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TAX ISSUES IN 501(c)(3) FINANCINGS SHORT OUTLINE

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I. OWNERSHIP OF BOND-FINANCED PROPERTY

Section 145(a)(1) of the Code provides that that a "qualified 501(c)(3) 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." Thus, qualified 501(c)(3) bonds cannot be used to finance even $0.01 of property to be *owned* by a private user – even though under the 95% requirement up to 5% of the proceeds of the issue may be *used* for any private business use.

Hypothetical: You are bond counsel for a potential 501(c)(3) financing for a new charter school, which is a corporation and an organization described under Section 501(c)(3) of the Code ("**Charter School**"). National Schools Co. ("**National**") is an affiliate of Charter Schools, which manages administrative tasks of Charter School, and is not an organization described under Section 501(c)(3) of the Code. Charter School wants to finance the costs of the acquisition of land (the "**Land**") and the acquisition and renovation of an existing school facility for its operation (the "**Buildings**," and together with the Land, the "**Bond-Financed Assets**"). The acquisition of the Land would comprise more than 25% of the net proceeds of the issue. Under the law of State A, where the Bond-Financed Assets will be located and the state that gives Charter School its charter, Charter School cannot use state funds to pay debt service on real property. To avoid this issue and other State A property reversionary limitations for charter schools, Charter School wants to structure the financing to have Charter School lease the Bond-Financed Assets from Property-LLC, a single member LLC, the sole member of which is National ("**Property-LLC**"). Property-LLC is not an organization described under Section 501(c)(3) of the Code. Before trying to hammer out how this structure would work from a deal perspective, Charter School comes to you and wants to know if it enters a long-term lease to use the Bond-Financed Assets will the ownership requirement for qualified 501(c)(3) bonds be satisfied.

1. What does ownership mean?

   a. "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 Charter School can be considered the owner, under federal tax principles.

b. The IRS can look a number of factors to determine if the burdens and benefits of ownership have transferred from one party to another, including the following seven criteria: (1) Right to possession; (2) An obligation to pay taxes, assessments and charges against the property; (3) Responsibility for insuring the property; (4) Duty to maintain the property; (5) Right to improve the property without the seller's consent; (6) Bearing of the risk of loss; and (7) Right to obtain legal title at any time by paying the balance of the full purchase price.[1]

c. As a general rule, if the 501(c)(3) organization's leasehold interest exceeds the expected economic life of the financed asset,[2] 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. This is because during the time that a 501(c)(3) organization is leasing such asset, the benefits and the burdens of ownership of the asset are transferred to the 501(c)(3) organization.

2. Analysis: This could possibly be permitted, if the lease term, including any and all unilateral options to renew by Charter School, is long enough to transfer the benefits and burdens of ownership of the Bond-Financed Assets to Charter School. We would need to do this analysis on an asset-by-asset basis.

a. **<u>The Buildings</u>**:

i. Revenue Procedure 62-21[3] provides that buildings, which includes the structural shell of the building and all integral parts thereof also includes 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.

ii. The lease term of the Buildings, including all unilateral renewal options, would need to be at least as long as the estimated useful life of the Buildings (between 40 years and 50 years).

b. **<u>The Land</u>:** Land is a trickier situation.

i. 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.

ii. 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.**

[1] See *<u>T.C. Summary Opinion 2014-77</u>* determining that ownership, for purposes of claiming a first-time homebuyer tax credit, was transferred when the taxpayers entered into the installment sale contract, not when the title to the property transferred.

[2] It may also be possible to conclude that the property is owned for tax purposes by the 501(c)(3) organization even when the 501(c)(3) organization isn't leasing the property for its full economic life, if there will be so little economic life left for the private business after the lease that the lease has effectively transferred the benefits and burdens of ownership to the 501(c)(3) organization.

[3] Rev. Proc. 62-21; 1962-2 C.B. 418

1. In general, land is not considered a depreciable asset because it is viewed to have an indefinite useful life.

2. It doesn't seem like Section 147(b)(3)(B)(ii) deals with federal tax ownership of land. Instead, this provision is preventing land, which has an indefinite useful life, from being financed in such a way that an issue of bonds can remain outstanding indefinitely.

3. To conclude that the benefits and burdens of federal tax ownership of the Land would be met:

   a. the lease term for the Land would also need to be indefinite;

   b. the lease would need to give Charter School the ability to divest the Land on its own accord, and

   c. the lease would need to convey Charter School the ability to retain the gain or bear the loss of the Land.

