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Qualified 501(c)(3) Bonds

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INTRODUCTION:

Under Section 103 of the Internal Revenue Code of 1986, as amended (the "Code"), interest on private activity bonds is included in the gross income of the holders of such bonds unless the bonds are "qualified private activity bonds." Qualified 501(c)(3) bonds are one type of qualified private activity bonds under Section 141(e)(1)(G) (unless otherwise identified, all section references are to the Code).

Qualified 501(c)(3) bonds share some features of both governmental bonds and private activity bonds. Prior to the 1986 Tax Act, financings for 501(c)(3) entities were treated the same as financings for governmental entities, as 501(c)(3) organizations were exempt persons for purposes of the private activity bond test (the "industrial development bond test" prior to the 1986 Act). The 1986 Act removed 501(c)(3) organizations from the exempt entity category and created a new exemption category under Section 145.

I. BASIC REQUIREMENTS OF SECTION 145.

Generally, to be qualified 501(c)(3) bonds, the bonds must meet the requirements of Section 145. Section 145(a) contains two tests for determining whether a bond is a qualified 501(c)(3) bond: the ownership test or requirement, and the modified private business tests. Both tests are applied to determine if the bond is a qualified 501(c)(3) bond, but the requirements for each test are not the same. For the bond to be a qualified 501(c)(3) bond, the bond-financed property must meet the ownership test or requirement and the bond must not exceed the limits set forth in the modified private business tests. Bonds issued for a 501(c)(3) organization that exceed the modified private business test limits or fail to meet the ownership test are private activity bonds that are not tax-exempt under the Code.

A. Section 145(a)(1): Ownership requirement. All property to be financed with proceeds of qualified 501(c)(3) bonds must be owned by a 501(c)(3) organization or a governmental unit. This is distinguished from the 95% use requirement discussed in I.C. below. Under the ownership requirement, none of property may be owned by a nongovernmental person. In contrast, under the 95% use requirement, up to 5% of the proceeds of a 501(c)(3) issue may be used by a nongovernmental person without affecting the tax-exempt status of the bonds.

One exception to the ownership requirement is the permissible use of proceeds to finance leasehold improvements. A 501(c)(3) organization may use bond proceeds to make leasehold improvements to facilities leased from a private business provided that the improvements may be readily removed from the leased property and such removal is permitted under the lease, or the leasehold interest exceeds the expected economic life of the financed asset.

B. Qualification as a 501(c)(3) organization. The tax-exemption of the bonds depends upon the status of the conduit borrower as a 501(c)(3) organization. As described below, in most transactions, bond counsel will rely on an opinion of borrower's counsel with respect to the 501(c)(3) status. However, for various reasons, it may be necessary or advisable for bond counsel to conduct its own due diligence on the matter.

See NABL Paper: "The 501(c)(3) Opinion in Qualified 501(c)(3) Bond Transactions" (2014).

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

(a) General Rule. The organization must:

(i) Be organized and operated exclusively for exempt purposes[1] (No Private Benefit)—the "organizational" and "operational" tests;

(ii) Permit no part of its net earnings to inure to the benefit of any private shareholders or individuals (essentially "insiders" (i.e., those in a position of significant influence or control, such as officers and directors)) or other private parties other than members of charitable classes of persons (No Private Inurement);

(iii) Not engage in lobbying activity as a substantial part of its activities;

(iv) Not engage in any political campaign activity; and

(v) Be categorized as either a public charity or private foundation.

(b) Evidence of 501(c)(3) status:

(i) A determination letter issued by the IRS in response to the filing of a Form 1023 application; or

(ii) Participation in a group ruling (e.g., many hospitals operated by a Catholic order and certain housing organizations).

(iii) With very few exceptions, for organizations created since 1969, filing Form 1023 or similar application is a requirement for 501(c)(3) status.

(iv) A single-member limited liability company owned by a 501(c)(3) organization may be treated as part of its exempt owner in some cases (i.e., as a disregarded

[1] The "exempt purposes" set forth in section 501(c)(3) are charitable, educational, religious, scientific, and literary, among other purposes defined in the Code. The term "charitable" is generally used to refer to relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.

entity for federal income tax purposes, and the operating agreement and the owner's IRS determination letter could be used as evidence of 501(c)(3) status).

