. The IRS no longer publishes Publication 78, but the Publication 78 data is now available as part of the “Exempt Organizations Select Check” on the IRS website. See footnotes 11 and 12 and accompanying text.

- Private Benefit/Inurement. Has the organization served private interests in a manner that creates either impermissible private inurement or results in impermissible levels of private benefit?
- Lobbying/Political Campaigns. Has the organization engaged in prohibited political campaigning or excessive lobbying?
- Unrelated Business Activity. Has the organization received an excessive amount of unrelated business income, or has it otherwise been involved to an excessive extent in unrelated business activity?
- Reporting Obligations. Has the organization met its required reporting obligations, including annual filings of Form 990?

Basic Documents for 501(c)(3) Review

Due diligence by borrower's counsel of the issues above will be conducted principally through a document review. Borrower's counsel generally will request documents through a diligence questionnaire or request list. Regardless of the type of borrower involved, key documents typically reviewed include the following:

- Organizational Documents. Borrower's counsel should review the articles of incorporation, organization or comparable organizational documents to confirm that the articles satisfy the organizational test discussed above, including in general limiting the organization's purposes to one or more of the enumerated exempt purposes specified in Section 501(c)(3) and, if applicable, contain provisions concerning the distribution of assets upon the dissolution of the organization. The organizational documents themselves (as opposed to secondary documents such as bylaws) must include the requisite language. In addition, if borrower's counsel is providing a Section 513 opinion with respect to particular activities of the borrower, this review would be necessary to determine whether the activities are included in the scope of the organization's exempt purposes.
- Bylaws and Other Governing Documents. Borrower's counsel should review the organization's governing documents (typically the bylaws), which may indicate the purposes of the organization and its governance and management structure. The governing documents may also include a conflicts of interest policy, the importance of which is discussed below.
- 501(c)(3) Determination Letter. This document is fundamental because it conveys the position of the IRS as to the borrower's status as a 501(c)(3) organization as of the date of the letter based, if applicable, upon the application filed by the borrower on Form 1023 and any supplemental filings. This determination is subject to revocation on a retroactive basis, however, should the borrower engage in activities inconsistent with its

status as a 501(c)(3) organization. Typically bond counsel will include a borrower's determination letter or letters in the closing transcript of the bond issue and require the borrower to certify that such determination letters have not been modified or revoked.

- Form 1023. If the application for the IRS recognition of tax-exempt status on Form 1023 is available, counsel will often review it to determine the basis on which the borrower sought, and received, its tax-exempt status. Because many tax-exempt organizations have been in existence for very long periods of time, Form 1023 may not have been filed and is often not otherwise available.
- Forms 990. If the borrower is required to file Form 990, borrower's counsel will generally review at least the most recent three years of filings. Reviewing Form 990 is important not only to ensure that the borrower's tax-exempt status is not subject to revocation because of failure to file Form 990 for three consecutive years, but also because Form 990 may indicate other areas of further inquiry, such as levels of unrelated business activity, senior executive compensation, interested party transactions, and lobbying activity.¹⁷
- Forms 990-T. Borrower's counsel is often interested in Forms 990-T filed by the organization with the IRS in one or more years preceding a transaction, which report the organization's unrelated business taxable income to the IRS. A substantial amount of unrelated business activity may call the organization's 501(c)(3) status into question. Although not relevant to the 501(c)(3) opinion, unrelated business taxable income may, depending on its source, give rise to a concern that private business use of bond-financed property may exist.
- IRS Correspondence. In addition to the IRS determination letter and Form 1023, counsel will generally review audit records or other correspondence between the borrower and the IRS that may be pertinent to a borrower's status as a 501(c)(3) organization.
- Operational Minutes. As part of its 501(c)(3) diligence, counsel will often review minutes of meetings of the 501(c)(3) organization's governing body and pertinent committees (e.g., compensation committee). This review may provide insights into, for example, the extent to which the organization has operated in furtherance of the purposes for which its tax-

¹⁷ A review of Schedule K to Form 990 may also indicate whether the borrower has other tax-exempt bond issues outstanding and whether compliance issues exist with respect to the private business use and arbitrage rules for those issues. Form 990 may also indicate whether the borrower has a post-issuance compliance policy in effect. Because of increased IRS emphasis on post-issuance compliance, if no policy is in place, bond counsel or borrower counsel may propose that the borrower establish a post-issuance compliance policy.

exempt status was obtained. It may also be relevant for reviewing compliance with the prohibition on private inurement, by providing insights into the process for approving contracts or other arrangements with insiders and, as discussed below, the organization's management compensation determinations and procedures.

