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OVERVIEW OF BOND FINANCING FOR 501(c)(3) NONPROFIT ORGANIZATIONS

Introduction. This memorandum provides a brief explanation and overview of tax-exempt Bond financing for 501(c)(3) nonprofit organizations under the Internal Revenue Code of 1986, as amended (the "I.R.C."). Tax-exempt 501(c)(3) Bonds may be issued for most facilities utilized for the exempt purposes of Section 501(c)(3) organizations, as outlined in this memorandum. The principal advantages of such bond financing are the low interest rates and the attractiveness of the debt to lenders and investors. Bond financing may permit a user to build its projects sooner, expand the scope of its projects, or direct its fundraising to other purposes. With facilities financed by low-interest, long-term bonds, fundraising can be directed to other purposes, as well as into debt reduction.

Purpose of this Overview. This brief overview discusses tax-exempt bond financing for 501(c)(3) nonprofit organizations (referred to herein as the "Nonprofit") under the I.R.C. The information provided may be useful in determining whether bond financing will be available in particular cases, how the transaction might be structured and proceed, what advantages exist, and what limitations are imposed. However, Bond Counsel should be consulted early to assist in determining whether a project qualifies and in assuring that the applicable legal requirements will be met.

BOND FINANCING

What is Bond Financing? Bond financing takes the form of loans, or some times leases or installment sales, from a local government entity, often a development authority or development corporation (the "Issuer"). State laws vary concerning Bonds, but they are available in most jurisdictions. The interest rate is low because Bonds issued by the Issuer can be qualified to pay tax-exempt interest to the investors under the I.R.C., and the low interest rate is passed on to the Nonprofit. The money raised from the Bonds is reloaned by the Issuer to the Nonprofit or used to acquire facilities to be leased or sold by the Issuer to the Nonprofit. The loan, lease or sale agreement is pledged by the Issuer as the payment source for the Bonds and the Issuer is not otherwise liable for the Bonds. Bonds offer considerable flexibility in structuring terms, such as variable and fixed interest rates, prepayment and long and short maturities. Tax-exempt Bonds issued to finance facilities for use by governmental bodies and by for-profit organizations are beyond the scope of this discussion, and are addressed in our "Overview of Governmental Financing" and our "Overview of Private Activity Bond Financing and Incentives," available on request.

Why Use Bond Financing? Interest on a qualified 501(c)(3) Bond is exempt from Federal income taxation, alternative minimum tax and, usually, income taxation in the state in which the Bonds are issued. Bond borrowing rates are substantially lower than interest rates on conventional borrowings. Such Bond issues usually are exempt from SEC and blue sky registrations. Another advantage to the use of Bond financing is that the public involvement in the financing can generate substantial community interest in and support for the Nonprofit.

How are Bonds Repaid? Bond financing is normally backed solely by the Nonprofit's credit and any credit enhancement that it furnishes, and sometimes by assets or other security that the Nonprofit may pledge for this purpose. Nonprofits commonly utilize bank letters of credit or other forms of "credit enhancement" such as bond insurance to back Bonds issued for their facilities. Credit enhancement assures that the Bonds can be readily sold and obtain the lowest interest rates, as investors examine and rely upon the credit enhancer's financial strength and not the Nonprofit's. The Nonprofit's credit, financial position, operating history and fundraising must be satisfactory to the credit enhancer, however, in order to obtain this type of financing.

Who Buys the Bonds? Tax-exempt Bonds may be publicly sold or privately placed. Bonds, particularly if they are credit enhanced, may be sold to institutional investors and mutual funds, and sometimes individuals, through an underwriter or placement agent. Banks may buy 501(c)(3) Bonds and hold them as loans, although the I.R.C. results in increased rates on bank-held Bonds unless they are "Bank-Qualified" as discussed below.