(v) In recent years, use of the Form 1023-EZ has become more widespread. Note that a determination letter issued by the IRS in response to the filing of a Form 1023-EZ is not conclusive. Special care should be taken when evaluating 501(c)(3) organizations formed utilizing a Form 1023-EZ.

(c) Private Benefit vs. Private Inurement.

(i) Private Benefit is a broader concept than Private Inurement, and defined in *American Campaign Academy v. Commissioner*, 92 TC 1053 (1989) as "nonincidental benefits conferred on disinterested persons that serve private interests."

(ii) IRS regulations prohibit more than an insubstantial part of a 501(c)(3) organization's activities from furthering private interests. This rule applies regardless of the amount of charitable or exempt activities the organization conducts.

a) Private Benefit is allowed so long as it is purely "incidental" (both quantitatively and qualitatively) to the organization's exempt purpose:

Contrast: Organization formed to preserve and enhance a lake as a public recreational facility funded by lake front property owners, community members and bordering municipalities. The lake is used extensively by public. IRS approved because benefits are primarily aimed at general public with improved public recreational facilities. Rev. Rul. 70-186

Organization formed to preserve and beautify a city block and improve the public facilities located on the block and funded by block parties and member contributions. Membership is limited to residents of the block and business owners on the block. IRS did not approve because the primary interest being served is the private interest of the block residents to increase their property value. Rev. Rul. 75-286

b) Benefit need not be a transfer of funds to private interests or excessive or above fair market value payments which are usually associated with private inurement.

c) Benefit does not have to involve parties affiliated with the 501(c)(3) organization.

(iii) Initial determination will be made during Form 1023 application process based on facts presented to the IRS, however, initial determination does not guarantee that Private Benefit will not occur once the organization is actually operating. Even though stated purposes in organizational documents evidence primarily public benefit, actual activities and actual beneficiaries need to be reviewed, as well as any changes in purposes.

(d) Due diligence and reliance on opinions of 501(c)(3) counsel.

(i) What should be reviewed in addition to the IRS determination letter?

Examples: Form 1023 application (if available); IRS Forms 990 (annual information return) and 990-T (exempt organization business income tax return); corporate minutes; agreements between organization and employees, directors or other interested parties.

(ii) What opinion should bond counsel require of the 501(c)(3) organization's counsel and what opinion might the 501(c)(3) organization's counsel be willing to give?

a) 501(c)(3) opinion based solely on IRS determination letter.

b) 501(c)(3) opinion based on IRS determination letter and due diligence and stating that nothing has come to counsel's attention that would cause counsel to believe that the IRS will revoke the determination letter.

c) 501(c)(3) opinion stating that as a matter of fact the entity is an organization described under Section 501(c)(3).

d) Any ancillary/additional opinions? (e.g, not a private foundation, opinion re: disregarded entity status of a single member LLC, unrelated trade or business opinions)

See NABL Paper: "The 501(c)(3) Opinion in Qualified 501(c)(3) Bond Transactions" (2014).

(2) Who or what really "owns" the bond-financed property?

(a) Partnerships, joint ventures and limited liability companies present special issues, because they may be treated as separate entities from their members, partners, or parties to joint ventures.

(i) Partnerships cannot be 501(c)(3) organizations even if all partners are 501(c)(3) organizations, and the IRS has stated in several private letter rulings that joint ventures or "joint operating agreements" may create a partnership for purposes of the Code and result in the "deemed" creation of a separate entity.

(ii) "Look through" treatment: In 2015, Treasury amended the private activity regulations to provide that a partnership is treated as an aggregate of its partners, rather than as an entity. (For federal tax purposes, an LLC is generally treated as a partnership unless the partners have elected to treat the LLC as a corporation.) The final regulations apply for private business use analysis and for the ownership test for 501(c)(3) financings. See Treasury Regulations Sections 1.141-1(e) and 1.141-3(g)(2)(v).

C. Section 145(a)(2): Use Requirement. Even if a 501(c)(3) organization or a governmental unit owns the property that will be financed with bond proceeds, that does not end the inquiry. The modified private business tests must still be applied to determine if the bonds are qualified under Section 145(a).