- Conflicts of interest policy. Whether contained in the governing documents or a stand-alone policy, a conflict of interest policy is often reviewed to confirm that appropriate safeguards have been established to deter transactions between the organization and insiders that might result in impermissible private inurement.
- Compensation materials. Counsel will often review materials relevant to whether the organization is following compensation procedures designed to avoid intermediate sanctions and private inurement. Relevant materials may include minutes of the organization's compensation committee, one or more recent compensation reports prepared by an independent compensation consultant, the organization's written compensation policies and procedures, and employment contracts with the organization's senior executives.

Further Diligence

In addition to reviewing the documentary record, the following are examples of ways in which borrower's counsel can obtain information relevant to the borrower's 501(c)(3) status:

- Direct Communications.
 - Due Diligence Teleconferences. Borrower's counsel may use individual phone calls or conference calls with the borrower to flesh out any information raised in the document review process.
 - Formal Due Diligence Sessions. In some instances, a formal diligence session, which may cover other matters such as the disclosure document in a public offering, can provide a venue for discussion of the borrower's tax-exempt status.

- Publicly Available Resources. Borrower’s counsel may review publicly available information. For example, borrower’s counsel may review Publication 78 data and certain information regarding revocation and suspension of 501(c)(3) status by using the “Exempt Organization Select Check” function on the IRS website.¹⁸ Mission statements and marketing materials appearing on the borrower’s website also may be useful in evaluating whether the borrower is operating primarily in a charitable rather than commercial manner. Internet searches may be useful as well. For example, if the borrower had recently been the subject of news reports concerning perceived excessive political activities or compensation paid to senior executives, that matter would be of interest to counsel.
- Institutional Knowledge. In some cases, borrower’s counsel may have accumulated knowledge about the borrower, whether from past transactions involving the borrower or other relationships with the borrower and its officers or board members, upon which counsel can draw in assessing the borrower’s qualification for Section 501(c)(3) status.
- Transaction Documentation. Borrower’s counsel may deem it helpful to walk the borrower through all representations and warranties regarding the borrower’s tax-exempt status in the key transactional documents and closing certificates, as they may prompt a discussion as to matters relevant to the borrower’s 501(c)(3) status.

Particular Types of Borrowers

The nature of the 501(c)(3) borrower being covered by a 501(c)(3) opinion will often call for diligence tailored to that type of borrower. Although the following provides examples of issues that may be applicable to specific sorts of organizations, it is by no means an exhaustive list of all issues and diligence items:

- Hospitals and Healthcare Systems. These entities can be quite complex and present numerous issues. With a lack of clear legislative guidance (other than the legislation resulting in Section 501(r) under the Affordable Care Act discussed below), the IRS has been left to provide its own interpretive guidance which is set forth in Revenue Ruling 69-545.¹⁹
- *Community benefit standard under Revenue Ruling 69-545.* The key determination for a health care organization seeking, or seeking to maintain, exempt status is whether it meets the “community benefit standard” of Revenue Ruling 69-545. Under the community benefit

¹⁸ See footnote 12 and accompanying text.

¹⁹ Rev. Rul. 69-545, 1969-2 C.B. 117 (1969).

standard, hospitals are assessed for 501(c)(3) eligibility based on whether they promote the health of a broad class of individuals in the community. The community benefit standard leads to considerations such as the following, all of which are indicia of a hospital satisfying the requirements to be classified as a 501(c)(3) organization:

- Does the hospital have a full time emergency room²⁰ in which no one requiring emergency care is denied treatment regardless of ability to pay?
- Does the hospital provide care for all persons in the community otherwise able to pay either directly or through third-party reimbursement (including governmental payer patients)? What is the extent of the hospital's charity care?
- Does the hospital direct surplus moneys to expansion and replacement of existing facilities and equipment, the improvement of patient care and medical training and to education and research?
- Is the hospital governed by a board of trustees or directors that is drawn from the community?
- Are hospital privileges extended to all qualified physicians?
- Does the hospital serve a sufficiently large number of persons in the community?
- To what extent does the hospital engage in activities that are educational or research oriented in nature?
- *The Affordable Care Act.* The Patient Protection and Affordable Care Act imposes additional requirements on 501(c)(3) organizations that operate one or more hospital facilities. Each such organization is required to meet four general requirements on a facility-by-facility basis and these requirements lead to the following inquiries as mentioned in Part I above:
 - Has the facility established written financial assistance and emergency medical care policies?

