

**OPINING ON THE 501(C)(3) TAX-FREE BOND
TRANSACTION: AVOIDING COMMON BORROWER'S
COUNSEL MISCONCEPTIONS**

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I. INTRODUCTION

Sections 103, 141, and 145 of the Internal Revenue Code¹ work together to provide a vehicle through which charitable organizations may obtain reduced-cost financing for their capital and other needs.² The vehicle involves a loan from a state or local government, where the governmental unit has issued bonds to obtain funds to make the loan. Purchasers of such state and local bonds are often willing to accept a lower interest rate from the borrower because the purchasers will pay no tax on any interest received.³

Health care organizations, colleges, and universities have

1. Unless otherwise indicated, all references and citations in this article to the Internal Revenue Code ("Code") refer to the Internal Revenue Code of 1986, as amended. I.R.C. (1986) (currently codified at 26 U.S.C.A. (West Supp. 2004)). All references to "section" refer to a section of the Internal Revenue Code.

2. I.R.C. §§ 103, 141, 145. Section 103 excludes from gross income the interest on state or local bonds other than specific "private activity bonds," "arbitrage bonds," and bonds that are not in registered form. *Id.* § 103. Sections 141 and 145 elaborate on the requirements applicable to "private activity bonds" and "qualified 501(c)(3) bonds," a subset of private activity bonds, respectively. *Id.* §§ 141, 145.

3. *Id.* § 103 (excluding from gross income interest on state or local bonds). It should be noted, however, that with respect to corporations (as defined for federal income tax purposes), interest on "tax-exempt" bonds is taken into account in determining adjusted current earnings for the purpose of computing the alternative minimum tax imposed on such corporations. *Id.* §§ 55, 56. Additional federal income tax consequences relative to "tax-exempt" bonds include the following: tax-exempt bond interest is included in the calculation of modified adjusted gross income required to determine the taxability of social security or railroad retirement benefits, *id.* § 86; the receipt of tax-exempt bond interest by life insurance companies may affect the federal income tax liabilities of such companies, *id.* § 832; the amount of certain loss deductions otherwise allowable to property and casualty insurance companies will be reduced (in certain instances below zero) by 15% of, among other things, tax-exempt bond interest, *id.* § 832; interest incurred or continued to purchase or carry tax-exempt bonds may not be deducted in determining federal income tax, *id.* § 265, except that commercial banks, thrift institutions and other financial institutions may deduct their costs of carrying certain tax-exempt obligations, *id.* § 265(b); interest on tax-exempt bonds is included in effectively connected earnings and profits for purposes of computing the branch profits tax on certain foreign corporations doing business in the U.S., *id.* § 884; and passive investment income, including interest on tax-exempt bonds, may be subject to federal income taxation for Subchapter S Corporations that have Subchapter C earnings and profits at the close of the taxable year if greater than 25% of the gross receipts of such Subchapter S Corporations is passive investment income, *id.* § 1375.

availed themselves of this financing vehicle for some time. More recently, other charitable organizations, including museums, arts organizations, public broadcast stations, private elementary and secondary schools, and independent living facilities for seniors, are increasingly using tax-exempt financing⁴. For many of these institutions a tax-exempt financing involves a “once in a lifetime” transaction, such as an acquisition of a headquarters or a new facility.

Specialized bond counsel firms (“bond counsel”) generally represent municipal issuers of tax-exempt bonds. Charitable organizations are also represented by counsel (“borrower’s counsel”); however, the charitable organizations’ lawyers, while experts in the laws relating to the charitable exemption,⁵ are often not as familiar with the rules relating to tax-exempt financing. The borrower’s counsel may be asked to provide a legal opinion with respect to the characterization of the uses to which the property financed with the tax-exempt bonds will be put. Universally in these transactions, the borrower’s counsel must also advise its charitable client regarding the entity’s certification that it will not use the proceeds of tax-exempt bonds in a manner that could cause the bonds to lose their tax-exempt status. Bond counsel will subsequently rely on both the legal opinion of the borrower’s counsel and the charitable entity’s certification to render the bond counsel’s tax opinion to potential purchasers of the bonds.

Section 145, governing qualified 501(c)(3) bonds, uses terms such as “private business use”⁶ and “unrelated trades or businesses”⁷

4. The terms “taxable” and “tax-exempt” financings are misnomers in that the exemption is provided as an exclusion of bond interest from otherwise taxable gross income under § 103. They are, however, customary and convenient terms and are thus used in this article. Depending on the applicable state law authority governing the issuer, tax-exempt financings can take the form of bonds, notes, draw-down loans, commercial paper programs, or installment or lease purchase agreements.

5. See I.R.C. § 501(c)(3) (exempting charitable organizations from federal taxation).

6. The “private business use test,” as defined in § 141(b), is incorporated into the definition of a “qualified 501(c)(3) bond,” but instead of limiting the percentage of bond proceeds that may be used for “private business use” to 10%, only 5% may be so used. *Id.* § 145(a)(2)(B). “Private business use” is defined in § 141 of the Code. § 141(b)(6).

7. “Unrelated trade or business” is defined as “any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.” *Id.* § 513.

which are similar, but not identical, to concepts familiar to counsel who are experts in exemption issues.⁸ Opportunities therefore exist for confusion on the part of borrowers' counsel and their clients that could lead to erroneous opinions and certification. This article is thus intended to provide practical advice to practitioners who are not experts in the tax-exempt financing rules but who provide general representation to charitable organizations.⁹

There are two areas where borrowers' counsel can easily misstep when representing a charitable organization in a tax-exempt bond deal. The first is failing to recognize that "private business use" under § 145 can (and does) result in situations that would not constitute an "unrelated trade or business" of the borrower.¹⁰ The second occurs when borrowers' counsel conflate the test for "unrelated business taxable income" under § 512¹¹ with the use of "unrelated trades or businesses" in the definition of a qualified 501(c)(3) bond under § 145.¹² A mistake in either of these areas could lead to an erroneous opinion that the use of bond proceeds will not result in taxation of interest on the bonds. This article will explain these distinctions and include helpful examples.¹³

In addition, there are two areas where charitable organizations often take actions that subsequently preclude the use of tax-exempt bonds for an otherwise eligible project. The first of these involves the reimbursement of project expenses with bond proceeds

8. *Id.* § 145. In order to be a "qualified 501(c)(3) bond" several requirements must be met, including that the bond would not be deemed a private activity bond if the "501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses." *Id.* § 145(a).

9. The terms "charity," "a 501(c)(3)," and "charitable organization" are used interchangeably to mean organizations determined by the Internal Revenue Service to be exempt from federal income taxation under § 501(c)(3). *See id.* § 501(c)(3).

10. A charitable organization, exempt from tax under § 501, may still be subject to taxation on "unrelated business income." *Id.* § 511(a)(2)(A).

11. *Id.* § 512. "Unrelated business taxable income" is defined as "the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b)." *Id.* § 512(a)(1).

12. *Id.* § 145(a)(2)(A).

13. *See infra* Part IV.B-C.

advanced from the charity's available funds.¹⁴ Borrowers' counsel may not be aware of rules that require certain actions contemporaneous with the advances if the advanced funds ultimately will be reimbursed with the proceeds of tax-exempt debt. Similarly, charitable organizations may inadvertently use donation solicitation materials that foreclose the future use of tax-exempt bond financing for a specific project. Although borrowers' counsel may be asked to review these materials before they are sent to potential donors, these counsel may not be sensitive to the application of the tax-exempt financing rules that govern the use of bonds to finance projects which are the subject of a capital campaign or other donation.¹⁵ This article will discuss the Treasury Regulations promulgated under § 148, defining arbitrage bonds and governing the creation of replacement proceeds, and their applicability to the reimbursement of advances and solicitation of donations.¹⁶

II. BACKGROUND

Section 103 of the Code currently provides that the interest on state and local bonds is not included in gross income.¹⁷ Private activity bonds,¹⁸ arbitrage bonds,¹⁹ and bonds that are not in registered form, however, do not currently receive the benefit of

14. See *infra* Part V.A.

15. See *infra* Part V.B.

16. See *infra* Part V.B. "Arbitrage bonds," the interest of which is not excluded from gross income pursuant to § 103, are bonds "issued as part of an issue any portion of the proceeds of which are reasonably expected . . . to be used directly or indirectly to [either] acquire higher yielding investments or to replace funds which were used directly or indirectly to acquire higher yielding investments." I.R.C. § 148 (a).

17. *Id.* § 103(a). Similar provisions have been part of every version of the federal tax code since its inception in 1913. See, e.g., Act of Oct. 3, 1913, ch. 16, § II, 38 Stat. 114, 168 and I.R.C. § 103 (1954). See generally Note, *Bedtime For [Industrial Development] Bonds?: Municipal Bond Tax Legislation of the First Reagan Administration*, 48 LAW & CONTEMP. PROBS. 213, 216 (1985) [hereinafter *Bedtime for Bonds*].

18. "Private Activity Bonds" are debt obligations that satisfy two "private business tests": 1) the "private business use test" and 2) the "private security or payment test." I.R.C. § 141. The "private business use test" applies if more than 10% of the proceeds of an issue are used for private business use. *Id.* § 141(b)(1). The "private security or payment test" similarly applies if more than 10% of an issue's proceeds are secured by an interest in property used for a private business use or if 10% of the proceeds are derived from payments "in respect of property or borrowed money, used or to be used for a private business use." *Id.* § 141(b)(2).

19. See *supra* note 16 (defining "arbitrage bond").

the exclusion.²⁰ Most states also exempt from tax the interest on certain municipal bonds, generally limited to bonds issued by their own state or local governments.²¹ Interest rates on municipal bonds are lower than interest rates on conventional bonds of similar creditworthiness because the holders of municipal bonds do not pay tax on the interest received.²² Lower interest rates mean that municipalities have lower costs associated with building and financing government projects.