4. A lease with an indefinite term that conveys all rights and burdens in the land could include a Fair Market Value buyout provision that the Property-LLC could exercise upon the retirement of the bond issue (or a refunding issue that refinances the original purchase of the land).

5. The requirements are usually not palatable to most entities and may not be legal in some states (think back to law school property law and the rule against perpetuities).

c. **Other Options**: How can this financing be structured?

   i. National could become an organization described under Section 501(c)(3) of the Code and then it could elect to treat Property-LLC as a disregarded entity for tax purposes. Then, Property-LLC, by virtue of having a sole member, who treats Property-LLC as disregarded entity for federal tax purposes, would be treated as being a 501(c)(3) organization. Then either National or Property-LLC would own the land for federal tax purposes. It is possible that Charter School could then finance the acquisition.

   ii. A Charter School Property-LLC entity could be formed. Charter School could be the sole member of Charter School Property-LLC.

      1. Then Charter School could elect to treat Charter School Property-LLC as a disregarded entity for federal tax purposes.

      2. Then Charter School Property-LLC could become the Borrower.

      3. This might not accomplish certain State law property reversionary issues though.

Hypothetical continued: 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?

1. Analysis: Possibly yes. As mentioned above, 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 (between 40 years and 50 years).
    a. Is this a Unilateral Option?
        i. When looking at a unilateral option to renew a lease there isn't a lot to look to. So, sometimes we look to the description of a unilateral option under Regulation § 1.1001-3(ii)(3) by analogy. To be a unilateral option under Regulation § 1.1001-3(ii)(3):
            1. 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;
            2. The exercise of the option doesn't require the consent or approval of:
                a. The other party (in this case Property-LLC),
                b. A person who is related to that party, whether or not that person is a party to the instrument; or
                c. A court or arbitrator.
            3. The exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information.
    b. It seems like State A's ability to approve/reject all renewals of the lease could be considered an intervening step, like the approval of a court or an arbitrator approval, that would make it seem like Charter School's option to renew the lease would not be unilateral.

II. PRIVATE BUSINESS USE OF BOND-FINANCED PROPERTY

Section 145(a)(2) of the Code provides that a "qualified 501(c)(3) bond" is "any private activity bond issued as part of an issue if – such bond would not be a private activity bond if – (A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and (B) paragraphs (1) and (2) of section 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears."

A. Use by a Governmental Unit

1. Federal government is a private user. Even borrowers that are generally cognizant of private use restrictions often do not realize that the federal government is a private user.

Hypotheticals:

i. A 501(c)(3) health system issues $5,000,000 of 501(c)(3) bonds and uses $500,000 of the proceeds to purchase a CT scanner. A year later, the local Veterans Administration hospital calls the 501(c)(3) health system, and says that their best CT scanner has broken, and that the VA hospital would like to use the 501(c)(3) health system's scanner until the VA hospital can get theirs fixed. The 501(c)(3) health system has multiple CT scanners, and so agrees to rent the bond-financed CT scanner to the VA hospital for $10,000 for month for six months. Is there private use? If so, how much?

ii. Same facts as (i), but at the end of 6 months the VA hospital says that due to supply chain issues their CT scanner cannot be fixed, and it will be another two years before the CT scanner can be replaced. 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. Is there private use? If so, how much?

iii. Same facts as (ii), but one year into the two-year agreement, the 501(c)(3) health system has gotten tired of making due without the bond-financed CT scanner, and the VA hospital is tired of waiting for a replacement to come in, so the 501(c)(3) health system and decides to sell the CT scanner to the VA for its depreciated value of $300,000. Is there private use? If so, how much?

2. Private use as between 501(c)(3) organizations and state and local governments is a one-way street. State and local governments are not private users of 501(c)(3) bonds, but 501(c)(3) organizations are private users of governmental bonds. Given the degree of joint venture activity in the healthcare space, the 10% private business use permitted for governmental bonds may be less useful for governmental healthcare organizations than the 5% private business use permitted for 501(c)(3) bonds (i.e., governmental hospitals may wish to elect to issue 501(c)(3) bonds, rather than governmental bonds).