What are "Bank-Qualified Bonds"? Generally, Banks and other financial institutions holding tax-exempt Bonds are not entitled to a tax deduction for their related carrying costs, or "cost of funds", determined by the ratio of the institution's borrowed funds to its equity, and banks and other financial institutions may find it relatively unattractive to hold tax-exempt Bonds. However, most Issuers that reasonably anticipate issuing not more than $10,000,000 of 501(c)(3) or governmental bonds during any calendar year may designate such Bonds as "Qualified Tax-Exempt Obligations." Such "Bank-Qualified" Bonds are subject to only a 20% disallowance of the allocable carrying cost and are attractive for Banks to hold. For the purpose of determining compliance with the $10,000,000 limitation, obligations of the Issuer and any subordinate entities must be aggregated, together with some obligations of superior entities. Note that an Issuer's Bank-Qualified Bonds may count against the ability of the superior entities to issue Bank-Qualified obligations.

Contents of this Memorandum. The remainder of this memorandum will outline who may issue 501(c)(3) Bonds and for what purposes, the limitations and requirements imposed by state and Federal law on 501(c)(3) Bond financing, the typical structures for such transactions, the steps necessary to complete the same, other incentives, and the role of Bond Counsel.

WHEN A PROJECT IS FINANCEABLE

What is Financeable? 501(c)(3) Bonds may be issued to finance most facilities used for the operation of 501(c)(3) non-profit organizations, such as charities and certain educational and healthcare organizations. No more than 5% of the proceeds of such Bonds may be used with respect to property that meets both of the "private business tests" described below. Outstanding conventional debt or loans in many cases can be refinanced with 501(c)(3) Bonds, if the debt paid costs that are financeable, and Bond Counsel is satisfied with the documentary record.

Private Business Tests. A 501(c)(3) Bond will be disqualified for tax exemption if more than 5% of the proceeds are put directly or indirectly to "private business use" and if payment of more than 5% of the Bonds is directly or indirectly secured by or to be derived from property put to "private business use" (or payments with respect to such property). "Private business use" means use by the 501(c)(3) organization that would be treated as "unrelated taxable business income" or use by others in any nongovernmental trade or business. In less technical terms, although property financed with 501(c)(3) Bonds may be used in the exempt operations of the 501(c)(3) organization and by the general public or governmental units, issues arise when property is used by other persons or entities or by the 501(c)(3) organization itself for non-exempt purposes. Of particular concern are leases, management contracts and similar user arrangements affecting financed property. A 501(c)(3) Bond also will be disqualified for tax-exemption if the private loan financing test is met. The private loan financing test is met if the lesser of 5% of Bond proceeds or $5,000,000 is used directly or indirectly to make or finance loans to persons other than governmental units. An indirect loan may be found, for example, if borrowings are used to finance facilities to be used by less than all of the general public and paid for by user fees. Any private business issues should be analyzed by Bond Counsel in the light of detailed regulations.

Management Contract Safe Harbors. Part or all of facilities to be financed by 501(c)(3) organizations, particularly healthcare organizations, are sometimes managed or operated by for-profit companies. "Safe harbor" guidelines can be used to assure that such arrangements do not impair the tax exemption of 501(c)(3) Bonds. Briefly, the guidelines require that the manager's or operator's compensation be determined by a periodic fixed fee, a capitation fee (an amount per person, regardless of services rendered), a per-unit-of-services fee, or a percentage of gross revenues or expenses, but in no case by a percentage of net revenues or profits. The permitted length of a contract (including all binding renewal options) is limited depending on the type of compensation; the more fixed compensation, the longer a contract may extend. If compensation is based on at least 95% fixed fees, contracts may be for a term up to 15-years; if at least 80% fixed fees, 10-years; if 50% fixed fees or 100% capitation fees (or a combination), 5-years (if the contract is cancellable by the 501(c)(3) within 3 years); if per-unit fees, 3-years (if the contract is cancellable by the 501(c)(3) within 2 years). A special rule applies to new facilities during a start-up period or to facilities primarily providing services to third parties: compensation can be based entirely on a percentage of fees charged, or a combination of per-unit-of-services fees and a fixed fee (or during the start-up period, a percentage of gross revenues, adjusted gross revenues or expenses), if the contract has a term of 2-years or less (cancellable by the 501(c)(3) within 1 year).