State and local governments have long issued debt to finance government projects. Historically, such projects consisted primarily of schools, roads, and government buildings. Just after the Great Depression, state and local governments began to use their ability to issue tax-exempt debt as a tool for less traditional economic development activities.²³ State and local governmental units issued bonds and loaned the proceeds of the sale of those bonds to the owners or developers of projects that the issuing governmental unit wanted to encourage.²⁴ In time, these projects included fast food outlets, discount retail and other commercial developments, low income housing, pollution control facilities, and manufacturing facilities.²⁵ Charitable organizations and trade associations were

20. *Id.* § 103(b).

21. *See, e.g.*, MICH. COMP. LAWS ANN. § 211.571 (2001) (originally enacted as 1909 Mich. Pub. Acts 88). "All bonds hereafter issued by any county, township, city, village, school district or community college district within the state pursuant to statute are exempted from all taxation." *Id.* In all, forty-one states exempt the interest on at least some bonds issued in their state from tax. RESEARCH INSTITUTE OF AMERICA, ALL STATES TAX GUIDE 237, available at ASTG P 237 WL (West 2004).

²² *See supra* note 3 (expounding on the manner in which interest on tax-exempt bonds is taken into account for certain federal tax purposes).

23. The first conduit industrial development bonds were issued in Mississippi in 1936 to construct hosiery mills. *Bedtime for Bonds, supra* note 17, at 219 n.52 and accompanying text. Industrial development bonds are a form of government-issued debt where the principal user is not a government agency, but a private entity. *Id.* at 213.

24. Although restrictions on the use of bond proceeds were relaxed over the years, initially, bonds were issued in limited numbers due to many states' constitutions prohibiting lending to private borrowers or for non-public purposes. *See id.* at 219, n. 52-53 and accompanying text.

25. Reportedly, K-Mart financed nearly 100 stores between 1975 and 1980 with \$220.5 million of tax-exempt bonds, while McDonalds used bonds to open thirty-two new restaurants in 1979 in Pennsylvania and Ohio alone. *Bedtime for Bonds, supra* note 17, at 224 n.98 and accompanying text (citing STAFF OF H.R. COMM. ON OVERSIGHT, 97TH CONG., BACKGROUND INFORMATION FOR HEARINGS ON TAX-EXEMPT "SMALL ISSUE" INDUSTRIAL REVENUE BONDS 23 (Comm. Print 1981) [hereinafter SMALL ISSUE]). Publicity regarding these and similar transactions led to the reforms in the conduit bond area described in this article. *See infra* text

also beneficiaries of this “conduit” financing.²⁶

State laws authorizing conduit-financing bonds, and the instruments pursuant to which the conduit bonds are issued, typically make clear that the purchasers of the bonds may not look to the issuing government unit for payment.²⁷ Rather, the ultimate recipient of the proceeds of the bonds—the conduit borrower—provides the basis for repayment of the bonds. Therefore, the encouragement that state and local governments provide for these projects is merely access to the lower-cost capital that results from the federal tax exemption.²⁸ This leaves the federal government, through lost tax revenue on the bond interest, to foot the bill.²⁹

After issuing several favorable rulings in the late 1950s and early 1960s,³⁰ the Treasury Department in early 1968 announced that it was reconsidering its position on the tax-exempt status of interest paid on almost all conduit bond issues.³¹ The Treasury

accompanying notes 30–42.

26. These transactions are called “conduit” financings because the governmental issuer of the bonds serves as the conduit between the bondholder and the ultimate obligor on the debt.

27. *See, e.g.*, MICH. COMP. LAWS ANN. § 125.1623(2) (2001). “The municipality shall not be liable on notes or bonds of the corporation and the notes and bonds shall not be a debt of the municipality. The notes and bonds shall contain on their face a statement to that effect.” *Id.* The same holds true for bonds issued by state governments. *See, e.g.*, MICH. COMP. LAWS ANN. § 331.42(h) (2001). “The state shall not be liable on any bonds of the state authority, the bonds and notes are not a debt of the state, and each bond and note shall contain on its face a statement to that effect.” *Id.*

28. And, to a much lesser extent, the exemption from state taxation where available.

29. The outstanding volume of industrial development bonds, a subspecies of private activity bonds, increased from \$100 million in 1960 to \$1.8 billion in 1968. *Bedtime for Bonds*, *supra* note 17, at 220 n.63 (citing SMALL ISSUE, *supra* note 25). By 1982, annual industrial development bond issuance exceeded \$5 billion. *Id.* at 223, n. 90 and accompanying text. By comparison, in 2003 less than \$2.2 billion of private activity bonds were issued. Susanna Duff Bennett, *Carryover Cap Record: States Keep \$18.4 Billion of Private Activity Authority*, THE BOND BUYER (May 26, 2004), at <http://www.bondbuyer.com>.

30. Rev. Rul. 54-106, 1954-1 C.B. 28 (holding that interest paid on bonds issued on behalf of a municipality to finance or construct industrial plants was exempt from federal income tax); Rev. Rul. 57-187, 1957-1 C.B. 65 (holding that interest received on bonds issued by an Alabama Industrial Development Board was exempt from federal income tax). *See also* Rev. Rul. 63-20, 1963-1 C.B. 24 (ruling that the specific bonds under consideration were not tax-exempt due to the bonds not being issued “on behalf of” a political organization, but clarifying that obligations issued by nonprofit corporations for the purpose of stimulating industrial development would be found tax-exempt if issued “on behalf of” a political subdivision).

31. S. REP. NO. 1014, at 2360 (1968) (addressing the Treasury Department’s

Department issued proposed rules to deny tax-exempt status to conduit financings that did not involve a charitable organization as the borrower.³² In response, Congress passed legislation as part of the Revenue and Expenditure Control Act of 1968 that specifically allowed some tax-exempt conduit financings, yet placed limits on conduit transactions.³³ As part of that legislation, bonds issued for the benefit of charitable organizations were exempt from the restrictions that were placed on other conduit bonds.³⁴ Bonds that benefited charitable organizations were thereby given the same favorable treatment as bonds used to finance traditional government projects, such as schools and roads.³⁵

Both Congress and the Treasury Department, however, continued to express concern about conduit financings.³⁶ In 1982, 1984, and again in 1986, Congress sharply limited the exemption from tax for interest on municipal bonds where the proceeds of the bonds were used and repaid by a nongovernmental person or entity.³⁷ These limitations included placing a "volume cap" on the

announcement, in Tech. Info. Rel. 972, that the Department was reconsidering its position on the tax-exempt status of the interest paid on industrial development bonds under § 103 of the 1954 Code).

32. Prop. Treas. Reg. § 1.103-7, 34 Fed. Reg. 508 (1968), *withdrawn*, 36 Fed. Reg. 10953 (1969).

33. Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 107(a), 82 Stat. 251, 266 (1968) (adding a new subsection to I.R.C. § 103 (1954) and stating that unless otherwise provided, the interest on industrial development bonds is not excluded from gross income), *amended in* Renegotiation Amendments Act of 1968, Pub. L. No. 90-634 § 401, 82 Stat. 1345, 1349 (1968).

34. Pub. L. No. 90-364 § 107(a) (including in the newly enacted § 103(c) a provision that § 501(c)(3) organizations that are exempt from tax do not fall within the definition of an "industrial development bond").

35. *See id.*

36. *See* J. COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, H.R. DOC. NO. 97-4961 at 98 (1982).

Congress was concerned with the volume of tax-exempt bonds used for private activities. There has been a tremendous increase in recent years in the volume of such bonds. In 1976, the volume of private activity bonds was about \$8.5 billion, or about 25 percent of the long-term tax-exempt bond market. The volume of private activity bonds rose to more than \$25 billion in 1981, representing 48 percent of the tax-exempt bond market. The Treasury Department estimated that over \$35 billion of private activity bonds would be issued in 1982, consuming over 55 percent of the entire long-term tax-exempt bond market.

Id.

37. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 214-21, 96 Stat. 326, 466-78 (creating public approval and reporting requirements for certain conduit bonds, shortening permissible maturities for certain conduit

total amount of most types of conduit debt annually issued in each state.³⁸ In the 1986 legislation, bonds benefiting charitable organizations were swept into the regime governing other conduit financings that benefit for-profit entities,³⁹ yet remained exempt from some of the more onerous restrictions.⁴⁰ Perhaps the most important of these exemptions is that bonds benefiting charitable organizations are not included in the annual volume cap placed on each state for most other conduit financings.⁴¹ In addition, Congress placed restrictions on the investment and use of all tax-exempt bonds, including bonds used for traditional governmental purposes.⁴² The effect of this piecemeal layering of statutory limitations on tax-exempt bonds resulted in an overly complex regulatory scheme best described as a foreign language taught in English.

III. ANATOMY OF A BOND DEAL

The tax-exempt bond regulatory regime is easier to understand if we digress into an explanation of the structure of a typical tax-exempt financing that involves a charitable organization. A financing usually begins with a charitable organization working

bonds and limiting the types of projects for which conduit bonds may be used); Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 611-48, 98 Stat. 494, 901-41 (imposing a state-wide cap on certain conduit bond issues and numerous other changes to tax-exempt bond rules). *See also* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1301-18, 100 Stat. 2085, 2602-2711.

38. *See* I.R.C. § 146 (limiting annual state issuance of most private activity bonds to the greater of \$75 multiplied by the state's population or \$225 million, both figures indexed for inflation after 2002).

39. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1301-18, 100 Stat. 2085, 2602-711. *See also* I.R.C. § 141(b)(6) (applying conduit-financing regulations to any "trade or business carried on by any person other than a governmental unit").

40. *See* I.R.C. § 147(h)(2). Qualified 501(c)(3) bonds are exempt from the following Internal Revenue Code provisions: § 147(a) (denying tax exemption to interest on bonds owned by a substantial user of the financed facility); § 147(c) (limiting the use of private activity bond proceeds used to acquire land); § 147(d) (prohibiting the acquisition of existing property, other than the housing property described *infra* note 66); and § 147(e) (restricting the use of bond proceeds to acquire health clubs). *Id.* In addition, the state bond volume cap in § 146 does not apply to qualified 501(c)(3) bonds. *Id.* § 146(g)(2).