(1) Modified private business tests. Section 145 modifies the private activity tests that apply to governmental bonds to apply to qualified 501(c)(3) bonds. The private activity test has two components: (i) private business use, and (ii) private payments or security. An issue of qualified 501(c)(3) bonds will meet the private business use test if more than 5% of the net proceeds (i.e., net of proceeds deposited to a debt service reserve fund but including certain earnings on the investment of bond proceeds) are to be used for any private business use. The issue will meet the private payment or security test if the payment of debt service on more than 5% percent of the net proceeds of the issue is secured by property used or to be used for a private business use, or payments in

respect of such property, or to be derived from payments (whether or not to the issuer or the 501(c)(3) organization) in respect of property, or borrowed money, used or to be used for a private business use. If both the private business use test and private payment or security test are met, the bonds will generally be taxable private activity bonds.

Facilities financed with proceeds of qualified 501(c)(3) bonds are generally revenue generating facilities (e.g., hospitals generate patient charges, universities generate student tuition, fees and other charges), and the private payment or security test will generally be met if there is private business use in excess of 5%.[2] Therefore, in order to avoid taxable private activity bonds, at least 95% of net proceeds must be used only by 501(c)(3) organizations engaged in exempt activities, by states or local governmental units, or by the general public (or otherwise qualify for an exception from private business use), such that the private business use test is not met. Use by the federal government is considered private business use, unless an exception applies.

(a) Use of property equals use of proceeds. Multiple uses of the same property (e.g., simultaneous uses or uses at different times) must be allocated.

(b) Costs of issuance financed from proceeds count against the 5% private business use limitation. See Treasury Regulations Section 1.145-2(c)(2); costs of issuance may not exceed 2% of the bond proceeds, effectively limiting the 5% private business use limitation to a private business use limitation as low as 3% (assuming the 2% limit for costs of issuance was reached).

(c) In addition to the 5% limitation on private business use, Section 141(b)(5) imposes an overall limitation of $15 million of private business use per issue unless private activity volume cap is obtained.

(2) Use by a 501(c)(3) organization engaged in an "unrelated trade or business" (without regard to whether the Unrelated Business Income Tax ("UBIT") tax applies) is *not* a "good" use, so it counts towards the 5% private business use limitation together with other private business use. See Section 513(a).

(a) An activity will be characterized as an "unrelated trade or business" if it is:

(i) A trade or business;

(ii) Regularly carried on; and

(iii) There is no substantial causal relationship to furthering the organization's exempt purposes (merely raising income to support exempt purposes is not a substantial causal relationship).

(b) "Unrelated trade or business" does <u>not</u> include any of the following:

(i) Activities conducted by the organization primarily for the convenience of the organization's members, students, patients, officers or employees (e.g., certain hospital gift shops, cafeterias, campus bookstores).

(ii) Activities in which substantially all the work in carrying on the trade or business is performed for the organization without compensation (i.e., by volunteers).

(iii) The selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

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[2] There may be exceptions, but this is generally not a bad assumption to start with.

(c) Common unrelated trade or business activities that may arise in a bond transaction include:

(i) Hospital lab work or pharmacy sales to persons who are neither patients nor employees of the hospital. Rev. Rul. 85-110, 1985-2 C.B. 166; Rev. Rul. 68-374, 1968-2 C.B. 242; Rev. Rul. 68-375, 1968-2 C.B. 245; Rev. Rul. 68-376, 1968-2 C.B. 246.

(ii) Providing administrative or other support services to 501(c)(3) organizations (B.S.W. Group, Inc. v. Comm'r, 70 T.C. 352 (1978); Rev. Rul. 69-528, 1968-2 C.B. 127) or to for-profit affiliates is a business activity and not an exempt purpose for a 501(c)(3) organization.

(iii) Rental of museum or school or other 501(c)(3) entity facilities after hours or during non-use by the 501(c)(3) for private events. PLR 9702003.

(iv) Operation of a parking lot open to the public or open during hours that the exempt organization is closed. Rev. Rul. 69-269, 1969-1 C.B. 160.

(3) Just as with ownership, joint ventures raise private business use issues. See I.B.(2)(a) above.

(4) Common types of "use" include leases (note that both lessee and lessor are users), management contracts, "other" service agreements, and cooperative research agreements.

