Tax Issues in 501(c)(3) Financings

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OCTOBER 18–20, 2023

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Ownership Requirement

Section 145(a)(1) provides that that a “qualified 501(c)(c) bond” is “any private activity bond issued as part of an issue if – all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit.

What Does Ownership Mean?

"Ownership" of property for this purpose is determined under federal tax principles and is not based upon who owns title to the property. So, we would need to look at whether the 501(c)(3) organization can be considered the owner, under federal tax principles.

The IRS can look at a number of factors to determine if the burdens and benefits of ownership have transferred from one party to another.

As a general rule, if the 501(c)(3) organization's leasehold interest exceeds the expected economic life of the financed asset, or if the financed asset can readily be removed from the leased space, and such removal is permitted under the terms of the lease, such improvements can be treated as owned by the 501(c)(3) organization, so that they are eligible for tax-exempt financing.

Ownership Hypothetical

Charter School, which is a corporation and a 501(c)(3) organization, wants to finance (1) the costs of the acquisition of land and (2) the construction of new school buildings for its operation (the "Bond Financed Assets").

Charter School's parent company, who owns all membership interests in Charter School, National Schools Co. ("National"), is not an organization described under Section 501(c)(3) of the Code. The acquisition of the Land would comprise more than 25% of the net proceeds of the issue.

Due to certain state law limitations and other State A property reversionary requirements for charter schools, Charter School wants to structure the financing to have Charter School lease the Bond-Financed Assets from single-member LLC of National ("Property-LLC").

Property-LLC is not an organization described under Section 501(c)(3) of the Code.

Will a long-term lease of the Bond-Financed Assets allow Charter School to satisfy the ownership requirement for qualified 501(c)(3) bonds?

Analysis – The Buildings

Revenue Procedure 62-21 provides that buildings, which includes the structural shell of the building and all integral parts thereof also including equipment which services normal heating, plumbing, air conditioning, fire prevention and power requirements, and equipment such as elevators and escalators, have a useful life of between 40 and 50 years.

Analysis – The Land

Section 147(b)(3)(B)(ii) provides that if 25 percent or more of the net proceeds of any issue is to be used to finance land, such land shall be taken into account under paragraph (1)(B) and shall be treated as having an economic life of 30 years.

Would a lease of the Land for at least 30 years be sufficient to transfer federal tax ownership of the Land to Charter School? It doesn't seem like it.

- In general, land is not considered a depreciable asset because it is viewed to have an indefinite useful life.
- To conclude that the benefits and burdens of federal tax ownership of the Land would be met:
  - the lease term for the Land would also need to be indefinite;
  - the lease would need to give Charter School the ability to divest the Land on its own accord; and
  - the lease would need to convey Charter School the ability to retain the gain or bear the loss of the Land.

Other Options – How can this financing be structured?

National could become an organization described under Section 501(c)(3) of the Code. Then National or Property-LLC could own the land and the buildings.

A Charter School Property-LLC entity could be formed. Charter School could be the sole member of Charter School Property-LLC – but this might not accomplish certain of Charter School and National's goals.

Ownership Hypothetical Cont.

Charter School comes back to you and decides to finance the Land with taxable bonds. However, it still wants to finance the Buildings with 501(c)(3) bonds. Charter School's counsel explains that the law of State A requires that State A approve the lease term, and all renewals of such lease. Presently, State A will only approve a 10-year lease, which is contemporaneous with Charter School's charter.

Will that be a problem?

Analysis

The lease term of the Buildings including all unilateral renewal options, would need to be for at least as long as estimated useful life of the Buildings. Is this a unilateral option?

Sometimes look to description of a unilateral option in the reissuance regs by analogy.

Analysis Cont.

To be a unilateral option under Reg. § 1.1001-3(ii)(3):

There does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the lease to a person who is related (within the meaning of Section 267(b) or Section 707(b)(1)) to Charter School;

The exercise of the option doesn't require the consent or approval of:

- The other party (in this case Property-LLC),
- A person who is related to that party, whether or not that person is a party to the instrument; or
- A court or arbitrator.

The exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information.

Use by a Governmental Unit – Federal Government

501(c)(3) health system issues $5,000,000 of 501(c)(3) bonds and uses $500,000 of proceeds to purchase a CT scanner. A year later, the local VA hospital asks to rent the CT scanner from the 501(c)(3) health system. The 501(c)(3) health system agrees to rent the CT scanner to the VA hospital for $10,000 for month for six months.