Intent to Finance Costs Must be Documented. For facility costs paid prior to the Bond issue to be financed with tax-exempt 501(c)(3) Bonds, an "official intent" to finance those costs must be declared not later than 60 days after the payment of such costs. A simple form of such declaration is a resolution of the board of directors of the 501(c)(3) organization evidencing such intent. An "official intent" must declare an intent to finance, establish a maximum amount of debt covered and generally describe the project. Bond counsel should be consulted to determine the sufficiency of an "official intent." An "Inducement" (discussed below under "Procedural Steps") by the Issuer also will serve as a declaration of official intent. If a declaration of official intent is made, Bonds generally may be issued as late as 3 years after the declaration and within 18 months after the facilities are completed. There is no downside to adopting an "official intent," as it only preserves the possibility of using Bonds in the future.

Disqualified Uses. In no event may proceeds of a 501(c)(3) Bond be used to provide an airplane, private luxury box, gambling facility or liquor store.

BOND ISSUERS

State Law. Bonds for 501(c)(3) organizations must be issued by governmental authorities. Virtually all states authorize Bond financing, and the types of Issuers and the projects that they may finance vary. Frequently included in financeable costs are preliminary studies, direct costs of the project, attorneys' fees and other financing and issuance costs, interest paid during construction and certain reserve funds. For illustrative purposes, several of the Issuers in the State of Georgia are described below.

Development Authorities. Created by statute in every Georgia city and county, and active in many, Development Authorities may issue 501(c)(3) Bonds to finance the acquisition, construction, improvement, modification, renovation or rehabilitation of any land, buildings, structures, facilities, fixtures, machinery, equipment, furniture or other property, provided that a majority of the directors of the Development Authority determines by resolution that the project will develop and promote trade, commerce, industry and employment opportunities for the public good and general welfare, and will promote the general welfare of the State. No facility may be financed by a Development Authority unless it will increase or maintain permanent employment in the jurisdiction to some degree. A number of regional Development Authorities also have been created in Georgia.

Downtown Development Authorities. Downtown Development Authorities also can be activated in any incorporated municipality in Georgia. A Downtown Development Authority may finance 501(c)(3) projects that the Authority determines will further the public purposes for which it was created. However, Downtown Development Authorities may finance projects only in designated downtown development areas.

Healthcare Authorities. Residential Care Facilities for the Elderly Authorities and Hospital Authorities also exist or can be activated in each county, with the capacity to issue 501(c)(3) Bonds for certain healthcare projects.

Constitutional Authorities. In approximately two-thirds of Georgia's counties, special authorities have been created by amendment to the Georgia Constitution with powers to issue Bonds. The particular legislation must be consulted in each instance.

ARBITRAGE

Arbitrage Restrictions. Bonds are not entitled to tax exemption if they are deemed "arbitrage bonds." Arbitrage rules are complex, and only a brief sketch is provided below. Bonds are arbitrage bonds if more than the lesser of 5% or $100,000 of amounts treated as bond proceeds are reasonably expected to be used, or to replace funds used, directly or indirectly to acquire higher yielding investments. Amounts treated as bond proceeds can include amounts pledged to payment of Bonds, or sinking funds or other funds from which repayment of Bonds may reasonably be expected to be made. The concept of "investments" is broad, including virtually any contract or property to which a rate of return can be ascribed. Exceptions are made for investment of proceeds during certain temporary periods, including the temporary investment of monies in a bona fide debt service fund and in a fund for proceeds awaiting use. The temporary period for investment of proceeds pending use for the acquisition or construction of property is three years. Amounts in a reasonably required reserve or replacement fund are not subject to investment yield restrictions, provided that the reserve or replacement fund cannot generally exceed 10% of the proceeds of the issue.

Replacement Funds and Fundraising. If Bonds finance facilities for which other funds were earmarked, these funds (as well as other School funds that secure repayment of the Bonds or having a sufficient "nexus" to the Bonds) may be subject to arbitrage yield restriction. This can occur when fundraising will be conducted in connection with the project. Bond counsel should be consulted early to ascertain whether such "replacement funds" are created.