(5) The private activity bond regulations and Revenue Procedures provide safe harbors for service and other management contacts and research agreements, pursuant to which such arrangements will not be treated as resulting in private business use. For many years, the safe harbors for management contracts were set forth in Revenue Procedure 97-13 ("Rev. Proc. 97-13"). In 2016, the IRS released Revenue Procedure 2016-44 ("Rev. Proc. 2016-44"), which was then superseded by Revenue Procedure 2017-13 ("Rev. Proc. 2017-13"), setting forth safe harbors that take "a more flexible and less formulaic approach" in determining whether a management contract gives rise to private business use. Rev. Proc. 2017-13 provides the management contract safe harbors for contracts entered into, materially modified, or extended, on or after January 17, 2017. Revenue Procedure 97-14 ("Rev. Proc. 97-14"), as modified and superseded by Revenue Procedure 2007-47, provides safe harbors relating to research agreements.

(a) Management Contracts

(i) Generally. Under the Treasury Regulations, a management contract is a management, service, or incentive payment contract between the exempt person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. Treasury Regulations Section 1.141-3(b)(4). A management contract does not include a contract for services solely incidental to the primary functions of a financed facility (e.g., janitorial, office equipment repair, hospital billing, or similar services), the mere granting of admitting privileges by a hospital to a doctor, or a contract to provide for services if the only compensation is the reimbursement of the service provider for actual and direct expenses paid to unrelated third parties. In addition, although structured as a management contract, an arrangement may also be characterized as a lease under federal income tax principles, and thus would result in private use regardless of the form of compensation.

(ii) Safe Harbors Under Rev. Proc. 2017-13. The safe harbors in Rev. Proc. 2017-13 released on January 17, 2017 (which modifies, amplifies and supersedes Rev. Proc. 2016-44, released on August 23, 2016) apply to any management contract that is entered into on or after January 17, 2017, and an issuer may apply these safe harbors to any management contract that was entered into before January 17, 2017. Under Rev. Proc. 2017-13 a management contract generally will not give rise to private business use so long as:

a) The payments to be made to the service provider qualify as "reasonable compensation";

b) The contract does not allow the service provider to receive a share of "net profits" from the operation of the managed property;

c) The contract does not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property;

d) The term of the contract (including all renewal options under which either party has a legally enforceable right to renew the contract (i.e., an automatic renewal absent cancellation by either party is not a renewal option)) is no greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property;

e) The governmental issuer or 501(c)(3) borrower exercises a significant degree of control over the use of the managed property,

f) The governmental issuer or 501(c)(3) borrower must bear the risk of loss upon damage or destruction of the managed property;

g) The service provider agrees not to take an inconsistent tax position with being a service provider to the governmental issuer or 501(c)(3) borrower with respect to the managed property; and

h) The service provider must not have any role or relationship with the governmental issuer or 501(c)(3) borrower that, in effect, substantially limits the issuer's or borrower's ability to exercise its rights under the management contract.

(b) Prior Safe Harbors under Rev. Proc. 97-13. Prior to Rev. Proc. 2017-13, safe harbors for management contracts were provided in Rev. Proc. 97-13, which applied a more formulaic approach than Rev. Proc. 2017-13. Under Rev. Proc. 97-13, the length of the contract determined the allowable structure for compensation, allowing more variability in compensation for shorter contracts, and more fixed compensation for longer contracts. An issuer may apply the safe harbors in Rev. Proc. 97-13, as modified by Revenue Procedure 2001-39 and amplified by Notice 2014-67, to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended on or after August 18, 2017 (other than pursuant to a renewal option as defined in Treasury Regulations Section 1.141-1(b)).

(c) Sponsored or Cooperative Research Agreements: Governed by Rev. Proc. 2007-47 (formerly Rev. Proc. 97-14). The issue is whether the business (or federal governmental) entity that provides the funding for (i.e., sponsors) the research gets particular benefits from the research. This is an issue primarily for universities and specialty healthcare facilities such as cancer centers.

(6) What happens if unexpected additional private business use occurs after issuance?

(a) The borrower must have had the reasonable expectation at the issue date that the bonds wouldn't meet the private activity tests (i.e., more than 5% private business use and private payments or private security). After issuance, if the borrower takes a deliberate action that results in the private activity tests being met, then the bonds cease to be qualified 501(c)(3) bonds.

(b) "Use" is generally measured over time on an average annual basis under Treasury Regulations Section 1.141-3(g).