²⁰ Rev. Rul. 83-157, 1983 C.B. 94 (1983). Revenue Ruling 83-157 concluded that a hospital need not necessarily have an emergency room to qualify as a 501(c)(3) organization, recognizing that in some circumstances a hospital need not operate such facilities, for instance, when a state agency has determined that the operation of an emergency room would be duplicative or when the organization operates in a specialized field.

- Does the facility limit amounts charged for emergency or other medically necessary care to individuals eligible for assistance under the hospital's financial assistance policy?
- Does the facility make reasonable efforts to determine whether an individual is eligible for assistance under the hospital's financial assistance policy before engaging in extraordinary collection actions against the individual?
- Does the facility conduct a community health needs assessment and adopt an implementation strategy at least once every three years?

Due diligence on the above matters in hospital financings may involve a considerable amount of documentary requests and review, interviews with appropriate officers and other officials, reviews of written policies and procedures, a review of organizational documents, mission statements, physician privileges procedures, and a review of minutes and information gleaned from publicly available sources such as those discussed above.

Due diligence is likely also to include a review of Schedule H to Form 990, which elicits information from hospitals, such as information covering financial assistance and certain other community care benefits at cost; community building activities; bad debt, Medicare and collections practices; management companies and joint ventures; facility information; community health needs assessments; financial assistance policies and policies relating to emergency care.

- Educational Institutions. Although often not as complex from a 501(c)(3) compliance standpoint as healthcare systems, these organizations also present potential challenges.²¹
 - *Anti-discrimination Policies.* Revenue Procedure 75-50²² and other guidance require that a private school adopt and maintain a racially nondiscriminatory admissions policy, publicize its adoption through newspaper or broadcast media and maintain nondiscriminatory facilities and programs, including scholarship and loan programs. A private school is also required to certify as to its nondiscrimination policies annually. Consequently, due diligence for an educational organization will include a review of anti-discrimination policies and representations by the borrower as to the presence of, and compliance with, such policies. In some circumstances, further review may be warranted including admissions

²¹ See the discussion below on issues presented by organizations engaged in religious activities, which may be particularly applicable in the tax-exempt financings of religiously-affiliated schools and activities (albeit that such issues are ordinarily considered of greater relevance to the *validity* of tax exempt bonds rather than the tax exempt status of the borrower *per se*).

²² Rev. Proc. 75-50, 1975-2 C.B. 587 (1975).

policies and applications, interviews with officials, inquiries concerning actual student demographics, and potentially a review of scholarship and loan programs. Also, Schedule E to Form 990 elicits information on these topics.

- Continuing Care Facilities.

- Revenue Ruling 61-72²³ results in diligence on the following items being paramount in establishing whether these types of organizations are exempt under Section 501(c)(3):

- Is the organization dedicated to providing, and does it in fact provide, care and housing to the aged who would otherwise be unable to provide for themselves without hardship?
- Are such services rendered to all or a reasonable proportion of its residents at substantially below the actual cost thereof, to the extent of the organization's financial ability?
- Are the services of the type which minister to the needs and the relief of hardships or distress of the aged?

Revenue Ruling 72-124²⁴ provides that an organization that does not satisfy the above criteria may, nonetheless, qualify for 501(c)(3) exemption if the following can be answered affirmatively:²⁵

- Does the facility satisfy the need for housing?
- Does the facility satisfy the need for health care?
- Does the facility address the need for financial security?

Diligence on matters such as these may include a review of the written policies touching the above, financial statements, Forms 990, mission statements, statistics on the various populations involved in different levels of health care (such as independent living, assisted living, skilled nursing and Alzheimer's facilities), publicly available information such as

²³ Rev. Rul. 61-72, 1961-1 C.B. 188 (1961).

²⁴ Rev. Rul. 72-124, 1972-1 C.B. 145 (1972).

²⁵ For greater detail on these matters *see generally* Revenue Ruling 72-124 and Revenue Ruling 79-18, 1979-1 C.B. 194 (1979), a review of which will be pertinent, along with Revenue Ruling 61-72, in any financing of this type of facility.

advertisements and websites, a review of minutes and correspondence (including matters of resident complaints), and interviews with, and reports and statistics obtained from, financial officers concerning varying levels of rents paid by residents of disparate financial means.