41. I.R.C. § 146. However, some qualified 501(c)(3) bonds are still subject to the now relatively fangless \$150 million limit on tax-exempt bonds that benefit a single entity. *See infra* note 65.

42. *See generally* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1301-18, 100 Stat. 2085, 2602-2711. *Compare* I.R.C. § 103 (1986), *with* I.R.C. §§ 103, 141 (2004).

in concert with a bank, financial advisor or investment banking firm.⁴³ A plan of finance is developed and potential purchasers of the proposed debt are identified. A state or local unit of government, generally through a governmentally-created authority constituted for that purpose, authorizes and issues the bonds.⁴⁴ Usually, the governmental unit holds a public hearing, after prior notice in a newspaper of general circulation, before issuing the bonds.⁴⁵ The bonds are then either sold by an investment banking firm to the intended public purchasers, or a private bank or other private purchaser will buy the bonds directly. The governmental unit then loans the proceeds of the sale of the bonds to the charitable entity, generally on terms that closely match the terms of the bonds.⁴⁶ The charitable organization then makes payments to the governmental unit on its loan and these payments are passed along, less any charges by the governmental unit, to the purchasers of the bonds.

These financings are heavily documented to provide adequate security for the purchasers of the bonds; several different law firms are usually involved in the documentation and in issuing opinions on various aspects of the financings.⁴⁷ Bond counsel will usually draft the financing documents and issue their unqualified opinion that interest on the bonds is exempt from federal, and in some

43. Generally speaking, for financings where the organization seeks to borrow less than \$3-5 million, a bank will become the direct purchaser of the bonds after it conducts its credit investigation of the charity. For larger borrowings, a financial advisory firm and/or investment banking firm will assist the charity in creating credit disclosure materials and the ultimate sale of the bonds to third party investors, including bond mutual funds and individual investors. These larger deals will often involve credit enhancement, in the form of either a bank letter of credit or the purchase of a policy of bond insurance.

44. For example, a state or local economic development corporation, public housing authority, education facility financing authority or health care facility financing authority.

45. Even if the state statute authorizing the issuance of conduit bonds does not require a public hearing, § 147 requires a public hearing in most conduit-bond financings, including those that benefit qualified 501(c)(3) borrowers. I.R.C. § 147(f), (h).

46. Many, but not all bond-issuing governmental units will charge an application fee; some will also charge a mark-up on the interest rate the governmental unit pays on the loan over the interest rate payable on the bonds.

47. Depending on the credit worthiness of the charitable organization, a financing may involve a mortgage on the organization's facilities, a pledge of revenues or endowment funds, personal or corporate guarantees, and/or a promise by the charity to abide by a variety of financial ratio and operational covenants.

cases state, taxation.⁴⁸ Bond counsel represent “the deal,” and the bond opinion must therefore be issued by a firm with recognized expertise in these matters in order for the bonds to be marketable.⁴⁹ Either the same bond counsel or separate counsel may also represent the governmental issuer of the bonds (“issuer’s counsel”).⁵⁰ Issuer’s counsel will opine as to the validity of the proceedings by which the bonds were approved. The underwriter and/or bank are also typically represented by their own counsel⁵¹ who will generally opine on the authority of their respective clients to execute certain documents and the subsequent enforceability of those documents against their clients. If the bonds are publicly offered, the underwriter and/or bank’s counsel will also opine in a narrow fashion on the completeness and accuracy of the offering documents and the existence of relevant exemptions and federal and state securities law registration requirements.

The charitable organization is represented by borrower’s counsel. Some charities hire special borrower’s counsel from the universe of firms that are routinely involved in state and local finance matters. Often, charities rely on their in-house counsel or customary outside law firm for representation in the bond financing. Borrower’s counsel is expected to opine on the tax status of the organization, the authority of the organization to borrow funds, the authority of the organization’s representatives to execute the transactional documents, the validity of the approval of the financing by the organization, and the enforceability of the

48. This opinion is commonly known as the “tax” or “bond” opinion and is rendered on both publicly or privately placed bond issues. “Bond opinions” typically confirm that interest will be tax exempt.

49. For this purpose, a firm is considered an expert if its name is included in *The Bond Buyer’s Municipal Marketplace*, commonly referred to in the industry as the “Red Book” because of the color of its cover. THE BOND BUYER’S MUNICIPAL MARKETPLACE (American Banker-Bond Buyer, Incorporated), available at <http://www.munimarketplace.com/mmo/> (last visited Oct. 3, 2004). To be included in the directory, a law firm must have accomplished at least one of the following during the two-year period preceding publication of the directory: rendered a sole legal opinion in connection with the sale of state and/or municipal bonds; or, served as underwriter’s counsel, co-counsel, or issuer’s counsel for a municipal bond offering. *Attorney Firm Application*, THE BOND BUYER’S MUNICIPAL MARKETPLACE ONLINE, <http://www.munimarketplace.com/mmo-attapp.html> (last visited Oct. 3, 2004).

50. The term “issuer” refers to the governmental unit issuing the bonds.

51. In some cases, the same law firm represents the bank, the underwriter, if any, and serves as bond counsel to the deal, with appropriate client advice and consent.

various covenants and agreements against the charity. In publicly offered bond financings, borrower's counsel will further provide an opinion about the completeness and accuracy of the disclosure in the offering documents about the borrowing organization and, often, an opinion about the summaries of the financing documents.

Some charitable organizations, typically hospital systems and larger educational organizations, are regular beneficiaries of tax-exempt bonds and their counsel are well versed in the nuances of the tax-exempt-bond regulatory regime. For many organizations, however, long-term borrowing is an infrequent, perhaps once-in-a-lifetime, transaction used to finance a headquarters or major facility. For these organizations and their counsel, the tax-exempt-bond regulatory scheme can be foreign and often counter-intuitive.

IV. ISSUES RELATING TO QUALIFICATION AS A 501(C)3 BOND

Section 103 provides the basis for exemption from tax of interest on bonds issued by state or local governments.⁵² Other sections of the Code, however, impose significant limitations on bonds issued by state and local governments that benefit nongovernmental businesses. In its 1986 amendments to the Internal Revenue Code, Congress added subsection 103(b), which excludes from the tax-exempt status "private activity bonds" that are not qualified bonds.⁵³ "Private activity bonds" include any bonds issued that either satisfy both "private business tests"⁵⁴ or satisfy the "private loan financing test."⁵⁵ The private business tests will be discussed below, as they apply to bonds that benefit charitable organizations.⁵⁶ The private loan financing test denies tax exemption to a bond if more than a set amount of the proceeds of the bond are used directly or indirectly to make or finance loans

52. I.R.C. § 103.

53. *Id.* § 103(b)(1) (excepting private activity bonds, arbitrage bonds and bonds not in registered form from the gross income exclusion provided by § 103(a)).

54. *Id.* §§ 141(b)(1) – (b)(2). Section 141 establishes a two-part private business test: § 141(b)(1) provides a test to determine if the bond is for private business use, while § 141(b)(2) provides a test to see if the bond has been privately secured. *Id.* If the bond passes both tests it is then deemed a private activity bond. *Id.*

55. *Id.* § 141(c) (defining the "private loan financing test").

56. *See infra* Part IV.B.

to persons other than state or local governmental units.⁵⁷ In a conduit financing that benefits a charity, all the proceeds of the sale of the bonds are loaned to the charitable organization, which is a nongovernmental person.⁵⁸ Therefore, all tax-exempt bonds used for conduit 501(c)(3) financings are private activity bonds.

Fortunately, the Internal Revenue Code provides specifically for conduit 501(c)(3) financings. Section 103(b) allows tax exemption for private activity bonds that are “qualified bonds.”⁵⁹ The term “qualified bond” includes private activity bonds that are “qualified 501(c)(3) bond[s].”⁶⁰ Thus, a bond, the proceeds of which are loaned to one or more charitable organizations, may be tax-exempt provided the bond meets all the requirements for a “qualified 501(c)(3) bond.”⁶¹

Section 145 defines the limits of a qualified 501(c)(3) bond,⁶² containing essentially four separate requirements that must be met: 1) an ownership test;⁶³ 2) a variant of the aforementioned private

57. Specifically, the lesser of \$5 million or 5% of the bond proceeds. I.R.C. § 141(c).

58. Some governmental affiliates obtain a determination that they qualify as a charitable organization. These affiliates may qualify as a state or local governmental unit and not be subject to many of the limitations described in this article.

59. I.R.C. § 103(b). Technically, private activity bonds that are “qualified bonds,” as defined by § 141, are excluded from the exception to the gross income exclusion provided in § 103(a). *Id.*

60. *Id.* § 141(e)(1)(G).

61. The benefits of tax-exempt bond financing under this provision are limited to charitable organizations. I.R.C. § 145(a). Other tax-exempt entities must qualify their bond-financed projects under another of the enumerated types of “qualified bonds” under § 141(e). I.R.C. § 141(e). This means the 1986 legislation effectively curtailed the use of bonds to build headquarters or otherwise benefit trade associations, political organizations, labor unions, or other tax-exempt entities. *See* I.R.C. § 501.

62. I.R.C. § 145(a).

[E]xcept as otherwise provided in this section, the term ‘qualified 501(c)(3) bond’ means any private activity bond issued as part of an issue if – (1) all property which is to be provided by the net proceeds of the issue is to be owned by a charitable organization or a governmental unit, and (2) such bond would not be a private activity bond if – (A) charitable 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.

Id.

63. *Id.* § 145(a)(1).

business use test;⁶⁴ 3) a \$150 million limit on the amount of certain “nonhospital” bonds benefiting a single charitable organization;⁶⁵ and 4) a prohibition against using bonds to finance certain residential housing units.⁶⁶ This article will focus on the ownership test⁶⁷ and the private business use tests,⁶⁸ as these are the tests most likely to trip up borrowers’ counsel in the most common types of conduit 501(c)(3) financings.