(c) Under Treasury Regulations Section 1.141-6, any private business use of a facility may be allocated first to qualified equity and then any remaining private business use is allocated to bond proceeds. Qualified equity means proceeds of bonds that are not tax-exempt or other tax-advantaged bonds and funds that are not derived from proceeds of a borrowing that are spent on the same project as the bonds, under the same plan of financing (e.g., equity provided by the borrower, capital campaign proceeds, etc.).

(d) If the measurement and allocation rules do not provide relief, Treasury Regulations Sections 1.141-2, 1.141-12, and 1.145-2 and Rev. Proc. 2018-26 provide that, so long as certain remedial actions are taken, change in use of a bond-financed facility from a qualifying use to a non-qualifying use will not cause interest on the bonds to become taxable.

(e) Generally, under Treasury Regulations Section 1.141-12, remedial actions include (1) prompt redemption or defeasance of the "non-qualified bonds" following the change in use, (2) allocation of the proceeds of an asset disposition giving rise to the change in use to new 501(c)(3) assets and (3) tracing the disposed asset to a new, qualifying use. Additional language added to Treasury Regulations § 1.141-12 allows issuers to take anticipatory remedial action if they anticipate a deliberate action (such as a sale of bond-financed property) will result in nonqualified use of the property. For certain remedial actions, it may be necessary to treat some or all of the bonds as reissued for tax purposes and, as a result, it may be necessary to undertake steps including, for example, a new TEFRA approval.

II. $150 MILLION LIMIT

A. The original rule–Section 145(b)(1): A bond, other than a qualified hospital bond (Note – *See Part E for a description of what constitutes a "hospital"*), will not be treated as a qualified 501(c)(3) bond if the aggregate amount of the bond allocated to a 501(c)(3) organization during the test period, plus the aggregate amount of all other non-hospital bonds allocated to that organization, exceeds $150 million. This rule was imposed as part of the Tax Reform Act of 1986.

B. In 1997, Congress partially repealed the $150 million limitation. The Taxpayer Relief Act of 1997 added Section 145(b)(5), which provides that the $150 million limit does not apply to a qualified 501(c)(3) bond issued after August 5, 1997, if at least 95% of the net proceeds are used to finance capital expenditures incurred after August 5, 1997. Section 145(b)(5) does not explicitly refer to refundings of new money issues that were not subject to the

$150 million limit by reason of Section 145(b)(5), but most practitioners take the position that the repeal also applies to such refundings.

C. Bonds to which the $150 million limit does not apply are not taken into account in applying the $150 million limit to other bonds.

D. The $150 million limit will continue to govern issuance of other non-hospital bonds (e.g., refunding bonds with respect to capital expenditures incurred before August 6, 1997, new money bonds for capital expenditures incurred before that date or new money bonds where less than 95% of net proceeds are spent on capital expenditures).

(1) For example, the $150 million limit may still apply to a new money financing where post-construction period interest and other working capital costs are financed with more than 5% of net proceeds.

(2) Qualified 501(c)(3) bonds are allocated to "test period beneficiaries." A "test period beneficiary" is any organization that is an owner of the financed property, or a user of more than 10% of the financed property during the "test period." Section 145(b)(4); Section 144(a)(10)(D).

(3) The test period ends three years after the later of the date the bonds were issued or the date the bond-financed property is placed in service.

(4) Once bonds are allocated to a test-period beneficiary, they remain so allocated until the bonds are actually retired.

E. Section 145(c): A qualified hospital bond is a bond at least 95% of the proceeds of which are used with respect to a "hospital".

(1) The term "hospital" includes a facility that primarily provides to inpatients diagnostic and therapeutic services or treatments by or under the care of physicians.

(2) The facility must be accredited by The Joint Commission (f/k/a/ The Joint Commission on Accreditation of Healthcare Organizations (JCAHO)), or be accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of The Joint Commission.

(3) The facility must require that every patient be under the care and supervision of a physician and must provide 24-hour nursing services.

(4) The term "hospital" does not include nursing homes, day care centers, medical school facilities, research laboratories, or most free-standing ambulatory care centers (unless they are totally integrated with and assist the in-patient hospital).

