501(c)(3) Tax-Exempt Financings

Presented by:

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Overview – Tax-Exempt Financing

- **Who:** 501(c)(3) organizations
- **What:** qualified projects
- **When:** raise money for projects or refinance high interest debt
- **Why:** lower borrowing costs compared to taxable financings
- **How:** financing process
Who? 501(c)(3) Organizations

- Tax-exempt bonds may be issued for the benefit of a 501(c)(3)

- Interest paid on “Qualified 501(c)(3) Bonds is exempt from gross income for Federal income tax purposes
Who? 501(c)(3) Organizations

- Hospitals/health systems
- Nursing homes/senior living institutions
- Private colleges and universities
- Charter schools, private schools and child care institutions
- YMCAs (and other similar charitable organizations)
- Charitable Foundations
- Museums
- Research institutions
What? Types of Financings

• New money financings (capital expenditures)

• Working capital expenditures (special rules)

• Refunding outstanding bonds and refinancing other indebtedness
### Why? Tax-Exempt Rate Savings

#### Example: $10,000,000 Financing

<table>
<thead>
<tr>
<th></th>
<th>Taxable Bonds</th>
<th>Tax-Exempt Bonds (37% / 21% Federal Tax Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>7.00%</td>
<td>4.41% / 5.53%</td>
</tr>
<tr>
<td>Annual Interest</td>
<td>$700,000</td>
<td>$441,000 / $553,000</td>
</tr>
<tr>
<td>Annual Savings</td>
<td>-</td>
<td>$259,000 / $147,000</td>
</tr>
</tbody>
</table>
How? Financing Process

• What are the capital projects?
• What are the options for financing?
• What can be financed tax-exempt?
Financing Process

• Capital project may be financed from:
  1. Excess operating revenues
  2. Donations
  3. Debt
  4. Grants
Financing Team

- **Conduit Issuer**
  - Conduit Issuer Counsel
  - Conduit Issuer Financial Advisor
- **501(c)(3) Borrower**
  - 501(c)(3) Borrower Counsel
  - 501(c)(3) Borrower Financial Advisor
- **Purchaser/Underwriter**
  - Purchaser/Underwriter Counsel

- Bond Counsel
- Bond Trustee
- Accountant
- Master Trustee
- Rating Agencies
- Placement Agent
- Liquidity / Credit Provider
Conduit Issuer

• Tax-Exempt Financings by 501(c)(3) Borrowers require a state or political subdivision to issue bonds = “Conduit Issuer”
  – Statewide issuers
  – Local issuers
  – Cities, counties

• Conduit Issuer is not liable for bond payments to be made by the 501(c)(3) borrower
Financing Process

• Due Diligence Request (securities law)
  – Underwriter and counsel

• Basic Documents
  – Bond Trust Indenture
  – Loan Agreement / Lease Agreement
  – Tax Agreement
  – Purchase Contract
  – Public Offering Disclosure Document or Bank Agreement
Financing Process

• Tax Due Diligence
  – New Money
    • Identify capital projects and budget
    • Identify location of each project
    • Determine which projects (or portion) of the projects can be financed tax-exempt based on expectations of use
  – Refinancing Prior Debt
    • Identify capital projects previously financed – Final Written Allocation
    • Confirm expectations of use
Financing Process

Follow the Rules

GILMORE BELL
Getting Started – Legal Considerations

Consider:

– **State and Federal law**
  - Constitutions, statutes, regulations, case law, etc.

– **Borrower’s corporate organization**
  - Organizational documents (articles, bylaws)
  - Corporate structure (parents, subsidiaries, members, affiliates, sponsors)

– **Financing documents for other debt**
Financing Document Considerations

• Limits on additional debt issuance
• Financial covenants
  – rate covenants
  – debt service coverage ratio
  – liquidity covenants
  – days cash on hand
• Consent rights
• Priority of indebtedness

• Limits on liens, encumbrances and transfers of property
• Existing liens and indebtedness
Revenue Bond Structure
Master Trust Indenture Structure
Master Trust Indenture (cont’d)

- **Purpose:**
  - consolidate credit and collateral pool
  - standardize covenants
  - streamline borrowing process
  - all Master Note holders (creditors) secured on parity basis
Public Offerings

• Underwriter

• Official Statement

• Public Investors

• Interest Modes:
  – Fixed rate to maturity
  – Variable rate modes (daily, weekly, short-term/CP, indexed/floating rate, long-term, etc.)
Direct Purchases / Private Placements

- Direct Purchase Bank (or other financial institution as purchaser)
- Placement Agent
- Bank Agreements
- Interest Modes:
  - Fixed rate to maturity
  - Fixed or floating/variable rate for term (e.g., bank hold period 5/7/10 years)
## Common Types of Bonds and Other Obligations