A. *The Ownership Test*

The ownership test stems from § 145(a)(1)’s requirement that “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.”⁶⁹ For this purpose, governmental units include only state or local governments, not the federal government.⁷⁰ There is no requirement that qualified 501(c)(3) bonds be used to acquire or construct property.⁷¹ Bonds may be used for operating expenses; however, if they are used for such purpose, certain restrictions will

64. *Id.* § 145(a)(2).

65. *Id.* § 145(b) (limiting the issuance of new “nonhospital” bonds, bonds not used with respect to a hospital, to the extent that the aggregate amount of outstanding nonhospital bonds, together with the new bonds, from which any charitable organization benefits, exceeds \$150 million). The Taxpayer Relief Act of 1997 modified this limitation. Taxpayer Relief Act of 1997, Pub. L. No. 105-34; 111 Stat. 788 (codified as amended in scattered sections of 26 U.S.C.). This limitation now only applies to bonds where less than 95% of the net proceeds are used to finance capital expenditures incurred after August 5, 1997. I.R.C. § 145(b)(5).

66. I.R.C. § 145(d) (providing that a qualified 501(c)(3) bond may not be used directly or indirectly to provide residential rental property for family units). A bond can be used to provide residential rental property for family units if either the first use of that property is pursuant to the bond issuance, substantial rehabilitation to the property occurs, or the property would qualify under § 142(d) as a low income residential rental housing project. *Id.*

67. *See infra* Part IV.A.

68. *See infra* Part IV.B.

69. I.R.C. § 145(a)(1).

70. *See id.* §§ 145(a)(1), 150(a)(2). In addition to the regulatory restrictions on long-term working-capital debt, charitable organizations may find it difficult to find a purchaser for bonds that do not finance a capital improvement or the acquisition of a new source of revenue, both of which provide additional security for bondholders.

71. *See* Priv. Ltr. Rul. 88-30-003 (July 29, 1988) (specifying that I.R.C. § 145(a)(1) does not require that the net proceeds of a qualified 501(c)(3) bond be used to provide property). This is in contrast to other types of tax-exempt conduit bonds, many of which must be used for capital expenditures relating to a particular type of property. *See, e.g.*, I.R.C. §§ 142(k), 144(a)(1)(A).

apply with respect to the length of time the bonds may be outstanding and the yield permitted on any investment of bond proceeds.⁷² However, to the extent property is acquired or refinanced using qualified 501(c)(3) bonds, that property must be owned by a charitable organization or a governmental unit for the entire period during which the bonds are outstanding.⁷³

Three aspects to the ownership test most commonly create problems in a qualified 501(c)(3) bond financing. The first involves financing the cost of leasehold improvements made by a charity to real property it leases from a nongovernmental person. The second involves an organization's use of separate entities to hold property that is used by one or more charitable organizations, including the use of limited liability companies (LLCs),⁷⁴ § 501(c)(2) holding companies,⁷⁵ or § 501(e) cooperative hospital service organizations.⁷⁶ The third involves the disposal of bond-financed property while the bonds that financed the property are still outstanding.

With regard to the first issue, a charity may lease a building from an unrelated owner and construct leasehold improvements to the building. The issue is whether the charity may use the proceeds of tax-exempt bonds to finance the cost of making these leasehold improvements, which are incorporated into a building not owned by a charitable organization or governmental unit. Ownership, for purposes of qualified 501(c)(3) bonds, is

72. Compare Treas. Reg. § 1.148-2(e)(2) (as amended in 1997), *with* Treas. Reg. § 1.148-2(e)(3) (as amended in 1997) (providing temporary periods during which bond proceeds may be invested at higher yields for, respectively, three years for capital project borrowings and thirteen months for working capital borrowings). Compare also Treas. Reg. § 1.148-1(c)(4)(i)(B)(1) (as amended in 2003), *with* Treas. Reg. § 1.148-1(c)(4)(i)(B)(2) (as amended in 2003) (providing safe harbors against the creation of "replacement proceeds," which may not be invested in higher-yielding investments for bonds outstanding, respectively, for two years for working-capital financings and 120% of the useful life of the project for capital financings).

73. See I.R.C. § 145(a)(1).

74. LLCs protect members from personal liability on the company's debts and obligations. See NICHOLAS G. KARAMBELAS, LTD. LIAB. CO.: L. PRAC. AND FORMS § 1:1 (2d ed. 2004).

75. Section 501(c)(2) holding companies are defined as companies organized for the exclusive purpose of holding title to property, of which the company remits the net income from the property to another exempt organization. *Id.* § 501(c)(2).

76. Section 501(e) cooperative hospital service organizations are defined as organizations organized and operated solely to perform, on a centralized basis, services on behalf of one or more tax-exempt hospitals. *Id.* § 501(e).

determined under the federal tax principles.⁷⁷ Actual titling of the property is not determinative.⁷⁸ Rather, ownership is determined based on a factual determination of which party has the “benefits and burdens of ownership.”⁷⁹ In cases where the useful life of the improvements is exhausted prior to the maturity of the bonds, where the improvements are removable by the charity, or where the lease requires that the building be returned without the leasehold improvements, many bond counsel will consider the leasehold improvements to be owned by the charity under the federal income tax principles of ownership.⁸⁰ This opens the door for use of tax-exempt bonds to finance the leasehold improvements.

With regard to the second issue, for liability or other reasons, a charitable organization may not want to own the bond-financed property directly. Instead, charitable organizations will often use related entities to hold the property. Borrowers’ counsel should exercise care in structuring related entities that will own property that may be the subject of bond financing. For example, placing property in a 501(c)(2) title holding company precludes the use of qualified 501(c)(3) bonds because the 501(c)(2) holding company is a separate legal entity that has not been determined to be a 501(c)(3) charitable organization.⁸¹ This is true even though the 501(c)(2) holding company is limited by the Code to holding property for the benefit of a tax-exempt entity, in this case a charitable organization.⁸² On the other hand, a single-member LLC that does not elect entity taxation under the § 7701 check-the-box rules⁸³ is disregarded as separate from its owner, and its operations are treated as a branch or division of its charitable

77. Treas. Reg. § 141-3(b)(2) (as amended in 2001).

78. JACOB MERTENS, JR., *THE LAW OF FEDERAL INCOME TAXATION* § 28:25 (1942) (revised by Eugene Levin, Nov. 1993).

79. *Id.*

80. National Association of Bond Lawyers, *Tax Issues in 501(c)(3) Financings* at 3, NATIONAL ASSOCIATION OF BOND LAWYERS 2003 BOND ATTORNEYS WORKSHOP, 2003 Workshop Materials [hereinafter BOND ATTORNEYS WORKSHOP].

81. See I.R.C. § 501(c)(2)-(3).

82. *Id.* § 501(c)(2). “Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under this section.” *Id.*

83. Treas. Reg. § 301.7701-1 (1996). The “check the box” system is the manner in which entities are classified for federal income tax purposes. *Id.*

organization member.⁸⁴ If the LLC elects separate entity taxation, the LLC must then seek a separate determination that it qualifies as a charitable organization.⁸⁵

The treatment of entities owned by more than one charity, or a mix of charitable and other entities, is not yet settled. In private guidance, the IRS has ruled that property owned by an LLC with two charities as its members is property owned by a 501(c)(3) organization for purposes of meeting the ownership test requirements.⁸⁶ Since there is no direct precedential authority on point, bond counsel and borrowers' counsel must therefore be comfortable in opining that a multi-member LLC that owns property is not a partnership separate from its members, which cannot qualify as a 501(c)(3) organization, but is instead aggregated with its members for this purpose.

Where an entity owned by more than one charity qualifies as a 501(e) organization, there is more support for the position that the entity's ownership of bond-financed property satisfies the ownership test. Section 501(e) provides that certain cooperative hospital services are treated as organized and operated exclusively for charitable purposes.⁸⁷ The IRS has not issued precedential guidance specific to whether property owned by 501(e) organizations is deemed owned by a charitable organization for purposes of the ownership test. Borrowers' counsel would have to be comfortable in opining that the ownership test is met based on the general language in the Treasury Regulations that a cooperative hospital service organization that meets the requirements of § 501(e) is treated as an organization described in § 501(c)(3).⁸⁸

84. I.R.S. Announcement 99-102, 1999-2 C.B. 545; Treas. Reg. § 301.7701-2(a) (as amended in 2003).

85. See I.R.S. Announcement 99-102. Determination is received from the Internal Revenue Service after application for charitable status on the Internal Revenue's Form 1023, entitled "Application for Recognition of Exemption Under § 501(c)(3) of the Internal Revenue Code."

86. Priv. Ltr. Rul. 99-29-041 (July 23, 1999) (stating expressly that the only two 501(c)(3) members of an LLC will each be treated as an owner of an undivided interest in the bond-financed hospital facilities, and so the bond-financed hospital facilities will be owned by charitable organizations). Using this analysis, however, it is unclear how the IRS would view an LLC that contains both 501(c)(3) entities and nongovernmental persons.

87. I.R.C. § 501(e).

88. Treas. Reg. § 1.501(e)-1(a) (1986).

Section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable

In regards to the third issue, concerning the disposal of bond-financed property, the requirement for charitable organization ownership of bond-financed property must be met in two ways. First there must be a reasonable expectation, at the time the bonds are issued, that the charitable organization ownership of property will exist; second, actual ownership of the property throughout the life of the bonds must occur.⁸⁹ Therefore, advisors to charitable organization borrowers must consider the impact of any sale or other disposal of bond-financed property on the tax status of the bonds. Disposals of bond-financed property after the issuance of bonds are governed by deliberate action⁹⁰ and change of use⁹¹ rules. A detailed discussion of the IRS regulations governing these rules is outside the scope of this article. However, a few comments are in order.