III. ADDITIONAL REQUIREMENTS FOR RESIDENTIAL RENTAL HOUSING

A. Section 145(d) (sometimes referred to as the "Donnelly Amendment") denies qualified 501(c)(3) bond treatment to any issue if any portion of the bond proceeds is used to directly or indirectly provide "residential rental property for family units." The basic policy rationale for this provision is to minimize the likelihood that non-profits will enter into direct competition in the traditional rental housing market with for-profit housing developers. Section 145(d) provides exceptions to the foregoing rule if:

(1) The bonds finance new residential rental property (first use of property is pursuant to such issue);

(2) The bonds finance qualified residential rental property as defined in Section 142(d) (requires meeting certain low income set aside minimums); or

(3) The bonds finance property that will be substantially rehabilitated (generally, rehabilitation expenditures at least equal to the adjusted basis of the building) within a 2-year period beginning no later than one year after the date of acquisition of such property.

B. What is "residential rental property for family units"?

(1) Residential rental property for family units consists of housing units that are not used on a transient basis and provide complete facilities for living, sleeping, eating, cooking, and sanitation. The "completeness" of a particular facility requires a fact-specific analysis. This description might include certain assisted living facilities.

(2) In September 1998, the IRS issued Revenue Ruling 98-47 in which it analyzed whether three buildings in an integrated assisted living complex constituted residential rental property for purposes of Sections 142(d) and 145(d). The Revenue Ruling seems to suggest a two-tier test:

(a) Is all or any part of the facility comprised of complete living units? If no (e.g., a nursing home), then not residential rental property and qualified 501(c)(3) bonds could be used. If yes, then you must answer the next question to determine if the facility is residential rental property.

(b) If the facility is comprised of complete living units, does the facility make available continual or frequent nursing, medical, or psychiatric services? If yes, then it is not residential rental property and qualified 501(c)(3) bonds could be used.

IV. OTHER TAX REQUIREMENTS

A. As with all tax-exempt bonds, qualified 501(c)(3) bonds must:

(1) Comply with the Section 148 arbitrage and rebate requirements. Two issues that arise frequently for qualified 501(c)(3) bonds are:

(a) Reimbursement

(i) "Official intent" requirement: by the conduit borrower or the issuer

(ii) Time periods

a) expenditures paid no earlier than 60 days prior to date of official intent

b) bonds issued (reimbursement allocation made) no later than 18 months after later of date expenditure is paid or date project is placed in service, but in no event later than three years after date expenditure is paid.

(iii) exception for "preliminary expenditures" (i.e., soft costs such as architectural, engineering, feasibility and legal expenses relating to the project to be financed regardless of when incurred).

(iv) once financed, not reimbursed (i.e. a refinancing of a prior obligation is a refunding, not a reimbursement)

(b) Replacement proceeds – if funds have a sufficiently direct nexus to the bond issue or to the governmental purpose of the issue to conclude that the amounts would have been used for the governmental purpose if the proceeds of the issue were not used or to be used.

(i) Endowment funds

(ii) Proceeds of capital campaigns specified for use on the financed project (see "Section VII: Use of Capital Campaign Pledges and Proceeds," below)

(iii) Pledged funds

(iv) Negative pledges – potential issues when reviewing financial covenants requested by bond insurers or banks (e.g. calculation of days cash on hand or other liquidity measures more frequently than semi-annually).

Note: For a discussion of the application of the replacement proceeds rules to nonprofit hospitals and to colleges and universities, see the reports of the Congressional Budget Office dated December 2006, entitled "Nonprofit Hospitals and Tax Arbitrage" and dated April 2010 entitled "Tax Arbitrage by Colleges and Universities," respectively.

(2) Be issued in registered form. Section 149(a).

(3) Not be federally guaranteed. Section 149(b).

(4) Not be hedge bonds. A bond is not a hedge bond if the conduit borrower reasonably expects that at least 85% of the net sale proceeds will be used to carry out the governmental purposes of the bond (including the use of proceeds by the 501(c)(3) borrower) within 3 years of the issue date, and not more than 50% of the proceeds of the bond, if any, are invested in investments having a substantially guaranteed yield for 4 or more years. Section 149(e).

(5) Reported by timely filing of IRS Form 8038. Section 149(g).

B. As a type of private activity bond, qualified 501(c)(3) bonds must comply with:

(1) Section 147(b) maturity limits (120% of average remaining useful life of facilities financed).

(2) Section 147(e) prohibitions against financing airplanes, skyboxes, gambling facilities, and liquor stores. Note that Section 147(e) generally prohibits the financing of health club facilities with private activity bonds, but Section 147(h)(2) excludes qualified 501(c)(3) bonds from this particular prohibition.