Same facts, but after 6 months the parties agree to a new two-year contract on the same economic terms, but the rental contract says that it can be terminated by either party upon 50 days' notice.

Same facts as (ii), but after a year, the 501(c)(3) health system agrees to sell the CT scanner to the VA for $300,000.

In each case, is there private use, and if so, how much?

Use by 501(c)(3) Organizations

Unrelated Trade or Business Activity

501(c)(3) hospital has a retail pharmacy located in space financed with tax-exempt bond proceeds. Each year around 2.8% of its revenues are unrelated trade or business. The CFO calls and says that they are planning to double the size of the retail pharmacy and expect to triple the amount of revenues after expenses.

The CFO says: “I know that this would be too much private business use, but Walgreens has agreed to manage the pharmacy for us, for a fixed annual management fee, and we will keep all the revenues. That meets the safe harbors of Rev. Proc. 2017-13, and so we won’t have any private use moving forward.”

Is the CFO correct?

Use by 501(c)(3)s

Use by Unrelated Organizations

Consistent charitable purposes

What diligence required? Is an opinion as to 501(c)(3) status enough?

Unrelated exempt purposes

i. A 501(c)(3) private high school, with educational charitable purposes, used $100,000 of tax-exempt bond proceeds to finance an expansion of its athletic facilities, consisting of a football field, bleachers, and a building that houses locker rooms, a small kitchen and concession stand. The school uses the facility for football practice from 3-6 on Mondays and Wednesdays, and for games from 3-7 on Tuesdays and Fridays. An unrelated 501(c)(3) organization that provides services to unhoused persons uses the locker rooms, kitchen and concession stand from 8-2 on Saturdays and Sundays, free of charge.

ii. Two years later, the school builds new locker rooms and kitchen facilities. It sells the old bond-financed facilities to the 501(c)(3) organization that provides services to unhoused persons for $5,000.

In each case is there private use and if so, how much?

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For-Profit Entities

"Licenses"

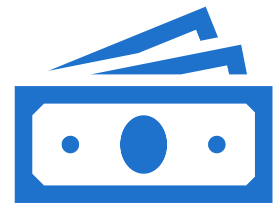
No physical use of bond-financed assets

i. A hospital is built using $100,000,000 of 501(c)(3) bond proceeds. Its 501(c)(3) owner hires a consultant to increase the profitability of the ICU and cardiology departments by 10-20% in one year. The consultant is paid 25% of the increased profits. Other than two on-site meetings, the consultant never sets foot in the hospital.

ii. After the first year, in which the consultant increases net profits of the ICU and cardiology departments by 12%, the hospital employs the consultant pursuant to a 5 year employment contract. The former consultant is paid 25% of any further increased profits from the ICU and cardiology departments, as well as 15% of any net savings from the ER department and hospitalist program. In the employment agreement, the hospital agrees to provide the former consultant with 5,000 sq. ft. of office space in the hospital's administrative offices.

In each case is there private use, and if so how much?

Working Capital and the $150 Million Test



Section 145(b) provides that a bond (other than a qualified hospital bond) shall not be treated as a qualified 501(c)(3) bond if the aggregate authorized face amount of the issue (of which such bond is a part) allocated to any 501(c)(3) organization which is a test-period beneficiary (when increased by the outstanding tax-exempt nonhospital bonds of such organization) exceeds $150,000,000.

Audience Polling Question

Has anyone been involved in an audit in which the IRS closely looked at the $150 million test?

Responses:

A) I have never had this question asked on audit.

B) I have seen this question asked on audit a few times but not often.

C) This question is asked all the time.

D) What is the $150 million test?

Historical Context

Partial repeal of $150 Million Test in 1997

- Section 145(b)(5) provides that the $150 million test shall not apply to "bonds issued after August 5, 1997, as part of an issue 95 percent or more of the net proceeds of which are used to finance capital expenditures incurred after such date".
- Under the partial repeal, an issue issued to finance expenditures incurred after August 5, 1997, in which less than 95 percent of the net proceeds are used to finance capital expenditures is subject to the $150 million test.

The partial repeal language can cause difficulty in structuring transactions involving old bonds subject to the $150 Million Test and new bonds financing capital and working capital expenditures post August 5, 1997.