First, the charity should be counseled to discuss with the bond counsel for the issuer of the bonds any contemplated disposal of more than a *de minimus* amount of bond-financed property.⁹² In fact, the charitable organization borrower may have covenanted in the bond documentation to obtain a bond counsel opinion before disposal of any bond-financed property.⁹³ Second, management should be aware that proper handling of disposals of property for more than salvage value may prevent violation of the ownership test and that their counsel should therefore be involved early in the process.

The Treasury Regulations under § 145 provide that the taking of specified remedial actions upon the early sale or disposal of

organization. A cooperative hospital service organization which meets the requirements of section 501(e) and this section shall be treated as an organization described in section 501(c)(3), exempt from taxation under section 501(a).

Id.

89. Treas. Reg. § 1.141-2(d) (as amended in 2002); Treas. Reg. § 1.145-2(a) (1997).

90. See Treas. Reg. § 1.141-2(c) (as amended in 2002); Treas. Reg. § 1.145-2(b)(3) (1997).

91. See Treas. Reg. § 1.141-12 (as amended in 2002); Treas. Reg. § 1.145-2(b)(3) (1997).

92. If an issuer or conduit borrower 501(c)(3) organization takes a "deliberate action, subsequent to the issue date that causes the issue to fail to comply with the requirements of sections 141(e) and 145," then the issue will cease to be an issue of qualified 501(c)(3) bonds. Treas. Reg. § 1.145-2(a) (1997).

93. As a general rule, bond counsel have concluded that the sale of property for salvage at the end of its useful life is permitted even though the bonds continue to remain outstanding. BOND ATTORNEYS WORKSHOP, *supra* note 80, at 3.

bond-financed property will be effective for purposes of the ownership test.⁹⁴ The regulations limit, however, the viability of remedial actions to those circumstances where the charity reasonably expected, on the day the bonds were issued, that the bonds would meet the ownership test for their entire term.⁹⁵ To accomplish an effective remediation, these rules also require that certain actions occur within timeframes as short as ninety days after the date the charity enters into a binding contract that is not subject to any material contingencies with a nongovernmental person for use of the financed property.⁹⁶ With knowledge of the parameters and benefits of the remedial action safe harbors, borrowers' counsel are able to structure property dispositions in a manner that will allow their clients to take advantage of them.

B. The Private Business Tests

Like the ownership test, compliance with the private business tests must be expected for the life of the bond issue at the time the bonds are issued and also met over the life of the bonds.⁹⁷ The private business use test for qualified 501(c)(3) bonds has two parts,⁹⁸ as does the general private business test for all private activity bonds.⁹⁹ The "private business use" test requires that no more than 5% of the net proceeds of the bond issue be used "in the trade or business of a nongovernmental person," treating charitable organizations in this instance as a governmental person with respect to their activities which do not constitute unrelated trades or businesses.¹⁰⁰ The "private payment or security test"

94. Treas. Reg. § 1.145-2(b)(3) (1997) (specifying that the references to the private business use test in §§ 1.141-2 and 1.141-12 include the ownership test of § 145(a)(1)).

95. Treas. Reg. §§ 1.141-12(a)(1), 1.145-2(b)(3) (1997). Charities without the requisite expectation will be limited to redeeming bonds that become "nonqualifying bonds" by reason of the disposition within six months after the date the charity enters into a binding contract that is not subject to any material contingencies with a nongovernmental person for use of the financed property, regardless of whether the transaction produced sufficient cash to effectuate the redemption. Treas. Reg. § 1.141-2(d)(2) (as amended in 2002).

96. See Treas. Reg. §§ 1.141-12(d) (1997); 1.141-2(e) (as amended in 2002).

97. Treas. Reg. § 1.141-2(d) (1997).

98. Section 141(b)(1) defines the general private business use test, limiting it to not more than 10%. I.R.C. § 141(b)(1); Treas. Reg. § 1.141-3(a) (as amended in 2001). The test as applied to qualified 501(c)(3) bonds further limits the private use to 5%. I.R.C. § 145(a)(2); Treas. Reg. § 1.145-2 (1997).

99. I.R.C. § 141(b)(1); Treas. Reg. § 1.141-3(a) (as amended in 2001).

100. I.R.C. § 141(b)(1); Treas. Reg. § 1.141-3(a) (as amended in 2001).

requires that no more than 5% of the payment of or security for the bonds come, directly or indirectly, from a private business user of the bond proceeds.¹⁰¹ The requisite percentages of both the private business use test and the private payment test must be exceeded for bonds to run afoul of the private business tests.¹⁰² For qualified 501(c)(3) bonds, issues generally arise in accurately identifying whether the private business use prong is met. Consequently, this article focuses on that prong of the private business tests.

For purposes of the above tests, the term “net proceeds” means the amounts received from the sale of the bonds before any costs of issuing the bonds are deducted, plus any receipts from investment of the sale proceeds, less amounts held in a reasonably required reserve or replacement fund.¹⁰³ Amounts paid to third parties as costs of issuing the bonds are included in the “net proceeds of the bonds” and must be included (if paid to nongovernmental persons) as part of the 5% private business use.¹⁰⁴

It is therefore important to identify properly who is a “nongovernmental person.” Governmental persons for these purposes include only state or local governments; the federal government is treated as a nongovernmental person.¹⁰⁵ This distinction is an important one for charitable institutions leasing to, or sharing space with, federal agencies, or engaging in certain federally sponsored research. With respect to qualified 501(c)(3) bonds, use by charitable organizations with respect to activities that do not constitute “unrelated trades or businesses” is considered use

501(c)(3) organizations are treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses. I.R.C. § 145(a)(2).

101. I.R.C. §§ 141(b)(2), 145(a)(2); Treas. Reg. § 1.141-4(a) (1997) (providing a detailed description of private payments or security arrangements that apply).

102. I.R.C. § 141(a)-(b); Treas. Reg. § 1.145-2 (1997).

103. I.R.C. § 150(a)(3). For a description of what constitutes a “reasonably required reserve and replacement” fund (a “4R” fund), *see* § 148(d). I.R.C. § 148(d). *See also* Treas. Reg. § 1.148-2(f) (as amended in 1997) (defining and limiting the size of a reasonably required reserve and replacement fund).

104. This is sometimes referred to as “bad money.” The underwriting discount, which is usually deducted from the sale proceeds of the bonds before the net funds are transmitted to the borrower, must be added back for these purposes, along with any costs of issuance unrelated to the acquisition of a “qualified guaranty.” *See* Treas. Reg. § 1.148-4(f) (as amended in 1999) (only qualified fees for risk reduction may be treated as additional interest).

105. I.R.C. § 150(a)(2).

by a governmental person.¹⁰⁶

Use of any property financed by the bonds is considered use of the proceeds of the bonds.¹⁰⁷ Determination of private business use includes analyzing who holds the ownership of the property and who holds any special rights to the property. Special rights that must be considered include actual or beneficial use of the property pursuant to a lease, or a management or incentive payment contract, or other agreement such as a take or pay or other output-type contract.¹⁰⁸ Other arrangements conveying special legal entitlements for the beneficial use of bond proceeds or of bond-financed facilities comparable to the special legal entitlements described above may also result in private business use.¹⁰⁹ Finally, where bond-financed property is unavailable for general public use,¹¹⁰ the regulations provide that private business use of such property arises if a private business derives special economic benefits from the property, based on all the facts and circumstances, even if the business has no special legal entitlements.¹¹¹

It is important to consider all expected uses and users of the bond-financed property. For example, when a charity leases its bond-financed property, both the ownership and leasehold uses must be analyzed. Similarly, both direct and indirect uses must be analyzed.¹¹² For example, “a facility is treated as being used for a private business use if it is leased to a nongovernmental person and subleased to a governmental” unit or charitable organization.¹¹³ Although the owner and the subtenant (and ultimate user) of the property are both charitable organizations, the intervening tenant is a private business user. This private business use could thus taint the tax-exempt status of the bonds.

The regulations take an expansive view of what constitutes “use

106. *Id.* § 145(a)(2)(A). Use by charitable organizations is considered a private business use of bonds issued for traditional governmental purposes. *Id.* § 145(a)(1). *See also infra* Part IV.C.

107. Treas. Reg. § 1.141-3(a)(1) (as amended in 2001).

108. *Id.* § 1.141-3(b)(1).

109. *Id.* § 1.141-3(a)(7)(i). “For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.” *Id.*

110. *See infra* text accompanying notes 115-22 (discussing “general public use”).

111. Treas. Reg. § 1.141-3(b)(7)(ii).

112. *Id.* § 1.141-3(a)(2).

113. *Id.*

in a trade or business.” The term “trade or business” is defined as “[a]ny activity carried on by a person other than a natural person.”¹¹⁴ Consequently, without other limitations, exemptions, and exclusions, it would be nearly impossible to find a facility where there was not private business use. Fortunately, the available guidance provides a more generous view of permissible use by non-natural persons.

Use by the general public¹¹⁵ and use by private businesses on the same basis as the general public are not considered private business uses.¹¹⁶ Use qualifies as general public use “if the property is intended to be available, and in fact is reasonably available for use [by a business] on the same basis [as use] by natural persons not engaged in a trade or business.”¹¹⁷ An example is a bond-financed road that is available for use by both commercial and noncommercial traffic. Property is not used on the same basis as the general public if it conveys priority rights or preferential benefits to a business user or users.¹¹⁸ “Arrangements providing for use that is available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits.”¹¹⁹ The regulations also exclude from the definition of general public use any arrangements of more than 200 days, disregarding certain fair market value renewal options.¹²⁰ For example, a parking garage open to all comers, and charging the same rates to all, will not have private business use despite the fact that employees and patrons of private businesses park in the garage. However, if certain areas of the garage are reserved for a private business’s employees and patrons, or if the business pays preferential rates,¹²¹ those portions

114. *Id.* § 1.141-3(a)(1).