Arbitrage Rebate. Even though Bonds may comply with the arbitrage rules referred to above, arbitrage earnings in excess of the yield on the Bonds must be rebated periodically to the federal government. The rebate rules require that periodic computations and filings be made. However, there are limited "2-year construction," "18-month" and "6-month" exemptions from the rebate requirement. The ability to comply with the appropriate exemption may influence the timing of when the Nonprofit will want to close the Bond issue.

2-Year Construction Exemption. The construction exemption applies to financings where at least 75% of the "net proceeds" of the obligations are to be used for construction, reconstruction or rehabilitation. The rebate requirement does not apply if the net proceeds are expended in accordance with the following minimum requirements: 10% within six months; 45% within one year; 75% within 18 months; and 100% within two years (except that the two year period may be extended to three years if the requirement would have been met within two years but for a reasonable retainage not exceeding 5% required to ensure compliance with the terms of a construction contract). "Net proceeds" includes the proceeds of the issue (except for amounts placed in a reasonably required reserve fund) plus investment proceeds earned before the close of the period. If, however, an election is made on the closing date, net proceeds excludes interest earnings on any reasonably required reserve fund, but interest earnings on such fund will be subject to the rebate requirement from the closing date, rather than from the end of the two-year expenditure period. If an election is made on or before the closing date to pay a penalty in lieu of payment of the rebate amount, the rebate requirement is deemed to be satisfied if the Issuer pays a penalty with respect to the close of each six-month period after the closing date equal to 1.5% of the amount of the net proceeds of the issue, which as of the close of such period are not spent as required.

18-Month Exemption. An exemption from the rebate requirement applies if all gross proceeds (except for proceeds placed in a reasonably required reserve fund) are expended in accordance with the following schedule: At least 15% within 6 months; at least 60% within 12 months; and 100% within 18 months (with an exception for reasonable retainage spent within 30 months).

Six-Month Exemption. An exemption from the rebate requirement applies if all gross proceeds (except for proceeds placed in a reasonably required reserve fund) are expended within six months.

Limitation of Exemptions. Compliance with the construction, 18-month or 6-month exemptions does not relieve the obligation to rebate arbitrage from investment of a reasonably required reserve fund or arbitrage on a bona fide debt service fund in excess of $100,000 per year.

OTHER LIMITATIONS

Length of 501(c)(3) Bond Financing. The average maturity of a 501(c)(3) Bond issue is limited by Federal law to 120% of the average reasonably expected economic life of the project financed. Average economic life must be weighed by taking into account the respective costs of the components of the project. Economic life is to be determined as of the later of the date a Bond is issued or the date facilities are placed into service. Midpoint lives under the old ADR system for personal property and guideline lives under Revenue Procedure 62-21 for buildings may be treated as safe harbors for determining economic lives. Land generally is not to be taken into account in determining the average.

Federal Guaranty Prohibition. 501(c)(3) Bonds are not entitled to tax exemption if the payment of principal or interest is directly or indirectly guaranteed in whole or in part by the United States or any of its agencies or instrumentalities. Bonds will be treated as guaranteed by the federal government if 5% or more of the proceeds are used to make loans guaranteed by the federal government or to invest in federally insured deposits or accounts. Exceptions are made to permit proceeds to be invested in United States Treasury obligations and to permit investments of bona fide debt service funds, reasonably required reserve funds, and funds to hold proceeds prior to their initial use.

Speculative Projects. Compliance with several provisions of Federal and state law requires that the particular assets to be financed with a 501(c)(3) Bond be ascertained with reasonable certainty prior to issuance. A 501(c)(3) Bond generally cannot be issued to finance undetermined projects or contingencies, or in an amount substantially in excess of that required for the project.

Issuance Costs. No more than 2% of the proceeds of a 501(c)(3) Bond may be used to pay costs associated with the issuance of the Bond. Any excess costs may be paid from other sources.

Change in Use. A change in use of a facility financed with a 501(c)(3) Bond to a use for which such a Bond could not have been issued may result in the interest on the Bond becoming taxable or other consequences.

