



1075 Peachtree Street, N.E.
Suite 2500
Atlanta, GA 30309-3962
(404) 885-1500
Fax (404) 892-7056
<http://www.seyfarth.com>
404.888.1883 direct
404.892.7056 fax
danmcræ@mindspring.com
dmcræ@seyfarth.com

FINANCING PROJECTS FOR “NON-PROFITS”

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Daniel M. McRae
Partner
Seyfarth Shaw LLP

404.888.1883
fax 404.892.7056

25th Floor
1075 Peachtree St. NE
Atlanta, GA 30309

dmcræ@seyfarth.com
dan@danmcræ.info

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INTRODUCTION

For purposes of this White Paper, “non-profits” refers to organizations that are tax-exempt 501(c)(3) organizations under the federal tax-law. In order to qualify as a 501(c)(3) organization, the organization must be “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment) or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual.” Also, it must not engage in certain prohibited activities, such as carrying on propaganda or attempting to influence legislation. Finally, in order for an organization’s 501(c)(3) status to be recognized, it either: (i) must have obtained a determination letter from the Internal Revenue Service as to such status; or (ii) be covered by a group determination letter (for example, in a situation in which a group determination letter issued to a convention of churches covers all such churches), or (iii) be a church with no determination letter (churches are not required to have determination letters or be covered by a group determination letter) or (iv) be a “disregarded entity” that is deemed to be a part of one of the foregoing (for example, a limited liability company which has not elected to be taxed as a “C” corporation and which has a 501(c)(3) organization as its sole member would be deemed to be a part of that 501(c)(3) organization).

“QUALIFIED 501(c)(3) BONDS” GENERALLY

501(c)(3) organizations have access to tax-advantaged financing for their projects, at lower interest rates, through “qualified 501(c)(3) bonds.” “Qualified 501(c)(3) bonds” are federally tax-exempt bonds that are issued by a state or local governmental unit (the “issuer”) to provide financing for a 501(c)(3) organization (herein called the “conduit borrower”) and that comply with the requirements of Section 145 and other applicable provisions of the Internal Revenue Code of 1986, as amended (the “Code”). Although the Code would permit bond proceeds to be used to finance working capital, applicable state law may restrict the use of bond proceeds to the financing of capital projects, including land, buildings, other land improvements (such as grading, paving, landscaping and utilities), machinery, equipment, furnishings and furniture. The bond proceeds may be loaned by the issuer to the conduit borrower, or used to pay the cost of facilities which are owned by the issuer and either leased to the conduit borrower under a financing lease or sold to the conduit borrower under an installment sale agreement. The choice of financing structure may be dictated by requirements of the particular state’s bond financing laws, or by other considerations, such as local property taxes or sales taxes. In any event, the conduit borrower would be the user of the bond-financed facilities and would make payments to the issuer (or to the bondholders or to a trustee for the bondholders, as assignee of the issuer) in the amounts needed to pay debt service on the bonds. In most cases the bonds would be secured by a pledge of the bond-financed facilities. Under the laws of most states, the bonds would be payable solely from payments made by the conduit borrower (or from credit

enhancement provided by the conduit borrower, such as a letter of credit); the issuer would serve only as a conduit and its own general credit would not be pledged to the repayment of the bonds.

Because 501(c)(3) organizations perform functions that are deemed to “relieve the burdens on government,” the federal income tax laws provide favorable tax treatment for bonds issued for the benefit of 501(c)(3) organizations. Under the old Internal Revenue Code of 1954, Code 501(c)(3), bonds issued by a governmental entity for the benefit of 501(c)(3) organizations were treated on the same basis as bonds issued for governmental purposes. Although, under the current Code, bonds issued for the benefit of 501(c)(3) organizations are classified as “private activity bonds,” the requirements of the Code have not presented a major obstacle to the tax-exempt financing of facilities for 501(c)(3) organizations.

PRIVATE ACTIVITY BOND STATUS

Section 103 of the Code provides that gross income does not include interest on any state or local bond, provided that such exemption will not apply to, among other things, any “private activity bond” which is not a “qualified bond” within the meaning of Section 141 of the Code. As a general rule, a bond is a private activity bond if (a) the amount of proceeds of the issue that are to be used to (directly or indirectly) make or finance loans (other than special loans) to persons other than state or local governmental units exceeds the lesser of 5% of the proceeds of the issue or \$5,000,000 (the “private loan financing test”) or if (b) both (i) more than 10% of the proceeds of the issue, or property financed with such proceeds, are used for any private business use (the “private business use test”) and (ii) if certain private source payments, including payments relating to debt service on the bonds, exceed 10% of the debt service (the “private payment test”). Except in highly unusual circumstances, either test (a) or test (b) will be met where bond proceeds are used for the benefit of a 501(c)(3) organization, and the 501(c)(3) will be making the payments for the financed property. Therefore, in order for such bonds to be tax-exempt, they must be “qualified bonds” within the meaning of Section 141 of the Code, which includes bonds that are classified as “qualified 501(c)(3) bonds” under Section 145 of the Code.