(3) Section 147(f) notice and public approval requirements (a/k/a "TEFRA" requirements).

(4) Section 147(g) limit on costs of issuance ("2% rule").

C. However, qualified 501(c)(3) bonds are exempt from certain limitations that apply to other categories of private activity bonds, including:

(1) Qualified 501(c)(3) bonds are not subject to the volume cap limitations in Section 146.

(2) Qualified 501(c)(3) bonds are not subject to the substantial user limitation in Section 147(a).

(3) Qualified 501(c)(3) bonds are not subject to the limitation on land acquisition in Section 147(c) or the limitation on acquiring existing property in Section 147(d).

D. Prior to the Tax Cuts and Jobs Act of 2017, most qualified 501(c)(3) bonds were able to be advance refunded one time under Section 149(d). The 2017 Act eliminated the ability to issue tax-exempt advance refunding bonds after December 31, 2017.

E. Interest on qualified 501(c)(3) bonds is not subject to the alternative minimum tax on individuals.

F. "Acquisition financing" vs. "refunding"

(1) Certain transactions involving both the repayment of a prior issue and a transfer of interests in the assets securing such issue will be treated as a sale of the assets rather than as a refunding for federal tax purposes, although not necessarily for state law purposes.

(2) Characterization of a financing as one or the other may be critical. See definitions of "refunding issue" and "controlled group" in Treasury Regulations Section 1.150-1(d) and (e) of the regulations.

(3) Important distinction for various purposes, including (i) determination of permitted escrow yield, (ii) avoiding impermissible advance refundings, and (iii) carryover of favorable treatment for refunding bonds.

G. Schedule K to Form 990.

(1) 501(c)(3) organizations must generally file annual tax returns on Forms 990. Schedule K to Form 990 requires reporting of outstanding tax-exempt bonds benefitting the organization, if the outstanding principal amount exceeds $100,000 and the bonds were issued after 12/31/2002.

(2) Schedule K requires detailed reporting as to the uses of proceeds of the outstanding bonds, including post-closing information such as unspent proceeds, redemptions of bonds and the establishment of new refunding or defeasance escrows.

(3) With respect to private business use, Schedule K requires identification of various types of private business use, as well as the percentage of private business use for the applicable year.

(4) Schedule K also requires the organization to identify certain information about arbitrage/rebate compliance for each issue of outstanding bonds.

H. Post-Issuance Compliance Procedures. Adopting and implementing a set of Post-Issuance Compliance Procedures can help 501(c)(3) borrowers stay in compliance with the various use and arbitrage restrictions applicable to the bonds.

V. "BANK QUALIFIED" STATUS

A. Bonds issued to provide financing for a 501(c)(3) entity may be eligible for "bank qualified" status under Section 265 (often referred to as "BQ"), but the status is based on the eligibility of the governmental issuer of the bonds. The governmental issuer must not anticipate issuing more than $10,000,000 in tax-exempt bonds (with certain bonds not counting toward this limit) during the calendar year and must designate the bonds as "bank qualified."

B. Under the American Recovery and Reinvestment Act of 2009 (the "Stimulus Act"), 501(c)(3) entities were allowed special treatment under the "bank qualified" status rules of Section 265. Basically, each 501(c)(3) entity was allowed its own $30 million per year exemption. This raised difficult questions about the treatment of related 501(c)(3) entities.

The Stimulus Act provisions expired December 31, 2010. Special treatment under Section 265 is no longer available, and a refunding or reissuance of any 501(c)(3) debt that received special treatment may result in a loss of Section 265 bank qualified status.

VI. FINANCING STRUCTURES FOR 501(c)(3) BONDS

A. Master Indenture financing structures – Used by many healthcare systems. It attempts to "pool" the credit of multiple nonprofit operating and other entities (e.g., a related foundation) known as an "obligated group" that are typically under common control or are party to an overarching joint operating structure.

(1) The Master Indenture can consolidate all financial covenants into a single document that is then used for each bond issue and allow for supplemental indentures to provide terms applicable to each individual bond issue.

