OLR RESEARCH REPORT

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501 (c) (3) BONDS

By: John Rappa, Chief Analyst

You asked for background on 501 (c) (3) bonds.

What are 501 (c) (3) bonds?

501 (c) (3) bonds are federal tax-exempt bonds municipal and state agencies, usually quasi-public authorities, issue on behalf of a nonprofit organization to finance a capital project or for other purposes permitted by the federal Internal Revenue Code (IRC). Because the agencies issue bonds on behalf of other organizations, the bonds are often referred to as "conduit" or "pass through" bonds. Further, the organizations must repay the bonds, not the issuing agency or the state.

Other types of tax-exempt bonds include mortgage revenue bonds, which help low- and moderate-income people purchase their first homes; industrial revenue bonds, which help manufacturers build, expand, or renovate facilities; and student loan bonds, which help students pay college tuition. Federal law imposes an annual cap on the amount of bonds each state can issue for these purposes, but the cap does not extend to 501 (c) (3) bonds (IRC § 146 (g) (2)).

Are the benefits of a 501 (c) (3) bond different than those of other tax-exempt bonds?

Sandra Norman-Eady, Director
Phone (860) 240-8400
FAX (860) 240-8881
http://www.cga.ct.gov/olr

Connecticut General Assembly
Office of Legislative Research

Room 5300
Legislative Office Building
Hartford, CT 06106-1591
Olr@cga.ct.gov

No. As with other tax-exempt bonds, 501 (c) (3) bonds benefit borrowers and investors. Borrowers benefit because they pay less interest on these bonds than they would on a taxable bond or bank loan. Investors benefit because the interest they earn on the bond is exempt from federal income taxes. Consequently, "the investor requires less interest to produce the same after tax return as taxable debt would produce" (*Nonprofit Corporations: Borrowing with Tax-Exempt Bonds*, Roger L. Davis (2001) http://www.orrick.com/fileupload/172.pdf).

Are all nonprofit organizations eligible for 501 (c) (3) bond financing?

Yes, if they meet the federal criteria for tax-exempt organizations, which are delineated in § 501 (c) (3) of the IRC. Based on those criteria, an organization qualifies as a 501 (c) (3) organization if it serves religious, charitable, scientific, literary, or educational purposes; fosters national or international sports competition; or prevents cruelty to children or animals. The organization must obtain a letter from the Internal Revenue Service (IRS) affirming that it meets the criteria (i.e., determination letter).

An IRS-certified nonprofit organization can request 501 (c) (3) bond financing for a range of activities, but most 501 (c) (3) bonds finance capital projects, including new facilities, infrastructure improvements, and machinery and equipment purchases. These projects must be owned by the nonprofit organization and used for its purposes.

501 (c) (3) bonds can also refinance bank loans and mortgages that finance capital projects that would have qualified for 501 (c) (3) bond financing or reimburse capital expenditures that were incurred after the bonds were issued or not more than 60 days before the nonprofit organization notified an issuing agency about requesting a bond for this purpose.

501 (c) (3) bond proceeds can be use for working capital, but "the tax rules governing the tax-exemption generally make such financing impractical, except in some cases for an amount not exceeding 5% of the bond proceeds (net of reserves) if used as working capital in connection with the project being financed with the balance of the bond issue" (Davis).

Lastly, 501 (c) (3) bond proceeds can be used to cover several types of financing costs. Up to 2% of the proceeds can be used to cover bond underwriter, bond counsel, rating agency, and trustee fees. They can also be used to make interest payments during a specified time period and create debt reserves.

Are there other factors besides lower interest rates nonprofit organizations should consider when considering 501 (c) (3) bond financing?

Yes. It generally costs more to issue a 501 (c) (3) bond than to underwrite a bank loan. "Higher transaction costs result from two factors: (1) the special legal opinions needed to verify the tax-exempt status for investors; and (2) the costs associated with selling debt on public credit markets, including credit ratings, printing, trustee fees, and investment banking fees." Consequently, "these higher transaction fees offset the savings from tax-exempt interest rates such that a minimum debt sale of several million dollars is often necessary for tax-exempt bonds to be financially beneficial," he concluded (Seidman, *Economic Development Finance* (2005), pp. 342-43).

Another factor that could affect the bond transaction costs is whether the nonprofit organization needs a "credit enhancement" to attract investors. Credit enhancements, such as letters of credit and bond insurance, help organizations lacking the financial wherewithal to back bonds by themselves by applying a third party's financial strength to shore up the bond. But a third party's willingness to lend its credit worthiness depends on the nonprofit organization's credit, financial position, operating history, and fundraising capacity.

How are 501 (c) (3) bonds issued?

The process for issuing 501 (c) (3) bonds varies with the government agencies authorized to issue them. (In Connecticut, these bonds are issued by the Connecticut Development Authority, Connecticut Housing Finance Authority, and Connecticut Health and Educational Facilities Authority.) Despite the variations, the process generally involves seven general steps, Richard A. Newman, an attorney with the law firm Arent Fox LLP, stated.

- Inquiry: The nonprofit organization determines if it is feasible to finance a project with a 501 (c) (3) bond and identifies government agency to issue the bond (i.e., issuer).

- Discussion: The organization and the issuer discuss the proposed project and the organization formally notifies the issuer that it intends to use 501 (c) (3) bond financing.

- Letter of Intent or Application: The organization submits a letter of intent or application to the issuer, along with supporting information.

- Administrative Review: The issuer reviews the application and supporting material.

- Resolution: The issuer's board of directors or governing bond adopts a resolution authorizing the bond issuance.

- Preparation of Bond Documents: The issuer's bond counsel, the bond underwriters, and the banks or other institutions providing a credit enhancement prepare the documents for transacting the bond sale.

- Closing: The organization adopts a final resolution approving the project based on the terms and conditions specified in the bond documents and sells the bond (Newman, *Tax-Exempt Financing for Nonprofit Facilities*, (undated), http://www.accessnationalbank.com/home/fiFiles/static/documents/taxexempt_financing_nonprofits_.pdf).

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