MORE DETAILED INFORMATION ON “QUALIFIED 501(c)(3) BONDS”

In General

Section 145 of the Internal Revenue Code permits federally tax-exempt qualified 501(c)(3) bonds to be issued by state and local governments for the purpose of financing activities and facilities which further the “exempt” (*i.e.*, charitable) purpose of the benefited 501(c)(3) organization. Qualified 501(c)(3) bonds are most commonly used to finance the following types of facilities for 501(c)(3) organizations: hospitals, clinics, nursing homes, adult congregate living facilities, low income housing and facilities for private schools and colleges. However, such bonds may be issued for other charitable purposes, as well.

The 95% Test

In order for bonds to constitute “qualified 501(c)(3) bonds,” all of the property which is to be financed by the net proceeds of the issue must be owned by either a 501(c)(3) organization or state or local governmental unit; and 95% or more of the net proceeds of the issue must be used for the exempt purposes of the organization (*i.e.*, not more than 5% can be used by the conduit borrower for an “unrelated trade or business” or by anyone for other private business use). Property would be used for “other private business use,” for example, if the conduit borrower leased it for use by a for-profit entity or if the conduit borrower permitted it to be operated by a for-profit entity under a management contract that does not comply with the tax rules relating to qualified management contracts. Thus, only governmental units and 501(c)(3) organizations may receive any material benefit from an issue of qualified 501(c)(3) bonds.

If the conduit borrower’s use of any part of the bond financed facility relates to an “unrelated trade or business,” and if such use, by itself or together with the use of the bond financed facilities by others for “private business use,” exceeds 5% of the net proceeds of the bonds, the entire bond issue will fail to qualify as an issue of “qualified 501(c)(3) bonds. If an organization wishes to finance facilities, a portion of which qualifies for tax-exempt financing (such as a portion of a hospital that involves no “private business use”) and a portion of which does not so qualify (such as a portion of a hospital to be used as offices for staff doctors in their private medical practices), a series of qualified 501(c)(3) bonds may be issued to finance the portion of the facilities which qualifies for tax-exempt financing and a series of federally taxable bonds can simultaneously be issued to finance the portion which does not qualify.

\$150,000,000 Limit Terminated as to “New Money” Issues

A nationwide limit of \$150,000,000 on the amount of qualified 501(c)(3) bonds that may be outstanding with respect to any 501(c)(3) organization and certain related parties (such as affiliates), that was originally included in the Code, is still in effect, but has been modified not apply to bonds that are issued after August 5, 1997, if 95% or more of the net proceeds of the issue are used, or to be used, to finance capital expenditures incurred after that date. Thus, the \$150,000,000 limit would continue to apply to refunding bonds issued after August 5, 1997 that refund bonds issued on or prior to that date. Bonds that are “qualified hospital bonds” (*i.e.*, bonds issued with respect to a hospital) do not count against this \$150,000,000 limit and did not count against this limit under prior law. Today, the \$150,000,000 limit most commonly impacts (i) private non-profit universities and (ii) charitable organizations that operate nursing home chains that wish to refund bonds that were issued on or prior to August 5, 1997.

Certain Other Tax Rules

The public notice, public hearing and public approval requirements (“TEFRA” requirements) that are applicable to private activity bonds, apply to qualified 501(c)(3) bonds. As a general rule, the average maturity of an issue of qualified 501(c)(3) bonds may not exceed 120% of the average reasonably expected economic life of the facilities being financed with bond proceeds. Not more than 2% of the proceeds may be used to pay bond issuance costs.

Qualified 501(c)(3) bonds may not be used to finance any airplane, skybox, gambling facility or liquor store. There are special rules, which are beyond the scope of this brief paper, which are applicable to 501(c)(3) bonds for residential rental housing facilities for family units. Qualified 501(c)(3) bonds are subject to certain limitations on the use of bond proceeds to reimburse pre-issuance expenditures and are subject to rules relating to arbitrage and rebate. Certain other rules that are generally applicable to private activity bonds are applicable to qualified 501(c)(3) bonds, including the requirement that a Form 8038 be filed with the Internal Revenue Service and rules relating to “arbitrage.”¹ However, there are exceptions from certain rules that generally apply to private activity bonds: (i) qualified 501(c)(3) bonds are not subject to the state volume cap relating to private activity bonds and thus may be freely issued without having to undergo the timely and uncertain state volume cap allocation process; (ii) the provisions of Code §147(a), that denies tax-exemption to interest on bonds owned by “substantial users” of the bond financed facilities, do not apply; (iii) the limitation, under Code §147(c), that limits expenditures for land to 25% of bond proceeds does not apply, and (iv) the limitation, under Code §147(d), on the use of bond proceeds to acquire existing property does not apply, except in the case of certain types of existing housing facilities.

