A Tax-Exempt Bond Primer for 501(c)(3) Organizations

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Any maturing 501(c)(3) organization will at some point have to decide whether to borrow in the tax-exempt market to finance the capital projects that will promote its mission. Although tax-exempt debt usually carries a lower interest rate than taxable debt, it also brings with it additional costs, in the form of various legal restrictions on how you can use the project and the rather unpleasant experience of having to deal with tax lawyers.

This article is aimed at 501(c)(3) organizations that have not borrowed in the tax-exempt debt market before, to prepare you for the federal tax aspects of your first deal. However, for our readers who are seasoned veterans of the tax-exempt borrowing process, before you close the browser window or turn the page, remember the admonition of the great muni bond tax lawyer Vince Lombardi— "Excellence is achieved by mastery of the fundamentals." Stick around—you, too, might find something useful here.

As always, a little planning goes a long way. Your first (or your fiftieth) tax-exempt debt deal can bewilder you, but there are some simple things to do before you begin that will smooth the path. We will begin there—first, what are the pre-transaction steps on the tax side? Next, we will talk about some of the tax papers you will be looking at in the transaction and discuss how to work effectively with your lawyer and the tax lawyer for the state or local issuer of the debt. We will end the article by talking about the unique post-closing responsibilities for the money that you borrow and the project that you build with the tax-exempt debt.

1. Hire a lawyer who understands your business and how it relates to § 501(c)(3) of the Code.

The first step is to make sure you have retained counsel that has experience in representing 501(c)(3) organizations in qualified 501(c)(3) bond issues. One good indication will be whether the firm has one or more members on the National Association of Bond Lawyers ("NABL"). The tax-exempt debt market standard is that investors will insist on an opinion that interest on the bonds **is** tax-exempt (not "more likely than not is," not "should be," not "you know, just, like, might be"—**is**). This opinion is typically given by counsel for the issuer, often referred to as "bond counsel."[1] To support the unqualified bond counsel's opinion, the market standard likewise is for counsel to the 501(c)(3) organization to provide an opinion that the 501(c)(3) organization **is** a 501(c)(3) organization. Counsel for the 501(c)(3) organization will also render various other opinions. In some jurisdictions, one of these additional opinions will be that the use of the project by the borrower will be "related" to the organization's exempt purpose. Bond counsel relies on this opinion. NABL prepared a very good report in 2014 on some of the issues relating to this opinion, which would be worth your time (or at least your counsel's time) to read. NABL members can find it on NABL's website (nabl.org) under the "Research" tab and the "Formal Reports & Model Documents" heading.

Your counsel will need to understand how your organization was created, the contours of its exempt purposes, and how it operates to pursue those exempt purposes. These facts will form the basis of the 501(c)(3) opinion. In addition to these tax matters, you will want to

make sure that your counsel has experience working with bond counsel in a tax-exempt debt transaction, so that they can adequately explain to you the representations and covenants you will need to provide to bond counsel in connection with the transaction. But more on that later. If your first tax-exempt debt issuance will be your first major borrowing of any kind (tax-exempt or taxable), you will of course want to make sure that your counsel also has experience in a debt transaction.

2. Once you're ready to start spending money on the project, ask: Is there any chance that I might want to finance this project with tax-exempt debt or refinance an initial taxable borrowing for the project with a later tax-exempt borrowing?

Most 501(c)(3) organizations don't have enough cash on hand to pay for a capital project of any substantial size. You will have to borrow to pay for most of it. However, as you begin to talk to bankers and advisors and to investigate how you are going to pay for the project, you might want to use some existing cash to pay initial project costs, with the intent of using the proceeds of a borrowing later to "reimburse" yourself. Once you're at this point, if there is any chance at all that you're going to use tax-exempt debt either to finance the project or to later refinance an initial taxable borrowing for the project, there is something you need to do.

The federal income tax laws require you to execute a "declaration of intent" to reimburse yourself for an expenditure that you pay (not merely incur, but pay) before the tax-exempt debt is issued.[2] You must execute the declaration of intent no more than sixty days after the payment of the expenditure.[3]

There are two exceptions to this requirement. First, "preliminary expenditures" are not subject to this requirement. Preliminary expenditures are expenditures such as design costs and architectural fees that are incurred prior to the commencement of construction of the project but are not incident to the construction of the project.[4] The amount of "preliminary expenditures" that do not satisfy the requirements of the reimbursement regulations and that are reimbursed with proceeds cannot exceed 20% of the aggregate issue price of the issue(s) of debt that you use to reimburse them.

Second, a *de minimis* amount of expenditures that are not preliminary expenditures are not subject to the requirement. This *de minimis* amount equals the lesser of $100,000 or 5% of the proceeds of the issue.