- Residential Rental Facilities. To what extent does the project being financed constitute a “residential rental project” to which restrictions on the use of qualified 501(c)(3) bonds apply, or does the project qualify as qualified 501(c)(3) bonds for a residential facility in which, for example, continued or frequent nursing, medical or psychiatric services are provided? Does an affordable housing project satisfy applicable safe harbor standards for determining whether it accomplishes the charitable purpose of the conduit borrower? E.g., if the purpose of the conduit borrower is to provide relief for the poor and distressed by providing affordable housing, is either (a) at least 20 percent of all units rented to tenants earning not more than 50 percent of area median income or (b) at least 40 percent of all units rented to tenants earning not more than sixty percent of area median income? And is at least 75 percent of all units rented to tenants earning not more than eighty percent of area median income? Are rents set so as to be affordable to residents at these income levels? ²⁶ If the purpose of the conduit borrower is not to provide relief for the poor and distressed by providing affordable housing, standards for accomplishing the charitable purpose of that borrower likely need to be determined based on a close review of the purpose of that entity and the activities of that entity described in its application to the IRS for 501(c)(3) status.
- Child Care Facilities. Section 501(k) of the Code expressly recognizes certain child care facilities as qualifying for 501(c)(3) status within the exemption for facilities engaged in “educational purposes” under Section 501(c)(3). For this purpose, the term “educational purposes” includes the providing of care of children away from their homes if substantially all of the care provided by the organization is for purposes of enabling individuals to be gainfully employed, and the services provided by the organization are available to the general public. Thus borrower’s counsel would likely undertake a review to confirm that any child care facility being financed is in furtherance of such “educational purposes”. Interviews with organization officials, marketing materials, and representations and information concerning the demographics of the child care facility would likely be a part of due diligence.
- Organizations Engaged in Religious Activities. Although often not considered an issue relating to the rendering of 501(c)(3) opinion *per se*, as opposed to raising issues relating to the validity of the bonds, there is some precedent to the effect that the religious nature of an organization and its activities may affect the exempt status of an organization under Section 501(c)(3), *to the extent* contrary to the Establishment Clause of the United States Constitution (and similar provisions in state constitutions). Such activities deemed

²⁶ See generally Revenue Procedure 96-32, 1996-1 C.B. 717 (1996). It is generally assumed, although the Revenue Procedure does not so specify, that the rents should be limited to 30 percent of a resident’s income.

contrary to the Establishment Clause could possibly include, for example, the teaching by a 501(c)(3) organization of religious doctrine as truth in public schools.²⁷

- Organizations that Lessen the Burdens of Government. Organizations that lessen the burdens of government may enjoy 501(c)(3) status by virtue of being included within the scope of “charitable” organizations under Section 501(c)(3). The IRS has stated that in order to be considered to lessen the burdens of government, there must be a “consideration of whether the organization’s activities are activities that a governmental unit considers to be its burdens, and whether such activities actually ‘lessen’ such governmental burden”.²⁸ This analysis takes all facts and circumstances into account, including whether there exists a statute that expressly creates the organization and clearly defines its purposes, whether a governmental unit expressly invited the organization to provide services, and whether the activity is an integral part of a larger program of a governmental unit.

Part IV. Bond Counsel Due Diligence as to 501(c)(3) Status

As discussed at the beginning of this report, the prevailing practice in 501(c)(3) bond transactions is for borrower’s counsel to render an opinion as to the 501(c)(3) status of the borrower, upon which bond counsel may rely in rendering its opinion as to the tax-exempt status of the interest on the bonds. This practice raises the issue of whether bond counsel may *exclusively* rely on the 501(c)(3) opinion of borrower’s counsel, or whether it is necessary for

²⁷ See General Counsel Memorandum 39800 (October 25, 1989), which addressed a proposal by the IRS to deny 501(c)(3) status to an organization formed to provide for the teaching of scripture to students in public high schools on a non-denominational basis. Although the IRS Chief Counsel’s Office held in favor of the granting of 501(c)(3) exemption, this GCM cautioned that if the organization ultimately were found to teach religious doctrine as truth to public high school students then the organization might be deemed to be engaged in activities so contrary to the fundamental federal policy of the Establishment Clause as to warrant a revocation of its 501(c)(3) status. Of course, this is not to say that the language of Section 501(c)(3) enabling tax-exempt status for organizations “organized and operated exclusively for religious . . . purposes” are *per se* unconstitutional, as evidenced by tax-exempt status being afforded to churches and other religious institutions on a regular basis; however, precedent does establish that religiously affiliated institutions can so run afoul of charitable principles as to have 501(c)(3) status revoked. See, e.g., *Bob Jones University v. United States*, 431 U.S. 574 (1983) (holding that while Congress’ intent was to bestow tax exempt status on religious, charitable or educational organizations that serve charitable purposes, the IRS may revoke such status if the organization fails to meet certain common-law standards of charity, such failure including the racially discriminatory practices of two private, religiously affiliated schools).