“BANK QUALIFIED” 501(c)(3) BONDS

Under the general rule contained in Section 265(a) of the Code, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. In the case of a financial institution, no deduction shall be allowed for that portion of the financial institution’s interest expense (such as interest paid by a bank on deposits) which is allocable to tax-exempt interest received by the financial institution. However, Section 265(b)(3) of the Code provides an exception in the case of tax-exempt interest received by the financial institution on any “qualified tax-exempt obligation” [sometimes referred to in banking circles as a “bank qualified” or “bank eligible” obligation] and herein called “**BQ**”. Only governmental purpose bonds (such as bonds issued to finance public property such as streets and public buildings) and private activity bond that are qualified 501(c)(3) bonds can be BQ obligations. Except as provided below: (i) in order for an issue of such bonds to be an issue of “qualified tax-exempt obligations,” the governmental issuer must designate them to be such (generally the designation would be in the bond resolution, may be reflected in a trust indenture or tax certificate and will be reflected in the IRS Form 8038 which is filed in connection with the bond issue); and (ii) in addition, the governmental issuer must be a “qualified small issuer,” being an issuer that does not reasonably anticipate that the amount of tax-exempt obligations (inclusive of the particular issue of bonds it is designating) and exclusive of “excluded obligations,” as defined below) which will be issued in calendar year of such issuance by the issuer and certain other described in Section 265(b)(3)(E) of the Code, will exceed \$10,000,000. The term “excluded obligations” means (principally) any private activity bond (other than any qualified 501(c)(3) bond) and certain current refunding obligations. Section 265(b)(3)(E) of the Code relating to the aggregations of issuers provides that: (i) an issuer and all entities which issue obligations on “on behalf of” the issuer shall be treated as one issuer, (ii) an entity formed or availed to avoid the purposes of Section 265(b)(3)(C) or (D) and all entities benefiting thereby will be treated as 1 issuer, and (iii) all obligations issued by a subordinate entity shall be treated as issued by the entity to which the issuer is subordinated (a local authority shall be deemed to be

subordinate to a city or county if the city or county has the right to remove a controlling portion of the members of the issuer from office without cause or has the right or power to require the use of funds or assets of the issuer for any purpose of such city or county). In most situations, an authority and the city or county for which it was created will not be treated as a single issuer for purposes of the \$10,000,000 limit. However, it is appropriate to determine if a particular authority is a subordinate entity of the city or county in which it operates. However, the American Recovery and Reinvestment Tax Act (the “**Recovery Act**”) provides that for bonds issued after February 17, 2009 and before January 1, 2011 (the “**Recovery Period**”): (i) the \$10,000,000 limit is raised to \$30 million; and (ii) the 501(c)(3) organization that uses the proceeds of the bonds is treated as the “issuer” of those bonds, and the bonds issued for such 501(c)(3) organization do not count against the governmental issuer’s own \$30 million BQ allowance.

VARIABLE RATE DEMAND BONDS

Qualified 501(c)(3) bonds can be issued as variable rate demand bonds (“**VRDBs**”), which are also called “lower floaters” and “multi-modal bonds.” VRDBs are long-term bonds, which have short-term interest rate modes that permit the bonds to bear lower interest rates than long-term fixed rate bonds of comparable maturities. VRDBs are sold through an underwriter to tax-exempt and taxable money market funds. Credit and liquidity support for the VRDBs are provided by an irrevocable, direct pay, bank letter of credit. Current debt service is paid with drawings under the letter of credit, and the conduit borrower reimburses the letter of credit bank for such drawings. VRDBs are most often issued in a weekly interest rate mode where the interest is reset weekly to current market rates for obligations having a seven-day maturity and is payable monthly or quarterly. When in a weekly interest rate mode, the bonds may be tendered by the holder for mandatory purchase on seven days’ notice. Tendered bonds are remarketed by a remarketing agent and the remarketing proceeds are used to pay the tendering bondholder the price of the tendered bonds. However, if the tendered bonds are not immediately sold in the remarketing, funds drawn under the letter of credit are used to pay the tendering bondholder, and such draws are repaid by the conduit borrower or from a sale of such tendered bonds in a subsequent remarketing. The conduit borrower may, from time to time, elect to convert the VRDBs to a different interest rate mode and for a different interest period.¹ VRDBs bear low interest rates because: (i) when the VRDBs are in a short-term interest mode, they bear short-term interest rates that, assuming a normal yield curve, are substantially lower than long-term rates; and (ii) VRDBs are sold on the basis of the credit rating (generally A or AA) of the bank that issues its letter of credit to provide credit enhancement and liquidity support for the VRDBs (rather on the basis of the credit of the conduit borrower, which may be unrated). A conduit borrower that wishes to hedge its exposure to interest rate fluctuations may do so with an interest rate swap, cap or collar.