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed to maturity (single interest rate through maturity)</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>callable after X-years no-call period, and/or tiered premium schedule</td>
</tr>
<tr>
<td>Daily Mode (interest rate reset daily)</td>
<td>yes</td>
<td>yes</td>
<td>yes - SPBA/RA</td>
<td>yes</td>
<td>yes</td>
<td>always callable</td>
</tr>
<tr>
<td>Weekly Mode (interest rate reset weekly)</td>
<td>yes</td>
<td>yes</td>
<td>yes - SPBA/RA</td>
<td>yes</td>
<td>yes</td>
<td>always callable</td>
</tr>
<tr>
<td>Short-Term / Commercial Paper Mode (period up to 270 days)</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>always callable</td>
</tr>
<tr>
<td>Long-Term Mode (fixed for term before maturity - e.g., 3/5/7/10 years)</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>callable at L-T Period end</td>
</tr>
<tr>
<td>Indexed Mode / Floating Rate Notes (reset monthly based on index (e.g., SIFMA, LIBOR -&gt; SOFR/EFFR, Swap, Treasury)</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>always callable</td>
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**Direct Purchase Interest Rate Modes/Mechanics (tax-exempt)**

<table>
<thead>
<tr>
<th>Fixed to maturity (single interest rate through maturity)</th>
<th>no</th>
<th>no</th>
<th>no</th>
<th>yes - CCA</th>
<th>yes</th>
<th>make-whole premium (precludes interest savings refundings)</th>
</tr>
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<tr>
<td>Fixed for term (fixed for term before maturity - e.g., 5/7/10 years)</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes - CCA</td>
<td>yes</td>
<td>make-whole to term</td>
</tr>
<tr>
<td>Floating/Variable based on Index/Formula (index reset monthly)</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes - CCA</td>
<td>yes</td>
<td>always callable</td>
</tr>
</tbody>
</table>

**Taxable**

<table>
<thead>
<tr>
<th>Fixed to maturity bonds (single interest rate through maturity)</th>
<th>yes</th>
<th>yes</th>
<th>no</th>
<th>no</th>
<th>optional</th>
<th>make-whole premium (precludes interest savings refundings)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Paper (period up to 270 days)</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>optional</td>
<td>always callable</td>
</tr>
<tr>
<td>Revolver - fixed rate</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>always prepayable</td>
</tr>
<tr>
<td>Revolver - variable rate</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>always prepayable</td>
</tr>
<tr>
<td>Bank Direct Term Loan</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>make-whole premium</td>
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# Common Types of Bonds and Other Obligations

## Public Offering Interest Rate Modes/Mechanics (tax-exempt)

<table>
<thead>
<tr>
<th>Bond Type</th>
<th>Put/ Remarketing Risk</th>
<th>Interest Rate Risk</th>
<th>Bank Renewal Risk</th>
<th>Borrower Assumes Bank's Regulatory, Tax and Increased Costs Risks</th>
<th>Federal Tax Compliance</th>
</tr>
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<tbody>
<tr>
<td>Fixed to maturity (single interest rate through maturity)</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Daily Mode (interest rate reset daily)</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes - regulatory and increased costs</td>
<td>yes</td>
</tr>
<tr>
<td>Weekly Mode (interest rate reset weekly)</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes - regulatory and increased costs</td>
<td>yes</td>
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<tr>
<td>Short-Term / Commercial Paper Mode (period up to 270 days)</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
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<td>Long-Term Mode (fixed for term before maturity - e.g., 3/5/7/10 years)</td>
<td>yes (period end)</td>
<td>yes (period end)</td>
<td>no</td>
<td>no</td>
<td>yes</td>
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<td>Indexed Mode / Floating Rate Notes (reset monthly based on index (e.g., SIFMA, LIBOR -&gt; SOFR/EFFR, Swap, Treasury))</td>
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## Direct Purchase Interest Rate Modes/Mechanics (tax-exempt)

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<tbody>
<tr>
<td>Fixed to maturity (single interest rate through maturity)</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes - all</td>
<td>yes</td>
</tr>
<tr>
<td>Fixed for term (fixed for term before maturity - e.g., 5/7/10 years)</td>
<td>yes (term end)</td>
<td>yes (term end)</td>
<td>yes</td>
<td>yes - all</td>
<td>yes</td>
</tr>
<tr>
<td>Floating/Variable based on Index/Formula (index reset monthly)</td>
<td>yes (term end)</td>
<td>yes</td>
<td>yes</td>
<td>yes - all</td>
<td>yes</td>
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## Taxable