The $150 Million Test "lurks like a virus" and presents a range of matters for tax counsel to consider and manage in connection with 501(c)(3) bonds.

Hypothetical #1

New money bonds are issued on January 1, 2023, to finance a new dormitory facility for "X" a Section 501(c)(3) organization. In the wake of the pandemic and uneven enrollment, X is seeking to finance interest on the bonds for as long as possible. It is expected that the dormitory facility will be placed in service March 1, 2024. In addition, X is also seeking to finance working capital for initial operating expenses associated with the new dormitory facility which will arise after the facility is placed in service.

What should bond counsel consider in this financing?

Hypothetical #1 Cont.

Under general tax principals, interest is generally capitalized up until the placed in-service date of the project. For the period of March 1, 2024, through January 1, 2026, does bond counsel need to consider the federal tax treatment of interest and whether such amount is a capital expenditure?

Under general tax principles, the financing of "initial operating expenses" are not treated as capital expenditures.

What if X has other bonds outstanding subject to the $150 Million Test?

Hypothetical #2

"Y" a Section 501(c)(3) organization which operates a museum is under financial distress. Y is seeking to current refund an outstanding tax-exempt bond issue and is also seeking to refinance an outstanding taxable bridge loan used primarily (but not exclusively) for Y's working capital expenditures.

Given Y's financial distress, bond counsel observes that Reg. § 1.148-6(d)(3)(A)(3) provides that it may be possible to finance interest on the refunding issue for a period ending on the later of: (i) 3 years from the issue date or (ii) 1 year after the placed in-service date.

Bond counsel notes that the language of Reg. § 1.148-6(d)(3)(A)(3) refers to "issue" and not new money issue, hence, perhaps providing the ability to issue up to 3 years of interest for the refunding bonds.

What does bond counsel need to consider in this financing?

Hypothetical #2 Cont.

Examine the use of proceeds of the taxable loan – what amount was applied to working capital?

Can bond counsel approve financing 3 years of interest on the refunding bonds and, if so, what are the potential consequences under the $150 million limit?

What if Y has bonds outstanding which are subject to the $150 million test and the size of the proposed refunding is $200 million?

Refinancing Bonds Subject to $150 Million Test Together with Post 8/5/97 Capital Expenditures.

There are circumstances in which non-profit borrower will seek to refund pre 8/5/97 bonds subject to the $150 million test and finance new projects in a single bond issue.

Section 145(b)(5) provide in part than the repeal applies to -- “bonds issued after August 5, 1997, as part of an issue 95 percent of more of the net proceeds were used to finance capital expenditures after such date”.

Taken literally, if more than 5% of the net proceeds of the bonds which are part of the issue financed capital expenditures incurred prior to 8/5/97, the entire new issue is subject to the $150 million cap.

Hypothetical #3

University W, a 501(c)(3) organization wants to finance $300 million of new capital improvements and current refund its outstanding $40 million balance of pre-1997 non-hospital bonds. The bankers have advised that to separate the sale dates of the new money and refunding bonds by more than 15 days would be expensive as a larger bond issue would garner more buy-side interest.

What does bond counsel need to consider with respect to the refinancing?

Hypothetical #3 Cont.

Given the partial repeal language in Section 145(b)(5), the issuer can make a separate issue allocation under Reg. § 1.150-1(c)(3) between the new money and refunding bonds (i.e., a firewall).

Given that the transaction involves a partial refunding, Reg. § 1.150-1(c)(3) requires that an eligible multipurpose allocation must be applied under Reg. § 1.148-9(h) to differentiate the refunding portion from the new money portion.

Under Reg. § 1.150-1(c)(3), the 95% good use test and the 120% economic life test are applied separately to each "issue."

For support of this technique, see example 5(iii) of Reg. § 1.141-13(g), in which Reg. § 1.150-1(c)(3) is used to create a firewall within a single bond issue containing both governmental airport bonds issued under Section 141 and private activity airport bonds issued under Section 142.

Other Observations

Is all of the above tax engineering and structuring necessary to protect the new money portion from being subject to the $150 million test?

Given the $150 million test is a volume cap limit, provided that a borrower does not exceed the $150 million test for any legacy bonds – should the analysis involve simply keeping track of pre 8/5/97 bonds to make sure that such limit does not exceed $150 million test?

Questions

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