INDUCEMENT

Inducement Resolutions. Although not necessarily required, the first step in a 501(c)(3) Bond transaction normally is obtaining an inducement resolution and agreement from the Issuer (the "Inducement"). This constitutes an agreement in principle by an Issuer to issue Bonds for a proposed Project. The Inducement can serve as the declaration of "official intent" discussed above, in lieu of a School's board resolution.

Expiration. An Inducement may or may not have an expiration date. In any event, a 501(c)(3) Bond must be issued within three years after the declaration of official intent and eighteen months after the later of the date a Project is acquired or placed in service.

FORM OF TRANSACTION

General. Because a 501(c)(3) Bond transaction utilizes an Issuer as an intermediary, the transaction takes a form different from a conventional financing transaction. The exact form to be used depends on the desires of the parties and local requirements. In any transaction the Issuer sells the Bond and makes the proceeds available for the Project. Three forms of transaction commonly are used: loans, leases and installment sales.

Loans. An Issuer may be authorized by statute to loan 501(c)(3) Bond proceeds to a Nonprofit for use on a project. When this form is used, the Nonprofit enters into a loan agreement with the Issuer and usually gives its note to evidence the loan. The Issuer will assign the loan agreement and note as security for the Bond. The Nonprofit holds title to the project in such a transaction. This is the simplest and most common arrangement.

Leases. Most Issuers can, and some Issuers must, own the project financed and lease it to the Nonprofit. When such form is used, the project site normally is conveyed to the Issuer and the project is constructed or acquired in the name of the Issuer with the proceeds from the Bond. The project is then leased to the Nonprofit, which agrees to pay rents to be applied to service principal and interest on the Bond. The Issuer assigns its rights under the lease as security for the Bond. When the Bond is paid, the Nonprofit normally purchases the project at a nominal purchase price.

Installment Sales. An installment sale transaction sometimes is used. This type of transaction is similar to the lease transaction in that the Issuer takes title to the project. Instead of leasing the project to the Nonprofit, the Nonprofit enters into an installment sale agreement whereby it agrees to pay purchase price installments equal to debt service on the Bond. Title to the project may be conveyed to the Nonprofit immediately or upon payment of the Bond.

Nonprofit's Control Over Project. Under any arrangement, loan, lease or sale, the Nonprofit normally is responsible for insurance, taxes and maintenance, has freedom with respect to design and construction, and may be regarded as the project "owner" for all practical purposes. During the term of the financing, the Nonprofit has essentially the same control over the project as under conventional financing. Furthermore, covenants and security devices usual in conventional lending normally can be incorporated in the Bond transaction.

Credit for Bonds. Regardless of the form of the transaction, *usually* neither the Issuer, the local government nor the state provides any credit for the Bonds. The bondholders look to the underlying obligation of the Nonprofit and any guaranties, mortgages, security instruments, insurance, letters of credit or other funds or credit enhancements that may be provided as arranged by the Nonprofit to pay the Bonds.

"Variable Rate Demand Bonds" Specialized methods of financing have developed in the Bond area that provide highly favorable terms. The "variable rate demand bond (VRDB)" or "lower floater" method of financing accesses short-term markets for a longer-term stated maturity, but with a "put" option whereby the bondholder at regular intervals (usually weekly) may cause the Bond to be repurchased on behalf of the Nonprofit. Because of the "put" feature, a variable rate demand Bond can be sold in the short-term market, which involves the lowest interest costs. Such a Bond bears interest at rates that may be reset by a remarketing agent. A variable rate demand Bond may be held by a particular holder for any period and normally would be "put" if the holder has other needs for its funds or market interest rates have shifted upward such that the rate borne by the Bond is not currently attractive. If a lower floater Bond is "put" because of an upward shift in rates, the remarketing agent will set a new, higher rate at which a remarketing agent can re-place the Bond; if market rates fall below the Bond rate, the agent will reset the rate at the lowest rate that will avoid the Bond being "put." A credit facility of a rated institution must be available to advance the repurchase price of any variable rate demand Bond that is "put" back.