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<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
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<tr>
<td>Revolver - fixed rate</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes/no</td>
<td>no</td>
</tr>
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<td>Revolver - variable rate</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes/no</td>
<td>no</td>
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<td>Bank Direct Term Loan</td>
<td>yes (term end)</td>
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<td>yes</td>
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Tax Law Considerations
501(c)(3) Tax Law Considerations

- Expenditure Reimbursement Rules
- TEFRA – Public Hearing and Approval
- Ownership Requirement
- Private Business Use – 5% Limit
- Unrelated Trade or Business Use
- 2% Costs of Issuance Limit
- Economic Life vs. Average Maturity
May reimburse expenses paid prior to the issue date if:

- Board adopts an “official intent” resolution early
- Resolution includes brief description of project, not to exceed dollar amount and intent to be reimbursed from proceeds of tax-exempt obligation
- Exceptions
  - Preliminary Expenditures
    » Architect, Engineering
  - De Minimis Amounts
* Special exceptions to reimbursement rules are available for certain small-issuers, long-term construction projects, de minimis expenditures, and preliminary expenditures (e.g., architectural, engineering, surveying, soil-testing). Additionally, certain expenditures may be reimbursed/refinanced if previously financed directly with a taxable 3rd party loan that is to be refinanced with proceeds of the tax-exempt bond issue.
What is “Private Use”? 

The sale of a financed project results in private use

Ownership Requirement!
What is “Private Use”?

• How long do we have to track this stuff?
  – IRS restricts the use of financed projects during the entire term of the bond issue (including refunding bond issues)

• Are you saying we have to track FOREVER???
What is “Private Use”? 

• Example: Bond issue financed MRI machine  
  – Five years later: Hospital decides to replace MRI machine and sells at a substantial discount  
  – Fifteen years later: Hospital disposes of the MRI machine

• Exception: No need to continue tracking if project has no remaining useful life
What is “Private Use”?

A lease of all or a portion of a financed project **may** result in private use.
What is “Private Use”?

- Example: Hospital leases space within MOB to physician practice group

- Short Term Exceptions:
  - Leases under 50 days
  - Leases under 100 days pursuant to rate scale
What is “Private Use”?

Arrangements for a third party to operate or manage financed projects may result in private use.
What is “Private Use”? 

• Example: Hospital enters into a contract with physician practice group to operate bond financed emergency department?
• Radiology department?
• Provide anesthesiology services?
What is “Private Use”?

- **Safe Harbor Requirements**
  - Revenue Procedures 2017-13
  - Proprietary interest vs. service providers
  - No sharing of “net profits”
  - Limit on term of contract
  - Discuss with legal counsel in advance
What is “Private Use”?

Use by a 501(c)(3) organization of a bond financed project in an unrelated trade or business results in private use (regardless of profit)
What is “Private Use”?

- Example: Hospital uses bond financed lab to perform tests for other hospitals and clinics in the area

If we have “private use”... what happens?
What is “Private Use”?

• Can we fix it?
  – Cash in the project
  – 5% limit on private use
  – Modify contract
  – Remedial Action
  – IRS Voluntary Closing Agreement Program
What is “Private Use”? 

• How can you help? 
  – Track the use of financed projects 
    • Annual Compliance Checklist 
  – Ask questions early and often! 
  – Identify issues early… 
    • More options available 
    • Avoid jeopardizing tax advantaged status of bonds
Joint Ventures/(c)(3)P3s
Mergers & Acquisitions
Sales and Dispositions
Joint Ventures and Public Private Partnerships

• Joint Ventures between nonprofit/governmental and for-profit entities
  - Partnership accounting tax-exempt bond rules
  - Tax-exempt eligible portions up to the nonprofit/governmental user’s partnership %s
  - Tax-exempt and taxable debt combination financing structures
  - Floating qualified equity, qualified management agreements and optimizing 5% private use

• Joint Ventures among multiple qualified 501(c)(3)/governmental entities
Mergers & Acquisitions

• Bond document related differences - mergers vs acquisitions
• Acquisition financing tax treatment
  - Survives tax reform’s elimination of tax-exempt advance refundings
  - Preserving ability to finance or refinance on a tax-exempt basis after original acquisition or initial taxable acquisition financing
    ▪ Cash acquisition → tax-exempt financing
    ▪ Taxable acquisition financing → tax-exempt financing
Sales, Non-Qualified Leases and other Dispositions

• Remedial Actions
  - Redemption or defeasance of non-qualified bonds
  - Alternative use of financed asset disposition proceeds (substituting new facilities)
  - Alternative use of financed assets (tax use agreements between seller and qualified user buyer)
  - Timing considerations
QUESTIONS
https://www.gilmorebell.com/

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