115. I.R.C. § 141(b)(6)(A).

116. “Use as a member of the general public is not private business use.” Treas. Reg. § 1.141-3(c)(1) (as amended in 2001). Similarly, use, at no charge, that is available to the general public is deemed “on the same basis as the general public.” *Id.* § 1.141-3(c)(2).

117. *Id.* § 1.141-3(c)(1).

118. *Id.* § 1.141-3(c)(2).

119. *Id.*

120. *Id.* § 1.141-3(c)(3).

121. This does not include permissible customary and reasonable classifications. *Id.* § 1.141-3(c)(2)(i). “Rates may be treated as generally applicable and uniformly applied even if . . . [d]ifferent rates apply to different classes of uses, such as volume purchasers, if the differences in rates are customary and reasonable.” *Id.*

of the garage would be deemed to be private business use. If that use is sufficiently large it could result in the taxation of interest on the bonds financing that facility.¹²²

It is often difficult for managers of exempt organizations to understand that private business use can arise in circumstances that generally do not create unrelated trade or business issues and where the use by outside parties is neither the ownership nor leasing of the bond-financed facilities.¹²³ Borrowers' counsel are often in the best position to identify these issues for purposes of their client's certification to bond counsel regarding the uses of the project. To assist borrowers' counsel, the following is a short discussion of some of the more counter-intuitive issues.

Treasury Regulations provide that a management contract for a bond-financed facility "may result in private business use of that property based on all the facts and circumstances."¹²⁴ A management contract is defined for these purposes as "a management, service, or incentive payment contract between [the charitable organization] and a service provider under which the service provider provides services involving all, or a portion of, or any function of, a [bond-financed] facility."¹²⁵ For example, a contract with a private firm to operate a school or museum cafeteria or bookstore would fall within the definition of a management contract.¹²⁶ Additional examples of management contracts include contracting to outsource the operation of an emergency room or radiology room of a charitable hospital to a physician group or contracting with a private firm for key management personnel.¹²⁷

Fortunately, the Treasury Regulations¹²⁸ and two related

122. It is often possible, however, to finance a portion of a project on a tax-exempt basis, while simultaneously incurring taxable debt (a "taxable tail") to finance the "bad money" portion of the project.

123. See, e.g., Priv. Ltr. Rul. 03-04-015 (Jan. 24, 2003) (explaining how proceeds of the bonds may be allocated to a university and government use of a stadium, including naming rights granted to the university and the limits placed upon the university for such rights).

124. Treas. Reg. § 1.141-3(b)(4)(i) (as amended in 2001).

125. *Id.* § 1.141-3(b)(4)(ii).

126. A contract with a for-profit subsidiary of the charitable organization, instead of a private firm, would similarly be a management contract.

127. Such arrangements are common in the charter school movement.

128. Treas. Reg. § 1.141-3(b)(4)(iii). The arrangements described as follows are generally not treated as management contracts that give rise to private business use:

(A) Contracts for services that are solely incidental to the primary

revenue procedures¹²⁹ have set forth a number of safe harbors describing when such contracts will not be treated as giving rise to private business use. Bond counsel will generally require that any management contracts relating to bond-financed facilities must fall clearly within one of these safe harbors. Often, modifications (albeit generally relatively modest) to the standard business terms of the private service providers are often needed to bring the contract within a safe harbor.¹³⁰ Managers of charitable organizations and their counsel are well advised to consider the safe harbors when negotiating contracts that involve facilities that are or may be bond financed. At a minimum, a clause should be inserted in agreements whereby the parties agree to renegotiate without penalty in the event the charity is informed by counsel that the agreement will negatively affect its tax status or the tax-exempt status of a current or proposed facilities financing.¹³¹ Since a material revision of the compensation arrangements of a management contract is treated as a new contract as of the date of the material revision,¹³² a clause such as this will permit the charity to alleviate private business use issues with respect to an offensive contract.¹³³

Certain research agreements relating to property used for the research may constitute private business use. An agreement by a

governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services); (B) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of *de minimis* services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities; (C) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; or, (D) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

Id.

129. See Rev. Proc. 97-13, 1997-1 C.B. 632, *as modified by*, Rev. Proc. 01-39, 2001-2 C.B. 38 (generally setting forth operating guidelines for management contracts, general compensation requirements, permissible arrangements, and modifying the definitions of capitation fee and per-unit fee).

130. For example, modifications could include adding specific termination dates or cancellation rights or adjusting incentive or volume-based payments.

131. See Rev. Proc. 93-19, 1993-1 C.B. 526, § 5.04.

132. Rev. Proc. 97-13, § 5.02(4).

133. See *id.* § 3.02(4).

nongovernmental person¹³⁴ to sponsor research performed by a charitable organization or a state or local governmental person may, based on all of the facts and circumstances, result in private business use of the property used for the research.¹³⁵ In addition to the facts and circumstances test of the regulations, safe harbors for certain types of sponsored research are set forth in a revenue procedure.¹³⁶ Research agreements that fall within these safe harbors will not result in private business use of the bond-financed facilities involved in the research.

In addition to the exclusion of use in the same manner as the general public and the safe harbors for certain management and research agreements, the regulations provide other exclusions from private business use.¹³⁷ Other exclusions include temporary ownership or use by the developer of the project,¹³⁸ certain uses incidental to a financing arrangement,¹³⁹ certain small incidental uses of the property,¹⁴⁰ use by persons solely in their capacity as agents for the charity,¹⁴¹ and certain short term uses that do not otherwise qualify as use on the same basis as the general public.¹⁴²

C. *Unrelated Trade or Business Use by Charitable Organizations*

The use of bond proceeds or bond-financed property by a charitable organization in an unrelated trade or business is treated as a “bad” private business use subject to the 5% restriction.¹⁴³ Unrelated trade or business use is determined in accordance with the provisions of § 513(a).¹⁴⁴ An in-depth discussion of what

134. In this case, a nongovernmental person does not mean a charitable organization or a state or local government. However, the federal government is a “nongovernmental person.” I.R.C. §§ 145(a)(1), 150(a)(2).

135. Treas. Reg. § 1.141-3(b)(6)(i) (as amended in 2001).

136. Rev. Proc. 97-14, 1997-1 C.B. 634, § 5.

137. See Treas. Reg. § 1.141-3(d) (describing exclusions for financing arrangements that involve certain government agents and certain incidental or temporary uses of bond-financed property by a nongovernmental person).

138. *Id.* § 1.141-3(d)(4).

139. *Id.* § 1.141-3(d)(2) (such as a title holder in a sale-leaseback arrangement).

140. *Id.* § 1.141-3(d)(5) (for example, the installation of pay phones or vending machines).

141. *Id.* § 1.141-3(d)(1).

142. *Id.* § 1.141-3(d)(3).

143. I.R.C. § 145(a)(2)(A).

144. *Id.* (stating an unrelated trade or business includes conduct not substantially related to charitable, educational, or other function exempted under § 501).

constitutes an unrelated trade or business under § 513(a) is beyond the scope of this article; however these issues should be familiar to most counsel representing tax-exempt organizations.

Generally speaking, the term “unrelated trade or business” means “any trade or business the conduct of which is not substantially related (aside from the need of the organization for 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(c)(3).”¹⁴⁵ The term does not include any trade or business “(1) in which substantially all the work in carrying on the trade or business is performed for the organization without compensation; (2) which is carried . . . on by the organization primarily for the convenience of its members, students, patients, officers, or employees; or (3) [which constitutes] the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.”¹⁴⁶

One common misconception among borrowers’ counsel is that the meaning of “unrelated trade or business” for purposes of § 513(a) and the § 145 private business use test is the same as “unrelated business taxable income” as defined in § 512.¹⁴⁷ Because § 145(a)¹⁴⁸ cross references § 513(a),¹⁴⁹ rather than § 512,¹⁵⁰ the modifications to the definition of “unrelated trade or business” in subsection 512(b)¹⁵¹ are not available for purposes of determining whether a bond is a qualified 501(c)(3) bond.¹⁵² Therefore, income from rents, royalties, dividends, and interest exempted

145. I.R.C. § 513(a).

146. *Id.*

147. *Compare* I.R.C. § 513(a) (defining “unrelated trade or business” as any conduct not substantially related to a charitable, educational, or other function exempted under I.R.C. § 501), *with* I.R.C. § 512 (defining “unrelated business taxable income” as gross income derived from any unrelated trade or business as defined in § 513 less any modifications contained in § 512(b)).

148. I.R.C. § 145(a) (applying § 513(a) to determine what constitutes an unrelated trade or business).

149. *Id.* § 513(a).

150. *Id.* § 512.

151. *Id.* § 512(b). Section 512 provides that “unrelated business taxable income” is found by taking gross income derived from unrelated trade or business (as defined in § 513) less deductions allowed in Chapter One of the Code. *Id.* § 512. These values for gross income and deductions are then modified as provided in § 512(b). *Id.* § 512(b).

152. *See* I.R.C. § 145.

from the unrelated business income tax under subsection 512(b)¹⁵³ is not excluded from the business use test of § 145 unless those activities are related to the exempt purpose of the organization.

Private guidance issued in 1990 provided a good example of rent related to an organization's exempt purpose.¹⁵⁴ A private letter ruling under § 513(a) of the 1954 Code private activity bond rules¹⁵⁵ held that summer rental by a 501(c)(3) liberal arts college of its bond-financed dormitories to corporations and law firms to provide housing for their summer interns and to organizations that conducted educational classes, seminars, and workshops was not an unrelated trade or business of the university, where that rental was accompanied by educational programming for the interns.¹⁵⁶ Similarly, construction by a 501(c)(3) development council of industrial buildings to rent to business tenants who will provide jobs in an impoverished area has been held not to be an unrelated trade or business under § 513(a).¹⁵⁷

It is important, however, to remember to analyze all uses of the property. The use of the dormitor, described in the example above by the private firms would be a private business use of the facility unless it met one of the safe harbors for short-term use by the general public.¹⁵⁸ In addition, if the buildings constructed for economic development purposes were leased to private businesses, that use would also constitute private business use of the bond-financed facilities.¹⁵⁹ Conversely, if a bond-financed facility is leased by a charity to another charitable organization for use in the lessee organization's exempt purpose, the lessee's use does not constitute private business use. If the leasing activity is not related to the exempt purpose of the owner, the rental income is exempt from

153. Rents, royalties, dividends, and interest are a few of the many modifications allowed under § 512. I.R.C. § 512.

154. See Priv. Ltr. Rul. 90-14-069 (Jan. 11, 1990) (applying I.R.C. § 103 (1954), which provided that interest on industrial development bonds is not typically tax-exempt).