Importantly, even if your initial financing is going to be a taxable financing, if you ever want to refinance that taxable debt with tax-exempt debt, the taxable debt needs to have satisfied this declaration of intent requirement for any expenditures you paid out of your own funds and reimbursed with the initial taxable financing that are not preliminary expenditures or that exceed the de minimis threshold.[5]

And about those taxable financings—although taxable financings (obviously) are not subject to the tax rules, if there is **any chance** that you'll want to refinance the taxable financing with tax-exempt debt, you should approach the taxable financing as though it were a tax-exempt financing. It is often faster for a 501(c)(3) to borrow directly from a bank than to borrow through a state or local government issuer, and the taxable financing does not require the 501(c)(3) to comply with all the complicated tax requirements that apply to tax-exempt debt. These taxable financings can take several forms, from commercial paper programs and similar revolving borrowings to longer term loans. No matter which form it takes, the taxable financing will typically carry a higher interest rate than a comparably structured tax-exempt financing. Thus, there will typically be an incentive to refinance the taxable financing with a tax-exempt financing. When tax-exempt debt is issued to refinance prior debt, many of the tax requirements applicable to the tax-exempt refinancing issue require the 501(c)(3) to look back to the refinanced debt. While there are some exceptions in the tax rules that allow the 501(c)(3) to ignore the original taxable financing,[6] there are some that do not.[7]

You don't need to follow all of the tax requirements for the taxable issue, of course, but you will want to carefully track the assets on which you spend the taxable proceeds, when they were placed in service, and their economic lives. In addition, if you use a shorter-term taxable borrowing, such as a line of credit or a commercial paper program, that you might one day refinance with a tax-exempt borrowing, you'll want to be sure that the program is not used for other assets that will not qualify for tax-exempt financing (such as most working capital

expenditures), and that you have a way to easily track the debt that is being refinanced to the assets that it financed originally and the cash flows that move in and out of the account as you borrow money and repay it.

3. If private businesses will have a role in the project, consider using sources other than tax-exempt debt for the permanent financing.

There are limits on the amount of involvement that private businesses can have with a project that you finance with tax-exempt debt. In general, not more than 5% of the net proceeds of the debt issue can be used in a private business use. The use of the *net proceeds*[8] of the debt is measured by the use of the *project*.[9] So, if a private business uses 12% of a project, it is treated as using 12% of the proceeds. The private business use of the debt issue generally is measured by the average annual private business use during the *measurement period*. If the project was financed with sources of funds other than proceeds, then those other sources can absorb the private business use and protect the tax-exempt debt if certain conditions are met. (By the way, the term that we use for sources other than tax-exempt debt is "equity," even though the concept of equity does not really apply to 501(c)(3)s and even though taxable debt is included in the definition of equity.) Thus, if you think that private businesses will have a role in the project, consider incorporating sources other than tax-exempt debt into the mix of permanent financing for the project.

Some specifics about equity.[10] While the rules are complicated and (personal bias notwithstanding) you'll want to talk to a tax lawyer about them, the general rule that will apply to most cases is this: Your equity can absorb your private business use, wherever it is located in the project from time to time, if:

1. You spend tax-exempt debt together with equity on a capital expenditure for the same project;
2. You spend the equity no earlier than a date on which you could have reimbursed the expenditure with proceeds of tax-exempt debt; and
3. You spend the other funds no later than (1) the issue date of the tax-exempt debt or (2) the placed-in-service date[11] of the project, whichever of those two is later.

4. As you're planning the transaction, start thinking about who will serve as the conduit issuer for the debt.

Tax-exempt debt must be issued by a state or local governmental unit;[12] any one will do. Depending on the jurisdiction where your project is located, there will likely be some options for who may issue debt and loan the proceeds to you. That question will depend on the organizing statute and documents that govern any particular issuer's power under state and local law. Conduit issuers typically charge a fee for issuing debt for the benefit of a 501(c)(3). You should consider both the amount of the fee and what services the issuer might provide in exchange. Ensuring that you've hired a corporate counsel who has worked on a tax-exempt deal before can help.

5. In the course of the transaction, you will have to sign documents that require you to abide by the tax rules that apply to tax-exempt debt to preserve the tax-exempt status of the debt.

As with any debt transaction, a tax-exempt debt transaction involves a mountain of documents to be read and signed. One of these documents is the document you sign with the state or local government issuer of the debt, which usually is styled as a "loan agreement," though it can come in other forms, too. In the loan agreement you agree to abide by various restrictions and to repay the issuer according to a set schedule. The issuer will then use these repayments to pay the holders of the debt. The loan agreement will usually contain a general provision under which you will agree to preserve the tax-exempt status of the debt. The specifics of this covenant are then usually fleshed out in the "tax certificate," in which you will represent the necessary facts and provide the necessary covenants to the issuer of the debt and to bond counsel so that bond counsel can render its opinion that interest on the debt **"is"** excluded from the gross income of the holders of the debt for federal income tax purposes.