FACILITIES WE HAVE FINANCED WITH QUALIFIED 501(c)(3) BONDS

Here are some examples of how our lawyers have assisted 501(c)(3) organizations to fund their needs with “qualified 501(c)(3) bonds.” In Georgia, our lawyers have (i) served as bond counsel on a \$5,445,000 bond issue that financed an approximately 30,000 square foot

building and related building fixtures, driveways, parking areas, exterior lighting, landscaping and equipment to be used by a private university as an educational facility, (ii) served as issuer's counsel and co-bond counsel on a \$17,000,000 issue of tax-exempt bonds for a development authority in north Georgia to finance an arts and technology center, costs of renovating equipping and improvements to a science center, to administrative offices, a media center and to classrooms for a private school, (iii) we served as bond counsel on a \$1,200,000 bond issue for a development authority in coastal Georgia to finance a 250 seat auditorium, a college bookstore, administrative offices, media center, computer lab, science lab, classrooms and fixtures for a private college, (iv) served as Bond Counsel on a \$8,805,000 bond issue to refund a prior issue (v) served as issuer's counsel in connection with a tax-exempt plan of financing for a Jewish religious organization for a Georgia recreational center/camp in northern Georgia, (vi) served as bond counsel on several bond issues for church schools, and (vii) served as conduit borrower's counsel on a number of bond issues that financed facilities for the use of a State university. Outside of Georgia, our lawyers have also: (a) served as counsel to a private university in connection with the refunding of qualified 501(c)(3) bonds for its college facilities in southeast Florida, and (b) served as bond counsel on qualified 501(c)(3) bonds for hospitals in four Florida counties, (iii) for nursing homes in two Florida counties, and (iv) for an upscale adult congregate living facility in southwest Florida.

THE ESTABLISHMENT CLAUSE

Some 501(c)(3) organizations are affiliated with religious organizations, and in such cases, consideration must be given to whether the issuance of bonds to finance facilities for such organizations violates the provisions of the "establishment clause" of the United States constitution¹ or similar provisions of the constitution and statutes governing the issuer. Such issues have arisen in the past in the context of facilities for private schools and colleges that are "pervasively sectarian" or where the bond-financed property of a church affiliated institution may be used for sectarian purposes. The recent trend of the case law under the federal constitution's "establishment clause" is favorable to the financing of facilities for "pervasively sectarian" schools and religious organizations. Conduit bonds for "pervasively sectarian" schools and religious organizations are not prohibited by the Georgia law. Some other states have laws that would restrict the issuance of such bonds in those states.

AUDITS OF 501(c)(3) BONDS

The Internal Revenue Service (the "IRS") is now aggressively auditing tax-exempt bonds, including bonds which are intended to be tax-exempt qualified 501(c)(3) bonds. The IRS may determine that an issue of such bonds is not tax-exempt either because the bonds initially failed to meet the qualifications for tax-exemption or because of a post-issuance failure to comply with the requirements for continuing the tax-exemption. A post-issuance failure to comply with the requirements for continuing the tax-exemption could include, among other things, a post issuance change in use of the bond-financed property. If the bonds initially fail to qualify for tax-exemption, the interest on the bonds would be taxable from their date of issue. If the bonds initially qualify for tax-exemption, but thereafter cease to qualify for tax exemption, in most cases, the interest on the bonds would also be taxable retroactively from their date of issue.

This recent audit activity makes it imperative that issuers and conduit borrower retain competent counsel in connection with the issuance of qualified 501(c)(3) bonds, and that the conduit borrower have competent counsel to advise it, after the bonds are issued, as to matters that may cause the tax-exempt status of the bonds to be lost. Further, in the event of a tax audit of qualified 501(c)(3) bonds, the real party in interest from an economic standpoint is the conduit borrower and, therefore, the conduit borrower should engage counsel that has both extensive bond experience and experience in federal tax controversies.

MORE INFORMATION

This White Paper is a quick-reference guide for executives and officers of organizations that are tax-exempt under Code Sec. 501(c)(3), economic developers and their communities, participants in the real estate and financial industries, and their advisors. The information in this White Paper is general in nature. Various points, which could be important in a particular case, have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case.

Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

Additional information concerning this topic, as well as White Papers and references on other topics, can be found at <http://danmcrae.info/>.

If you have any questions or comments, we would be pleased to provide more information. Please contact:

Daniel M. McRae, Partner
Seyfarth Shaw LLP
1075 Peachtree Street, N.E., 25th Floor
Atlanta, Georgia 30309
Telephone: 404/888-1883
Facsimile: 404/892-7056

dmcrae@seyfarth.com
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