B. Use by 501(c)(3) Organizations

1. Unrelated trade or business activity is private use. 501(c)(3) borrowers often overlook that they themselves can be private users, depending on the activities performed. This is especially the case if no taxation is owed (UBIT). This is also why review of UBIT reported on 990-Ts may not be sufficient diligence to uncover all unrelated trade or business activity.

Hypothetical: 501(c)(3) hospital has a retail pharmacy located in space financed with tax-exempt bond proceeds that gives rise to 2.8% private business use on an annual basis. The CFO calls you and says that they are planning to double the size of the retail pharmacy and expect to triple the amount of net profits generated by the retail pharmacy. You start to speak, but the CFO cuts you off and says: "I know that this would be too much private business use, but the good news is that Walgreens has agreed to manage the pharmacy for us, for a fixed annual management fee, and we will keep all the revenues, so that is compliant with Rev. Proc. 17-13, and so we won't have any private use moving forward." Is the CFO correct?

2. 501(c)(3) Organizations Unrelated to the Borrower(s). Because 501(c)(3) entities are generally not private users, they frequently allow other 501(c)(3) organizations to use their facilities, such as a 501(c)(3) university that leases out space to another 501(c)(3) university, or a 501(c)(3) hospital that has a management contract that includes payment based on net profits with physicians employed by another 501(c)(3) health system. What level of diligence should bond counsel perform on 501(c)(3) users that are not the borrower?

3. 501(c)(3) Organizations with Unrelated Exempt Purposes. 501(c)(3) organizations are generally created for specific charitable purposes. Section 513(a) of the Code defines "unrelated trade or business" as "any business the conduct of which is not substantially related (aside from the need of the

organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501."

Hypotheticals:

i. A 501(c)(3) private high school, whose charitable purposes are the education of children, 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 for the football team and a small kitchen and concession stand for use during football games. An unrelated local 501(c)(3) organization that provides services to unhoused persons approaches the school with a request to lease the locker rooms, kitchen and concession stand from 8-2 on Saturdays and Sundays to provide showers and food service to unhoused persons in the community. As the school only uses the facility for football practice on Mondays and Wednesdays from 3-6, and for games on Tuesdays and Fridays from 3-7, they agree to allow the other organization to use the facilities free of charge. Is there private use? If so, how much?

ii. Two years later, the same school decides to expand its main school building, and to build new locker rooms and kitchen facilities as part of that expansion, so that students can use the facilities for other sports, and for home economics classes. Since the school no longer needs the standalone locker rooms, kitchen and concession stand, it decides to sell those facilities to the 501(c)(3) organization that provides services to unhoused persons for $5,000. Is there private use? If so, how much?

C. For-Profit Entities

Even where there is clearly a private user, in the form of a for-profit entity, questions can arise as to what constitutes use, or how much use there might be.

1. "Licenses." Sometimes agreements that provide a private party with the right to come into bond-financed space and perform services therein are characterized as a "license." This may describe a use of space that is covered by a private use exception (such as the 2.5% nonpossessory incidental use exception, or the 50 day short-term use exception), or it may be used to describe an agreement that is clearly private use, such as a lease. The substance of the agreement controls, rather than the form.

2. No physical use of bond-financed assets. While most forms of private use require a physical use of bond-financed assets, Regulation § 1.141-3(a)(2) provides that indirect use can give rise to private use, and Regulation § 1.141-3(b)(1) provides that both actual and beneficial use may be treated as private business use.

Hypotheticals:

i. A hospital was constructed using $100,000,000 of 501(c)(3) bond proceeds. Its 501(c)(3) owner has been experiencing financial difficulties, particularly due to increased contract labor costs in the ICU and cardiology department. The hospital hires a consultant who specializes in hospital service line practice improvement, who agrees to increase the net profitability of the ICU and cardiology departments by 10-20% in a one-year period. The consultant will be paid 25% of the increased

profits during the one-year period. Other than two on-site meetings, the consultant never sets foot in the hospital. Does the agreement give rise to private use? If so, how much?

ii. Same facts as above, but after the first year, in which the consultant increases net profits of the ICU and cardiology departments by 12%, the hospital wishes to have the consultant continue monitoring changes to the ICU and cardiology departments, but to also decrease the economic losses from the ER department and the hospitalist program. The hospital decides to employ the consultant, pursuant to a 5 year employment agreement, under which the former consultant will be paid 25% of any further increased profits from the ICU and cardiology departments but will also be paid 15% of any net savings from the ER department and hospitalist program. As part of the employment agreement, the hospital agrees to provide the consultant with 5,000 square feet of office space in the hospital's administrative offices. Does this agreement give rise to private use? If so, how much?

