

Qualified 501(c)(3) Bonds

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The Essentials

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

Qualified 501(c)(3) bonds are generally issued by a state or local government and the proceeds loaned to and 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.

Determining 501(c)(3) Status

What are the requirements to be a Section 501(c)(3) organization?

- **General Rules:**
 - No Private Benefit
 - Organized and operated exclusively for exempt purposes
 - No private inurement
 - No part of the organization's net earnings may inure to or for the benefit of any private shareholders or individuals
 - Cannot engage in lobbying activity as a substantial part of its activities
 - Cannot engage in political campaign activity
- **Evidence of 501(c)(3) status**
 - IRS Determination Letter after Form 1023
 - 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 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 (campus bookstore, hospital pharmacy, cafeteria)

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

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

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 opinions are you willing to give as 501(c)(3) counsel and what must you see as bond counsel or underwriter's counsel?

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

Some aspects of governmental bonds (private business use, etc.)

Some features like private activity bonds (TEFRA, 2% COI, etc.), but no volume cap requirement

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.
 - Note: Use by the federal government is not a “good” use as the federal government is considered a nongovernmental person for this purpose.

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

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 (e.g., naming rights)

\$150 Million Limit on Non-hospital Bonds

501(c)(3) organization cannot have more than \$150 million of outstanding “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%

Residential Rental Housing

501(c)(3) organization cannot have more than \$150 million of outstanding “non-hospital” bonds allocated to it

- 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

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?

Step 1. Is all or any part of the facility comprised of complete living units?

- Yes – go to step 2
- No – the facilities are NOT residential rental property

Step 2. If so, does the facility make available continual or frequent nursing, medical or psychiatric services?

- Yes – the facilities are NOT residential rental property
- No – the facility is residential rental property

Other Tax Requirements

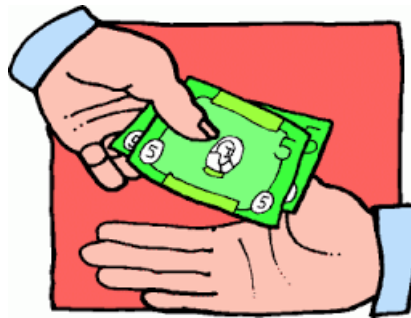
- **Section 147(b)** – average maturity of the bonds cannot exceed 120% of the average reasonably expected economic life of the property financed or refinanced with the proceeds of the bond issue
- **Section 147(e)** – no skyboxes, airplanes, gambling facilities and liquor stores (but health club facilities 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
- Schedule K to Form 990



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



Other Tax Requirements

Reimbursement. 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 (see Treasury Regulations Section 1.150-1)

- **Declaration of “official intent” within 60 days after the payment of the original expenditures to be reimbursed**
 - Can be made 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 are no longer allowed
- Escrow yield
- Carryover treatment of favorable tax laws

Section 1.150-1(d) & (e) define “refunding issue” and “controlled group”

Schedule K to Form 990

501(c)(3) borrowers must complete Schedule K to the 990

- For outstanding bonds exceeding \$100,000 and issued after 12/31/2002
- **Includes:**
 - Detailed uses of the bond proceeds
 - Private business use
 - Arbitrage and rebate compliance

Common Financing Structures

Conduit Issuer and Single Borrower

- Loan or financing agreement or agreements and a note or bond
- Publicly sold debt with indenture or trust agreement as well as loan agreement

Governmental Issuer/Borrower

- Election to treat bonds as 501(c)(3) bonds under Section 141(b)(9)

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

Facilities for Religious Organizations

Potential federal and state constitutional issues

- Establishment Clause
 - Lemon v. Kurtzman: 3 part test
 - Hunt v. McNair: “pervasively sectarian”
- Free Exercise Clause
 - 3 recent cases holding that states cannot withhold a general benefit on the basis of religious status or use

Tension between Establishment Clause, Free Exercise Clause and state law provisions

Questions

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