If borrower’s counsel is concerned about this issue in the context of a private school financing, for example, due diligence may include examining mission statements, admissions policies and procedures, requirements for professions of faith for admissions or faculty positions, the religious nature of the curriculum, worship service attendance requirements and official ties to a church or religious organization. Borrower’s counsel may deem due diligence along other lines as being warranted for financings of facilities for other types of organizations, such as healthcare facilities, facilities for the aged, and community centers with a substantial amount of religious activities or precepts.

²⁸ Rev. Rul. 85-1, 1985-1 C.B. 177, 179 (1985); see also Rev. Rul. 85-2, 1985-1 C.B. 178 (1985).

bond counsel to perform its own due diligence as to 501(c)(3) matters. The answer depends on various factors, including (as discussed above) the phrasing of the 501(c)(3) opinion and the diligence performed by borrower's counsel. As a starting point in considering this issue, this Part IV discusses the opinion standards applicable to bond counsel and reliance on opinions of others generally. It then discusses certain examples of additional due diligence that bond counsel, depending on the circumstances, might perform.

Bond Opinion Standards

Bond opinions, including an opinion that interest on the bonds is excludable from the gross income of the holders thereof for federal income tax purposes, are traditionally “unqualified” in nature.²⁹ Bond counsel may render an “unqualified” opinion regarding the validity and tax exemption of bonds if “firmly convinced” (also characterized as having “a high degree of confidence”) that under the law in effect on the date of the opinion, the highest court of the relevant jurisdiction, acting reasonably and properly briefed on the issues, would reach the legal conclusions stated in the opinion.³⁰ In the area of federal income tax matters addressed in the opinion, certain special circumstances are recognized. Accordingly, bond counsel may give an “unqualified” opinion with respect to federal income tax matters if firmly convinced that, upon due consideration of the material facts and all relevant sources of applicable law on federal income tax matters, the U.S. Supreme Court would reach the federal income tax conclusions stated in the opinion or the IRS would concur or acquiesce in the federal income tax conclusions stated in the opinion.³¹

If bond counsel is relying on the opinion of borrower's counsel as to the borrower's 501(c)(3) status, bond counsel usually states its reliance on this third-party opinion in the bond opinion.³² For example, bond counsel's opinion may state that: “With respect to the status of the Borrower as an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”), we refer you to, and have relied upon, the opinion of [borrower's counsel] of even date herewith on that subject.”³³

²⁹ *Model Bond Opinion Report* at 7; *Functions* at 11.

³⁰ *Model Bond Opinion Report* at 7; *Functions* at 11. For issues of state law, the relevant court is the highest court of that state; for issues of federal law (e.g., matters relating to the federal income tax treatment of interest on the bonds), such court is the U.S. Supreme Court. The recitation that the court has been “properly briefed” presupposes that it has been duly briefed on the material facts and all relevant law. *Model Bond Opinion Report* at 7.

³¹ *Model Bond Opinion Report* at 7-8; *Functions* at 11-12.

³² *See Model Bond Opinion Report* at 34.

³³ In addition, some bond counsel deem it appropriate to amplify upon this disclaimer with language such as, “Failure of the Borrower to be organized and operated in accordance with the Internal Revenue Service's requirements for the maintenance of its status as an organization described in Section 501(c)(3) of the Code may result in interest on the Bonds being included in gross income for federal income tax purposes, possibly from the date of issuance of the Bonds.”

Reliance on Opinions of Others Generally

Under general legal opinion principles, by stating reliance upon the opinion of borrower's counsel as to the borrower's 501(c)(3) status in the bond opinion, bond counsel must make a professional judgment that such reliance is reasonable based on the reputation of borrower's counsel for competence in such matters and determine that the opinion of borrower's counsel is responsive to bond counsel's needs.³⁴ In its 1998 report on third-party closing opinions, the TriBar Opinion Committee concluded:

By stating reliance on the opinion of a local or specialized law firm or inside counsel (other than counsel for the opinion recipient), the primary opinion giver indicates that such reliance in its professional judgment is reasonable. To establish that reasonableness, the preparers of the primary opinion must ascertain the reputation of counsel relied on for competence in matters of the kind involved. Such a determination is ordinarily made as a part of the process of engaging the other counsel to render the required opinion. In addition, the preparers of the primary opinion must determine that the opinion of other counsel responds to the needs of the primary opinion giver in its opinion. Since the primary opinion giver's opinion normally will mirror that of other counsel, that burden is not a substantial one.³⁵

In a qualified 501(c)(3) bond transaction, there are two caveats to this analysis: (1) bond counsel usually is not part of the process of engaging borrower's counsel, and (2) the opinion given by bond counsel as to the tax-exempt status of the bonds is broader than, and thus in a strict sense does not mirror, the opinion of borrower's counsel with respect to 501(c)(3) status.

If bond counsel is relying on the opinion of borrower's counsel in rendering its opinion that interest on the bonds is excludable from gross income for federal income tax purposes, bond counsel also must comply with Section 10.37 of Circular 230,³⁶ which establishes requirements for written advice concerning federal tax matters. Section 10.37(b) of Circular 230 provides that:

(b) *Reliance on advice of others.* A practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is not reasonable when—

(1) The practitioner knows or reasonably should know that the opinion of the other person should not be relied on;

³⁴ See Donald W. Glazer, Scott T. Fitzgibbon and Steven O. Weise, *Glazer and Fitzgibbon on Legal Opinions* (3d Ed. 2013), §5.3.3 at 185.

³⁵ TriBar Opinion Committee, "Third-Party 'Closing' Opinions: A Report of the TriBar Opinion Committee," 53 *Bus. Law.* 591, 638 (1998).

³⁶ 31 C.F.R. §§ 10.0 *et seq.*

(2) The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or

(3) The practitioner knows or reasonably should know that the other person has a conflict of interest in violation of the rules described in this part.³⁷

Like general legal opinion standards, Circular 230 requires bond counsel to conclude that borrower's counsel is competent to render the 501(c)(3) opinion. However, Circular 230 provides no guidance as to what, if any, due diligence is required on the part of bond counsel to avoid the conclusion that bond counsel should have known that the opinion of borrower's counsel should not be relied upon.

Reliance on the Opinion of Borrower's Counsel and Related Due Diligence

When bond counsel states in its opinion that it is relying on the opinion of borrower's counsel with respect to the 501(c)(3) status of the borrower, it needs to consider whether it should "look behind" the opinion of borrower's counsel and conduct its own due diligence and, if so, the extent of such diligence. This determination is likely to depend upon a number of factors, including:

- the expertise of borrower's counsel in 501(c)(3) matters;
- the extent of the historical relationship between borrower's counsel and bond counsel;
- the extent of the historical relationship between borrower's counsel and the borrower; and
- the scope of the 501(c)(3) opinion that borrower's counsel is willing to render.

In some cases, bond counsel may conclude that it can rely on the opinion of borrower's counsel without doing more. In some other cases, bond counsel may choose to perform certain limited due diligence to either confirm the basic requirements of 501(c)(3) status of the borrower or at least satisfy itself that borrower's counsel has performed the necessary due diligence to render an opinion with respect to the 501(c)(3) status of the borrower. For example, bond counsel may review the organizational documents of the borrower, review the borrower's IRS determination letter, review to the degree deemed appropriate the three most recent IRS Forms 990, inquire about any IRS audits of the borrower, and discuss with borrower's counsel the nature of due diligence undertaken by borrower's counsel. In yet other cases, based on the considerations discussed in this report, including when the opinion of borrower's counsel contains a limited formulation of the 501(c)(3) opinion as described in Part II above or states

³⁷ 31 C.F.R. § 10.37(b).

reliance solely on the borrower's determination letter and limited certifications made by an officer of the borrower, bond counsel may consider it necessary to increase the level of due diligence it performs.

Conclusion

To ensure that the 501(c)(3) status of the borrower is appropriately evaluated, it is important that, as early as possible during the course of a qualified 501(c)(3) bond transaction, bond counsel, borrower's counsel and other applicable counsel (e.g., underwriter's counsel in a publicly offered bond issue, purchaser's counsel in a privately placed bond issue) allocate responsibilities for conducting due diligence and opining (either expressly or impliedly) on the 501(c)(3) status of the borrower. Counsel opining on the 501(c)(3) status of the borrower will need to consider the due diligence it needs to perform in rendering such an opinion. When relying on the 501(c)(3) opinion of borrower's counsel, bond counsel also will need to consider the due diligence, if any, it needs to perform.