PROCEDURAL STEPS

Bond Placement. After an Inducement is obtained and Bond Counsel has determined that the transaction can be appropriately structured as a 501(c)(3) Bond project, generally the Nonprofit will place the Bonds, generally through an investment banker or underwriter. Bonds may be privately placed, for example, with an investor group or a financial institution, placed with a mutual fund or sold publicly. Disclosure documents normally are prepared when a bond fund or public sale is utilized. Depending on the nature and number of the bondholders, a trustee may be appointed for the issue.

Legal Documentation. When the type of Bond sale has been determined, the terms and provisions of the Bond and the related documents must be negotiated and settled upon. Bond Counsel will prepare most of the necessary documentation for the transaction. Provided that a declaration of official intent has been made, the acquisition and construction of the Project could be commenced during this period if funds are available.

"TEFRA" Hearing. Federal law requires that a public "TEFRA" hearing be held at least 14 days after the giving of published notice apprising the community of a proposed 501(c)(3) Bond and the nature and the location of the project. Following such public hearing, both the Issuer and an appropriate elected official or legislative body with jurisdiction over the project must approve the Bond.

Validation and Other Procedures. States frequently require additional procedural steps prior to the issuance of a Bond. For example, most Bonds in Georgia must be judicially validated in a proceeding to which the State, the Issuer and the Nonprofit are parties. Another public notice must be published in advance of this proceeding. Both the TEFRA and the state procedures affect the closing date.

Information Report. In connection with the closing of the transaction, an information report providing details of the 501(c)(3) Bond, the Issuer, the Nonprofit and the project must be filed with the Internal Revenue Service.

LIVING WITH A BOND ISSUE

After Bonds are issued, there are only a few obligations of the Nonprofit that are different from a conventional loan. Principally, the Nonprofit must remain its 501(c)(3) status and the project must not be used by for-profit entities or operations. The Nonprofit must avoid arbitrage practices and pay arbitrage rebate if an exemption does not apply.

BOND COUNSEL

Counsel experienced in municipal bond law should be retained to serve as Bond Counsel. The function of Bond Counsel is to structure and document the transaction and to issue an opinion on the validity and tax status of the Bond. Fees of Bond Counsel are payable by the Nonprofit from Bond proceeds. Bond Counsel may represent other parties or the Nonprofit, the Issuer and the Bond purchaser or underwriter may be separately represented. Smith, Gambrell & Russell, LLP is a "Red Book" listed Bond Counsel firm.

SUMMARY

This memorandum has been designed to provide a brief overview of 501(c)(3) Bond financing. Tax-exempt Bonds may provide significant advantages, but are subject to extensive regulation on the federal and/or state levels. This outline can do no more than touch upon some of the more salient issues and must not be regarded as an in-depth treatment on all legal issues. Instead, this Overview provides some basic information that may serve as the basis for further discussions with Bond Counsel.

James P. Monacell

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MATERIALS AVAILABLE ON REQUEST

1. How Counties Borrow
2. How Cities Borrow
3. How School Systems Borrow
4. Living With a Governmental Bond Issue – A Compliance Guide
5. How To Live With a 501(c)(3) Bond Issue
6. Overview of Private Activity Bond Financing and Incentives
7. Overview of Governmental Financing
8. Overview of Bond Financing for 501(c)(3) Nonprofit Organizations
9. Overview of Bond Financing for Nonprofit Schools
10. Overview of Tax-Exempt Financing for Nonprofit Hospitals
11. Overview of Revised Special Purpose Local Option Sales Tax (SPLOST) and Related Financing
12. Overview of Special Purpose Local Option Sales Tax for Educational Purposes (Education SPLOST) and Related Financing
13. Overview of Lease-Purchase Financing and COPs
14. Overview of Georgia Debt Referendum Requirements
15. Overview of Continuing Disclosure Requirements for Tax-Exempt Bonds
16. Regional Solid Waste Management Authorities
17. Taxable Versus Tax-Exempt Bond Financing for Project Financing
18. Georgia Ad Valorem Tax Incentives through Bond – Lease Transactions in Georgia
19. Community Improvement Districts as a Tool for Infrastructure Financing
20. Reimbursement of Prior Expenditures with Bond Proceeds – Final Reimbursement Bond Regulations
21. Requirements for a "True Lease" for Exclusion From Treatment as a Capital Expenditure
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