(a) Financial and other covenants at the obligated group level may provide the security necessary to market the bonds to potential buyers. Examples of common covenants are restrictions on incurring additional debt unless minimum debt service coverage ratios are met, restrictions on transferring property outside of the obligated group, restrictions on placing liens on certain property, restrictions on mergers and acquisitions, etc.

(b) Benefits:

(i) Provides single set of financial covenants; no need to renegotiate for each succeeding bond issue. (However, this is not always the result as bank purchasers, parties providing letters of credit or other credit enhancement, or other entities involved in the financing may require additional covenants or different formulations of covenants. In addition, what the "market" will require from a particular credit may change, as may the credit itself.)

(ii) By "pooling" the entities in the obligated group into a single credit, there is the potential for increasing the credit worthiness of the group as a whole and decreasing borrowing costs for those entities in the group with lesser credit attributes.

(2) The Master Indenture also operates as an intercreditor agreement, allowing various creditors secured by the Master Indenture to share on a pro rata basis in collateral subject to the Master Indenture (e.g., revenues and/or mortgaged facilities). This avoids relegating future creditors to subordinate or junior lien status, although additional security may be given in specific transactions outside of the Master Indenture and limited to the specific creditor(s).

(3) Obligated Groups vs. Restricted Groups.

(a) Each member of the Obligated Group is jointly and severally liable for debt issued under the Master Indenture and a party to the Master Indenture.

(b) The Master Indenture may provide for "Restricted Affiliates" or a "Restricted Group". Restricted Affiliates or members of the Restricted Group may be brought in through provisions of the corporate formation documents and/or contribution agreements by which they agree to provide funds to pay debt service on a limited amount (or all) of indebtedness secured by the Master Indenture.

(4) Issues raised by the Master Indenture structure.

(a) Fraudulent conveyance/bankruptcy issues – If one obligated group member must pay debt service on indebtedness from which it received no benefit, the transfer (i.e. the payment) may be voidable under bankruptcy law or treated as a fraudulent conveyance.

(b) Violation of "public charity" doctrines – Possibility of reluctance of a court to enforce joint and several obligation if the corporation is not able to carry out its charitable purposes or if it is insolvent because it was forced to pay debt service for another obligated group member's debt.

B. "Corporate Style" Master Indentures. Limited financial covenants (with or without revenue or other pledged security) and remaining covenants are tested based on the financials of the "System" (i.e. all of the entities that are controlled directly or indirectly by the primary borrower).

VII. USE OF CAPITAL CAMPAIGN PLEDGES AND PROCEEDS

A 501(c)(3) organization may wish to finance a facility (for example, a museum) that will be paid for in part by pledges to be realized over time from a related capital fundraising campaign and in part through the issuance of tax-exempt bonds. The proceeds of those pledges may constitute replacement proceeds. The actual amount of pledges to be received, and the timing of those receipts, may make it difficult to size a tax-exempt bond issue for the facility. If bonds are issued in anticipation of the pledges to be received, overissuance and sinking fund concerns may be avoided by having bonds redeemed periodically (for example, annually) with pledges in excess of the amount necessary to pay the required annual maturity of bonds. Alternatively, one or more additional series of bonds may be short-term in nature or provide for mandatory redemption from fundraising proceeds, reflecting the expected fundraising. Note that fundraising for a 501(c)(3) organization's general purposes, as opposed to being dedicated to the specific project(s), will not constitute replacement proceeds, even if used by the 501(c)(3) for the specific project(s). In connection with due diligence, bond counsel will often request copies of fundraising or campaign materials and inquire as to receipt or any expected receipt of restricted gifts or funds to be used for the project for which bond proceeds are being issued to assist in its analysis of these issues.

VIII. FINANCING FACILITIES SPONSORED BY OR AFFILIATED WITH RELIGIOUS ORGANIZATIONS

Religious use is both a federal and state constitutional law issue that can impact the validity of a conduit bond issue (whether taxable or tax-exempt). This is an evolving area of law. In prior decades, Supreme Court cases focused on whether the religious status of borrowers and use of bond-financed facilities violated the Establishment Clause (or parallel state provisions). However, recent Supreme Court decisions have held that a prohibition on providing government aid that is based on either religious status or on the use of the funds for sectarian purposes violates the Free Exercise Clause. When reviewing a financing for a religious institution, bond counsel must carefully balance the potentially conflicting concerns of the Establishment Clause, the Free Exercise Clause and any applicable state laws or constitutional provisions.