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Nonprofit Organizations Committee Legal Quick Hit:

Tax-Exempt Financing for Tax-Exempt Organizations:

Is Your Nonprofit Eligible, and Do the Benefits Outweigh the Costs?

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TUESDAY, JUNE 11, 2013

3:00 p.m. EDT

Overview

- Eligible Organizations: Those qualified under Section 501(c)(3) of the Internal Revenue Code.
- More complicated than the typical bank loan.
- To qualify for tax exemption, the debt must be issued by a government entity, with the proceeds being re-loaned to the exempt organization.
- Typically, the issuer of the debt is a state or local government entity (the “Issuer”) where the exempt organization and its proposed project are located.

Overview (cont'd.)

- Referred to as a "conduit borrowing," with the government entity typically assuming no obligation on the debt.
- Rather, the government issuer serves as a mere conduit to pass the loan proceeds on to the true borrower, the 501(c)(3) conduit borrower, and remitting the debt service payments from that borrower to the lender(s).

Taxable or Tax-Exempt?

Evaluating the Costs:

- Compare the difference in interest rates that can be expected to be available to your organization.
- Spread between tax-exempt and taxable interest rates.
  - Function of the marginal tax rate on taxable interest income.
  - Interest rates vary with a variety of factors:
    - Creditworthiness of the borrower,
    - Assets that borrower has available to pledge,
    - Term of the debt, and
    - Applicable federal and state income tax rates.

Taxable or Tax-Exempt? (cont'd.)

Evaluating the Costs:

- Costs of issuing tax-exempt debt:
  - Fees of a conduit issuer,
  - Bank application and loan fees or an underwriter's commission,
  - Various legal counsel costs,
  - Retaining a trustee (if needed), and
  - Costs for drafting and printing offering documents in the case of a public offering of the debt.
    - Transaction costs are a significant obstacle for transactions under $5,000,000, and remain a factor for larger transactions.
    - A financial advisor can assist in quantifying the potential interest rate savings versus the various transaction costs and provide advice on the overall cost savings potential of pursuing tax-exempt financing.

Taxable or Tax-Exempt? (cont'd.)

Evaluating the Costs:

- Ongoing compliance with federal income tax law requirements.
- Ongoing reporting requirements for the benefit of your lenders.
  - Will generally be the same whether the debt is tax-exempt or taxable.
- Do the potential interest rate savings outweigh the monetary and other incremental costs of tax-exempt financing?

Financing Structure

- Issued by the conduit government issuer.
- In the form of a bond or bonds.
  - Financing labels and structures are also used (e.g., tax-exempt leases).
- Bank placements:
  - Resembles a conventional taxable bank loan.
  - Have only one holder of the debt instrument.
  - Frequently more cost effective than other structures when the transaction size is below roughly $10 million.

Financing Structure (cont'd.)

- Public offerings and private placements:
  - Marketed to multiple bondholders.
  - Bond trustee needed to represent the interest of those multiple bondholders.
  - Placement agent services usually provided by an investment bank.
  - Sold pursuant to an "Official Statement" or a "Private Placement Memorandum."

Credit Enhancements

- Obtaining a credit rating (including Standard & Poor’s, Moody’s, and Fitch).
- Bond insurance policy.
- Backing by a letter of credit issued by a financial institution.

The Typical Process

- Three- to six-month timeline – begin six to nine months ahead.
- Preliminary internal approval.
- Federal income tax law: declaration of intent to finance costs.
- Identify and make application to the appropriate conduit issuer.

The Typical Process (cont'd.)

- Negotiate the basic financial terms.
- Term sheet and a list of parties.
- Obtain and complete application and questionnaire as may be required by the issuer.
  - "TEFRA" notice, hearing and approval process required by federal income tax law:
    a) The holding of a public hearing permitting public comment on the proposed financing.
    b) Formal approval of the financing by a publicly elected official of the issuer.

The Finance Team

- A variety of professionals will typically be engaged in connection with the issuance of the conduit debt on behalf of the 501(c)(3) borrower.
  - The conduit issuer will have personnel responsible for assisting with the issuance process and will have retained outside counsel to represent it in connection with the issuance (“bond counsel” and/or “issuer’s counsel”).
- Private placement, with a single bank being the sole lender.
  - Bank will usually retain its own internal or external counsel (“bank counsel”).

The Finance Team (cont'd.)

- Publicly offered with the assistance of an underwriter.
  - Underwriter retains its own counsel.
- Dual representations: Parties may consent to have a single counsel represent two of the parties so as to reduce the overall counsel fees and perhaps create efficiencies in the issuance process.
- Borrower's legal counsel:
  - Must be familiar with the unique aspects of the tax-exempt financing process,
  - Capable of giving the opinions required to support the tax-exempt status of the debt, and
  - Real estate and construction competencies (as needed).

The Finance Team (cont'd.)