155. I.R.C. § 103 (1954).

156. *Id.*

157. Priv. Ltr. Rul. 02-13-027 (Dec. 21, 2002).

158. Treas. Reg. § 1.141-3(c) (as amended in 2001). The lease of the dormitories to the law firms and employers did not impact the tax status of the bonds in the 1990 Private Letter Ruling only because the amount of private business use created by the rental was below the 1954 Code threshold of 25%. See I.R.C. § 103(b) (1986). See also Priv. Let. Rul. 90-14-069 (Jan. 11, 1990).

159. See Priv. Let. Rul. 02-13-027.

the unrelated business income tax under § 512(b).¹⁶⁰ The activity, however, is an unrelated trade or business of the owner under § 513(a)¹⁶¹ and consequently is a private business use under § 145.¹⁶²

Borrowers' counsel should confirm that their charitable-organization client understands the need to carefully analyze the private business use test. The client should understand that use by charitable organizations will be measured by the trade or business definition of § 513(a), not by whether the use will generate unrelated business taxable income.¹⁶³ An assumption that because the organization has no unrelated business taxable income there is not private business use of its bond-financed facilities can be fatal to the exempt status of the interest on the bonds. Another fatal mistake is the failure to analyze all types of private business use of the facility, whether expected before the issuance of the bonds or arising at any time the bonds are outstanding. Management contracts, research agreements, and the granting of special privileges with respect to bond-financed property are especially prone to mischaracterization by charitable organization managers. Borrowers' counsel can play a key role in identifying problems before they occur, and most issues can be resolved favorably with proper attention to the private business use regulations.

V. ISSUES RELATING TO THE CREATION OF REPLACEMENT PROCEEDS

The private business use test is not the only area that provides traps for the unwary borrower's counsel. The following sections discuss two problem areas of which counsel should be aware.

A. *Problem Area I: Using Cash and Expecting Bond Reimbursement*

Issues can arise when a charitable organization begins a project using its own funds and expects to reimburse itself later with the proceeds of tax-exempt bonds. Reimbursement financings can be a prudent course of action for several reasons. First, borrowing as late as possible reduces overall interest costs, especially where investment returns on the organization's available

160. I.R.C. § 512(b)(3) (exempting rental income from real property).

161. *Id.* § 513(a). It would be an unrelated business activity because the activity is not substantially related to the conduct of the business.

162. Section 145 refers the reader to § 513(a) for the determination of what constitutes an unrelated business activity. *Id.* § 145.

163. *See id.*

funds are relatively low.¹⁶⁴ Second, lenders are more willing to loan funds for a project nearing completion, particularly when that project will be revenue-producing.

This prudent financial planning may be frustrated, however, if the charitable organization's managers and its counsel are not familiar with the rules associated with tax-exempt bonds. Treasury Regulations may preclude the use of tax-exempt bond proceeds to reimburse a borrower for expenditures made before the bonds are issued.¹⁶⁵ Most commonly, this problem arises when a charity acquires land with its own funds well before the commencement of construction. With proper planning, this issue can be completely avoided.

Treasury Regulation § 1.150-2 governs the use of bond proceeds to reimburse a borrower for previously expended funds.¹⁶⁶ The rule provides that reimbursement allocation is treated as a valid expenditure of bond proceeds only if, not later than sixty days after payment of the original expenditure, the "issuer" adopts an "official intent" for the original expenditure and the allocation of bond proceeds to the reimbursement is made within a specific time period.¹⁶⁷

The charitable organization should evidence its "official" intention to reimburse itself with the proceeds of debt no later than sixty days after the first expenditure of funds for the project occurs.¹⁶⁸ Generally, this notice is in the form of a resolution of the

164. This statement assumes that fixed interest rates do not rise sharply in the interim, such that the higher rates might offset the savings from a later borrowing.

165. Treas. Reg. § 1.150-2 (1993). These regulations were promulgated by the Treasury Department in response to perceived abuse by bond issuers. The Treasury believed that issuers were avoiding rules that limit an issuer's ability to invest bond proceeds for profit by allocating bond proceeds to reimbursing itself for projects long since completed. These bonds were called "pyramid bonds" because, using this reimbursement theory, it was said that bonds could be deemed used to finance the construction of the Egyptian Pyramids. *See Introduction of Legislation Limiting Issuance Costs for Tax-Exempt Bonds*, 134 Cong. Rec. E3068-01 (1988) (statement of the Honorable Brian J. Donnelly of Massachusetts). The rules work relatively well to permit prudent reimbursement practices without allowing abuse, provided the beneficiary of the bonds and its counsel are aware of the regulations early enough in the process to comply with them.

166. Treas. Reg. § 1.150-2 (1993).

167. *Id.* § 1.150-2(d). In the case of a qualified 501(c)(3) bond, an issuer is defined as "the entity that actually issues the reimbursement bond," or the conduit borrower. *Id.* § 1.150-2(c)(1)-(2). "Official intent" is defined as "an issuer's declaration of intent to reimburse an original expenditure with proceeds of an obligation." *Id.* § 1.150-2(c).

168. *Id.* § 1.150-2(d)(1). Exceptions from this rule apply for preliminary

charity's board, although the board may delegate the issuance of such notices to an officer or committee.¹⁶⁹ If involved early enough, the bond issuer may also provide the official evidence of the charity's intention to reimburse itself.¹⁷⁰

The notice of intent may take any reasonable form but it must describe the project for which the original expenditure is paid and it must state the maximum principal amount of bonds expected to be issued for the project.¹⁷¹ A "project" for this purpose includes any property, project, or program.¹⁷² Identification of the expenditures need not specifically identify each piece of property to be acquired using reimbursement.¹⁷³ Instead, a specific fund or budget line item may be identified.¹⁷⁴ "A project description is sufficient if it identifies, by name and functional purpose, the fund or account from which the original expenditure is paid."¹⁷⁵ Consequently, a reimbursement resolution might specify that the charity plans to seek bond financing for some or all of the expenditures to be made in 2004 from its capital expense account.

"Deviations between a project described in an official intent and the actual project financed with reimbursement bonds do not invalidate the official intent to the extent that the actual project is reasonably related in function to the described project."¹⁷⁶ For example, "hospital equipment is a reasonable deviation from

expenditures not exceeding 20% of the tax-exempt bond issue or issues that finance, or are reasonably expected to finance, the project for which the preliminary expenditures were incurred. *Id.* § 1.150-2(f)(2). Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project. *Id.* Preliminary expenditures do not include land acquisition, site preparation, and similar costs incident to commencement of construction. *Id.* In addition to the exception for preliminary expenditures, up to \$100,000, or 5% of the proceeds of the bond issue, whichever is smaller, may be reimbursed without proper notice under a *de minimus* exception. *Id.* § 1.150-2(f)(1).

169. Treas. Reg. § 1.150-2(e)(1).

170. *Id.* § 1.150-2(c)(1)-(2).

171. *Id.* § 1.150-2(e)(2)(i).

172. *Id.* The regulations give the examples of a "highway capital improvement program, hospital equipment acquisition, or school building renovation." *Id.*

173. Treas. Reg. § 1.150-2(e)(2)(ii).

174. *See id.*

175. *Id.* § 1.150-2(e)(2)(ii). The regulations give the example of the designation of "the parks and recreation fund-recreational facility capital improvement program." *Id.*

176. *Id.* § 1.150-2(e)(2)(iii).

hospital building improvements.”¹⁷⁷ In contrast, the use of bond proceeds to reimburse the expenses of a city office building rehabilitation is not a reasonable deviation from an official intent designation to reimburse highway improvements.¹⁷⁸

On the date of the declaration of official intent, the charity must have a reasonable expectation that it will reimburse the original expenditure with proceeds of an “obligation” (for these purposes, an obligation could consist of either taxable or tax-exempt debt).¹⁷⁹ “Official intents declared as a matter of course or in amounts substantially in excess of the amounts expected to be necessary for the project . . . are not reasonable.”¹⁸⁰ Similarly, “a pattern of failure to reimburse actual original expenditures covered by official intents (other than in extraordinary circumstances) is evidence of unreasonableness.”¹⁸¹

The allocation of debt proceeds to reimburse a borrower must occur within a specified timeframe. This may create problems for a charitable organization whose project is delayed or multi-phased. The reimbursement allocation must occur no later than eighteen months after the reimbursed expenditure is made.¹⁸² If later, the reimbursement allocation may occur within eighteen months of when the financed project is placed in service.¹⁸³ However, except for certain very long-term construction projects,¹⁸⁴ in no event may the reimbursement occur more than three years after the expenditure was made.¹⁸⁵

177. *Id.*

178. *Id.*

179. *Id.* § 1.148-1(b) (as amended in 2003) (stating that an issuer’s expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or would take those same actions, based on all the objective facts and circumstances). Relevant factors include the history of conduct, the level of inquiry into factual matters, and “the existence of covenants, enforceable by bondholders, that require implementation of specific expectations.” *Id.* The relevant factors change for a conduit financing issue and include “the reasonable expectations of the conduit borrower, but only if, under the circumstances, it is reasonable and prudent for the issuer to rely on those expectations.” *Id.*

180. *Id.* For example, blanket declarations are not permitted.

181. *Id.*

182. *Id.* § 1.150-2(d)(2)(i)(A).