III. WORKING CAPITAL AND THE $150 MILLION TEST

Section 145(b) of the Code 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.

A. General Background

1. The $150 million test on outstanding non-hospital 501(c)(3) bonds (Section 145(b)(1)) was enacted as part of the Tax Reform Act of 1986.

2. Prior to the passage of the 1986 Act, the federal tax rules regarding the issuance of government bonds and bonds benefiting 501(c)(3) organizations were essentially identical.

3. In enacting Section 145 of the 1986 Act, Congress treated bonds issued for the benefit of 501(c)(3) organizations as "private activity bonds" and the $150 million test for non-hospital bonds served effectively as a "volume cap" on each 501(c)(3) entity-borrower.

B. 1997 - Partial Repeal of the $150 Million Test

1. In 1997, the $150 million test was repealed – but unfortunately not entirely.

2. 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".

3. 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.

4. As will be discussed, the above repeal language can cause practical difficulty in structuring transactions involving bonds subject to the $150 million test and bonds financing capital expenditures incurred after August 5, 1997.

5. Given this partial repeal, 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.

C. <u>How Can the $150 Million Test Arise in New Bond Financings?</u>

Hypothetical: New money bonds are issued on January 1, 2023, to finance a new dormitory facility for "X" a Section 501I(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.

Regulation § 1.148-6(d)(3)(A)(3) provides that it is permissible to finance interest on an issue for a period commencing on the issue date and ending on the later of: (i) 3 years from the issue date, or (ii) 1 year after the placed in-service date, and such expenditures are not subject to the "proceeds spend last" method for working capital expenditures.

Regulation § 1.148-6(d)(3)(A)(5) provides that "initial operating expenses" directly related to capital expenditures that do not exceed 5 percent of the sale proceeds of an issue may be financed and such expenditures are not subject to the "proceeds spend last" method for working capital expenditures.

Questions: What should bond counsel consider in this financing?

i. 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?

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

iii. What if X has other bonds outstanding subject to the $150 million test?

Hypothetical: "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 Regulation § 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 1 year after the placed in-service date is not subject to the "proceeds spend last" method for working capital expenditures.

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

Questions: What does bond counsel need to consider in this financing?

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

ii. Should bond counsel approve financing 3 years of interest on the refunding bonds and, if so, what are the potential consequences?

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

D. Refinancing Bonds Issued to Finance Pre-8/5/97 Expenditures and Post-Cap Bonds.

1. Given that the $150 million test was partially repealed about 25 years ago, there is a diminishing amount of non-hospital bond issues subject to the $150 million test.

2. Nevertheless, 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.

3. Navigating the pre-cap/post-cap tax landscape is made more difficult by the language used in Section 145(b)(5).

4. 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 new proceeds were used to finance capital expenditures after such date.

5. 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 issue is subject to the $150 million cap.

6. A goal is to create some sort of "firewall" in the structure so that the new money bonds are not "tainted" by refunding bonds with pre-8/5/97 expenditures in a single bond issue.

Hypothetical: University W, a Section 501(c)(3) organization wants to finance $300 million of new capital improvements and current refund the outstanding $40 million balance of pre-1997 bonds subject to the $150 million test.

The bankers have advised the issuer and the University that to separate the sale dates of the new money and refunding bonds by more than 15 days would be unduly expensive as the $40 million stand along issue would not garner buy-side interest. Accordingly, the bankers want to sell the new money bonds and refunding bonds in a single tax issue.

Questions: What does bond counsel need to consider in this financing?

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

ii. This technique creates a "firewall" between the cap and non-cap bonds.

iii. Under Regulation § 1.150-1(c)(3) – the 95% good use test and the 120% economic life test are applied separately to each "issue." That is, no private use blending and no asset blending between each portion.

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

v. For support of this technique, see example 5(iii) of Regulation § 1.141-13(g), in which Regulation § 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.

E. Other Observations.

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

2. Did Congress intend that a firewall be created under Regulation § 1.150-1(c)(3) to protect post-cap bonds issued as part of the same issue as pre-cap bonds?

3. 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?

4. This tracking is now made easier given the repeal of advance refundings as there is no ability to "double-up" pre-cap bonds.

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