The tax certificate will contain a number of different provisions that cover all of the tax requirements. Among these requirements are provisions dealing with the "arbitrage" restrictions in § 48 of the Internal Revenue Code. These provisions prevent you from earning a profit ("positive arbitrage") from investing proceeds of tax-exempt debt before you spend them, in most cases.[13] This

profit arises when you invest proceeds of the tax-exempt debt at a yield that exceeds the yield you are paying on the tax-exempt debt to the issuer (and that the issuer is then paying to the holders of the debt). In those limited cases where you are allowed to earn a profit, you will most of the time have to pay it over to the IRS in the form of a "rebate" payment.[14] In addition, the tax certificate will require you to make a number of certifications and covenants about who uses the property on which you spend the tax-exempt proceeds, including many certifications and covenants about private business use, as described above.

6. Even after the deal closes, the tax requirements impose restrictions on how you can invest the proceeds of the tax-exempt debt before you spend them and how you can use the property that you finance with the debt.

The tax requirements generally apply over the life of the debt. In other words, the actions that you take (or don't take) after the deal closes can affect the tax status of interest on the debt. For example, private business use of the bond issue is measured as the average annual private business of the property that you finance with the bonds over the life of the bonds. In addition, tax-exempt qualified 501(c)(3) bonds have a requirement that 100% of the bond-financed property must be owned at all times by a state or local government or a 501(c)(3). If you sell even the smallest piece of equipment to a private party, you may need to redeem some of the bonds or use the proceeds for other assets that would have been eligible to be financed with the tax-exempt debt in the first place.

In addition, if you are a 501(c)(3) organization that files IRS Form 990 each year, you must also now complete Schedule K to Form 990, on which you will report a number of details about the bond issue. Be especially careful in completing Schedule K. It contains a number of traps for the unwary, and completing it is far from an intuitive exercise. Consider periodically engaging your counsel or bond counsel to review it. Many times, Schedule K simply gets lumped in with the remainder of the Form, but it contains a number of unique aspects that require expertise in the tax-exempt bond rules.

Endnotes

1 In some cases, the issuer will have its own separate counsel, and in other cases the opinion may be given by a "special tax counsel." For simplicity, this article will use the term "bond counsel" to refer to both.

2 Treas. Reg. § 1.150-2.

3 § 1.150-2(d)(1).

4 § 1.150-2(f)(2).

5 § 1.150-2(g)(2). The IRS interpreted this regulation in IRS Private Letter Ruling 200116004. There, the IRS ruled that the issuer could issue tax-exempt bonds to refund an initial taxable financing that the issuer used to reimburse itself for expenditures that it paid from its own funds prior to the issuance date of the **taxable** financing. This was because the issuer satisfied the declaration of intent requirement as to the initial taxable financing.

6 For example, the rules that limit the use of the bond-financed property by private businesses allow the 501(c)(3) to ignore private business use that occurred prior to the issuance of the tax-exempt debt. § 1.141-13(b)(1).

7 For example, the "hedge bond" rules, which require the timely expenditure of tax-exempt bond proceeds, I.R.C. § 149(g)(3)(C), are satisfied for a tax-exempt refinancing issue only if the original debt satisfied these rules, and there is no apparent exception for tax-exempt refundings of taxable debts.

8 Of course there is a complicated formula—net proceeds is sale proceeds (which includes the amount that the underwriter retains as underwriter's discount if there is an underwriter, even though the 501(c)(3) never receives that money) minus proceeds deposited in a reserve fund, plus investment earnings on the remainder until the 501(c)(3) spends them. I.R.C. § 150(a)(3).

9 Treas. Reg. § 1.141-3(g)(1).

10 *See also* Squire Patton Boggs, *Undivided Portion and Qualified Equity*, The Pub. Fin. Tax Blog (Dec. 11, 2015), https://www.publicfinancetaxblog.com/2015/12/undivided-portion-and-qualified-equity/.

11 *Placed in service* means, with respect to a facility, the date on which, based on all the facts and circumstances:

(1) The facility has reached a degree of completion which would permit its operation at substantially its design level; and

(2) The facility is, in fact, in operation at such level.

Treas. Reg. § 1.150-2(c).

12 Treas. Reg. § 1.103-1.

13 For many years, the low prevailing interest rates in the market have made these rules all but moot; it has been impossible to earn a yield on investments of bond proceeds that exceeds the yield on the bonds.

14 The term "rebate" is a bit of a misnomer. *See* Squire Patton Boggs, *How Did Arbitrage Rebate Get Its Name?*, The Pub. Fin. Tax Blog (Nov. 21, 2016), https://www.publicfinancetaxblog.com/2016/11/how-did-arbitrage-rebate-get-its-name/.