183. *Id.* § 1.150-2(d)(2)(i)(B).

184. *Id.* § 1.150-2(d)(2)(B)(iii) (defining long-term construction projects as those “for which both the issuer and a licensed architect or engineer certify that at least five years is necessary to complete construction of the project”).

185. *Id.* § 1.150-2(d)(2)(i)(B). The longer reimbursement period for small bond issues under the Treasury Regulations does not apply to 501(c)(3)

If a charity wishes to refinance a bank line of credit or other taxable debt with tax-exempt bonds, its management or counsel must identify the sequencing of the expenditures made with the bank debt. If the debt was used to pay expenditures directly, that is, it was not used to reimburse the charitable organization for expenditures made with the charity's funds, the reimbursement rules of Treasury Regulation § 1.150-2(d) do not apply.¹⁸⁶ If, as is more typical, the charitable organization draws periodically on a bank line of credit or a draw-down loan, or otherwise borrows to reimburse itself for expenditures of its own funds, the reimbursement allocation must satisfy the requirements of Treasury Regulation § 1.150-2(g)(2).¹⁸⁷ This provision requires that the purported reimbursement must have been a "valid expenditure under applicable law on reimbursement expenditures" on the date the original bank debt was issued.¹⁸⁸

B. Problem Area II: Excessively Narrow Capital Campaign Appeals

A related and frequently arising issue occurs when a charitable organization decides to take advantage of long-term, low interest rates to finance a project while undertaking a capital campaign to raise funds for the same project. Sometimes, charitable organizations are approached by potential lenders who show the charity how it can profit by investing capital campaign funds at higher rates than would be payable on tax-exempt bonds. Although there are many legitimate reasons to incur long-term project debt in lieu of exhausting available funds, the Treasury Department and Congress agree that "arbitraging"¹⁸⁹ tax-exempt bond proceeds through higher yielding investments is not a legitimate reason.

Among the restrictions Congress has placed on all tax-exempt bond issues is a prohibition against exploiting the difference between taxable and tax-exempt interest rates for "arbitrage" profit.¹⁹⁰ The Treasury Regulations amplify this prohibition.¹⁹¹ In

borrowers, as they do not have general taxing powers. *Id.* § 1.150-2(d)(2)(ii).

186. *Id.* § 1.150-2(g)(1).

187. *Id.* § 1.150-2(g)(2).

188. *Id.*

189. *See supra* note 16 (defining arbitrage pursuant to § 148(a)).

190. *See* I.R.C. § 103(b)(2) (excepting "arbitrage bonds" from the gross income exclusion of interest on state or local bonds).

191. *See* Treas. Reg. § 1.148-1 – 11 (providing the rules that govern arbitrage).

broad terms, these prohibitions restrict transactions that result in taking advantage of the differential between taxable and tax-exempt rates by issuing more tax-exempt bonds, issuing the bonds earlier, or allowing the bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the exempt purpose for which the bonds are issued.¹⁹²

Under one of these restrictions, the “gross proceeds” of a tax-exempt bond issue may not be invested in higher yielding investments.¹⁹³ Numerous exceptions to this general proscription exist for situations that neither Congress nor the Treasury Department perceived as being abusive.¹⁹⁴ Failure to comply with these requirements will result in revocation of the tax-exempt status of the bonds retroactive to the date of issue.

Congress and the Department of Treasury were not just concerned about the direct investment of bond proceeds but they also cast a wary eye as borrowers, and their advisors, devised ways to obtain the same result using bonds for expenditures for which the entity already had available cash. The borrowers engaged in transactions that, in effect, “replaced” funds earmarked for a project with bond proceeds. The borrowers reasoned that the bond proceeds were spent on the project, not invested, and that their “replaced” funds were eligible for investment at rates higher than the bond interest rate.

Congress’s reaction was to prohibit tax-exempt status for “arbitrage” bonds, the proceeds of which are used to replace funds that are invested at higher than the yield on the bonds.¹⁹⁵ The IRS implemented this concept by promulgating regulations that limit

192. *See id.*

193. Treas. Reg. § 1.148-2(a) (as amended in 1997).

194. For example, bond proceeds invested for specified temporary periods, I.R.C. § 148(c), Treas. Reg. § 1.148-2(e); a minor portion of the bond issue, as described in I.R.C. § 148(e) and Treas. Reg. § 1.148-2(g); and amounts held in a reasonably required reserve or replacement fund as described in I.R.C. § 148(d) and Treas. Reg. § 1.148-2(f).

195. *See* Revenue & Expenditure Control Act, Pub. L. No. 90-364 § 107(a), 82 Stat. 251, 266 (1968)).

Arbitrage bond defined – For purposes of § 103, the term “arbitrage bond” means “any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly – (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments.”

Id.

the bond yield to the investment of most of the “gross proceeds”¹⁹⁶ of a bond issue.¹⁹⁷ Included in the ambit of gross proceeds is a category called “replacement proceeds.”¹⁹⁸

Replacement proceeds include amounts with a “sufficiently direct nexus to the bonds or to the governmental purpose of the bonds to conclude that the amounts would have been used for that governmental purpose if the proceeds of the bonds were not used or to be used for that governmental purpose.”¹⁹⁹ In this instance, “governmental purposes include the expected use of amounts for the payment of debt service on a particular date.”²⁰⁰ So, for example, the expected use of capital campaign donations to pay off a bond issue at maturity will make those donations replacement proceeds of the bond issue. Investment earnings on those donations may not, even potentially, exceed the yield on the bonds for the life of the bond issue.²⁰¹

The regulations relating to “yield restriction”²⁰² in the case of replacement proceeds do not allow a borrower to make investments and determine retrospectively whether these investments exceed bond yield.²⁰³ Rather, bond counsel must be able to conclude that there is no reasonable expectation that the bond yield could be exceeded.²⁰⁴ This generally results in an investment at less than bond yield, making the transaction less advantageous than redeeming the bonds when the donations are received.

The regulations, however, provide that “the mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause

196. “Gross proceeds” are defined as “any proceeds and replacements bonds of an issue.” Treas. Reg. § 1.148-1(b) (as amended in 1997).

197. *Id.* § 1.148-2(a) (as amended in 1997) (explaining which circumstances do not cause bonds of the issue to become arbitrage bonds).

198. *Id.* § 1.148-1(b).

199. *Id.* § 1.148-1(c).

200. *Id.*

201. *See, e.g.*, T.D. 8418, 1992-1 C.B. 29 (1992) (containing regulations that relate to the arbitrage rebate requirements applicable to tax-exempt bonds issued by state and local governments under § 103).

202. Treas. Reg. § 1.148-2 (as amended in 1997) (providing the general rules restricting arbitrage yields).

203. *Id.* § 1.148-5(c) (as amended in 2003) (governing “yield and valuation of investments”).

204. *Id.* § 1.148-2 (stating the issuer must reasonably expect that as of the issue date “there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund”).

those amounts to be replacement proceeds.”²⁰⁵ Therefore, even if an exempt organization preliminarily identified its capital campaign as a potential source of funding for a project, with proper planning it may still use bonds to finance the project. To be so used, donations to the capital campaign must not be restricted for use solely for the project to be financed. Donations may be deemed so restricted by action of the organization’s governing board or by the donor.

If a donor specifies a donation is for a particular purpose, and the exempt organization is required by state law to observe that donor restriction, then the donation may not be invested while bond proceeds are used in its place for the project.²⁰⁶ Less obvious, perhaps, is the situation where capital campaign solicitation materials represent to potential donors that their donations will be used solely for a project, and donors respond to those materials. In that case, bond counsel may find that bonds may not be used for that project in lieu of those donated funds.

Charitable organizations also must use care when using “naming rights” to induce donations. If donors expect their donation will be used for a building, room, or other part of the project named for them, this may cause bond counsel to find that bonds may not finance those named facilities. If, on the other hand, donations at specified levels to a multi-purpose capital campaign are recognized with signage or naming rights to a facility with no restriction by the donor that the funds must be used on that facility, it may be possible to use bonds to finance the named facility.

The governing board of a charitable organization may also create replacement proceeds if it earmarks capital campaign funds in a way that prevents the subsequent use of bonds in lieu of capital campaign funds. If a board authorizes a capital campaign for the sole purpose of constructing a project, then those capital campaign funds must be used for that project. If, however, the board authorizes multiple possible uses of capital campaign funds, for example, building the project, use for future capital improvements, and raising an endowment fund, capital campaign funds may be

205. *Id.* § 1.148-1(c)(1). Replacement proceeds include, but are not limited to, proceeds of bonds outstanding longer than necessary, sinking funds, and pledged funds to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. *Id.* § 1.148-1(c)(4).

206. *See id.*

used for any of those purposes and need not first be used for the bond-financed project.

Issues relating to the use of bonds for projects that are the subject of capital campaigns have not been the subject of specific IRS guidance. It is advisable, therefore, for exempt organization counsel to consult with the bond counsel of the governmental unit that would issue any tax-exempt bonds for a project before the board authorizes capital campaigns and before campaign materials are circulated to potential donors.

All this being said, bonds may be issued to construct a project if the bonds are paid down soon after any earmarked donations are received. Further, if sufficient restricted donations are not raised to complete the project, bonds may be issued to fill the gap. Bond proceeds may be used first, with donor dollars used to complete the project.²⁰⁷ These shorter-term “donation anticipation” bond issues, while helpful, should be the result of intentional financial management on the part of a charity and not the consequence of ignorance of the replacement proceeds rules by its management and counsel.

VI. CONCLUSION

Tax-exempt bonds can provide low-cost, long-term financing for charitable organizations. Because many charitable organizations infrequently have the need for project financing, their management and counsel may find alien the regulations relating to the qualification for, and maintenance of, the tax-exempt status of interest on their debt. Hopefully, this article provides some guidance to permit borrowers’ counsel to opine and advise with confidence on their clients’ tax-exempt bond financings.

207. *See id.* § 1.148-6(d).