- Borrower's financial advisor:
  - – Underwriter may be a source of financial advice.
    - Disclaimer of fiduciary responsibility to the borrower.
- Swap advisor.
- Conduit issuer: May also have own financial advisor.
- Borrower's accountant: Role depends on the financing structure chosen.
  - – Simple loan structure: copies of audited financial statements.
  - – Public offering will be accompanied by the borrower's audited financial statements.
    - With the consent of the auditor and appropriate diligence procedures.
    - Consult on financial covenant and feasibility issues.

Opinions

- Market requires an opinion of bond counsel supporting:
  - Tax-exempt status of the bond, and
  - Proper issuance of the debt.
- Bond counsel typically requires and relies upon the borrower's counsel for an opinion.
  - Borrower's tax-exempt status.

Opinions (cont'd.)

- Other opinions about regulatory compliance, securities disclosure and the like.
  - Each party's counsel will generally issue an opinion as
    - Authority of the party that it represents to undertake the transaction, and
    - Validity of the approvals of that party to enter into the transaction.
- Diligence and certification requirements imposed on the parties to the transaction.
  - By each legal counsel.

Sale and Closing

- Private placement:
  - Sale and closing are typically combined as one event.
  - Term sheet or commitment letter may be agreed to in advance.
- Publicly sold bonds:
  - Sale and closing components are two distinct events.
    - Separated by one or two weeks.
    - Primary document (the “official statement”):
      - Details the terms of and security for the bonds.
      - Used by the underwriters to market the bonds to potential purchasers.
      - Appendix A: Description of the borrower.

Sale and Closing (cont'd.)

- Period of marketing using the "preliminary official statement."
- Sale of the bonds on a date established in the offering materials.
- Final form of documents prepared incorporating sale terms.
- Closing:
  - All of the bond documents will be completed and signed.
  - Usually the day before "closing."
- Funding:
  - Net bond proceeds available for the use of the borrower (on the closing date).

Federal Tax Law Requirements

- Various requirements as conditions to the exempt status of the interest payable.
- All property to be financed with tax-exempt debt must be owned by a tax-exempt 501(c)(3) organization.
- Alternatively, may be owned by a wholly owned limited liability company or other entity which is “disregarded” as a separate entity from its sole member for federal income tax purposes.

Federal Tax Law Requirements (cont'd.)

- At least 95% of the financed property must be used by the 501(c)(3) conduit borrower in fulfillment of its tax-exempt purposes.
  - 5% allowance (often referred to as the "private business use allowance") that must cover:
    i. Issuance costs funded from debt proceeds, and
    ii. Any uses either
       A. In an unrelated trade or business activity of the 501(c)(3) conduit borrower, or
       B. By third parties that are not themselves tax-exempt 501(c)(3) organizations.

Federal Tax Law Requirements (cont'd.)

- Typical uses that may give rise to private business use subject to the 5% limitation:
  - Unrelated trade or business activity of the conduit borrower (regardless of whether operated at a loss).
  - Leases of unneeded space in a financed facility to a private business.
  - Retention of private managers to operate food service facilities, a gift shop or bookstore.
- "Safe harbor" guidelines
  - Available for a potentially prohibited private use that results from a management and other professional service contract involving bond-financed facilities.
  - Provide permitted combinations of compensation, term and termination provisions.
  - If complied with, ensure that private business use will not be considered to result from such management and service contracts.

Federal Tax Law Requirements (cont'd.)

- No more than 2% of the debt proceeds can be used to pay the issuance costs.
  - "Issuance costs" also count against the 5% allowance for private business use.
  - Excess above the 2% limit must be financed out of equity or a separate, taxable borrowing (often called a "taxable tail").
  - Many borrowers elect to pay all costs of issuance, with equity to preserve the full 5% allowance for private business use.

Post-Issuance Compliance

- Various requirements of federal income tax law:
  - Time of initial issuance of the 501(c)(3) bonds.
  - And so long as any portion of the debt is outstanding.
- Written procedures detailing how and by whom.
- Form 990 – Schedule K: Supplemental Information on Tax-Exempt Bonds:
  - Requires annual reporting regarding
    - Uses of proceeds,
    - Statistics on private business use, and
    - Arbitrage and rebate compliance facts.

Summary

- Historically, 501(c)(3) organizations have found the benefits of tax-exempt debt to outweigh its costs and burdens.
  - But small loan sizes will not justify the additional costs.
- In the current economic environment, with interest rates at historically low levels, the margin of savings between taxable and tax-exempt interest rates may not merit the additional costs and burdens of pursuing tax-exempt debt.

Summary (cont'd.)

- The services of a financial advisor, whether the 501(c)(3) conduit borrower's regular banking relationship manager or a professional dedicated to advising in this area, can be invaluable in assisting with this evaluation.
- The 501(c)(3) conduit borrower's legal counsel may also have expertise in tax-exempt finance and will be a valuable participant on the team that evaluates financing options.

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