Everything You Always Wanted To Know About Tax-Exempt 501(c)(3) Bonds But Didn't Know How To Ask

WILLIAM L. NUSBAUM

Partner

Norfolk, VA

T 757.629.0612

F 757.629.0660

wnusbaum@williamsmullen.com

1) What is a tax-exempt bond?

A bond is basically a promise to pay - essentially a promissory note issued by a business or government to evidence its obligation to repay a loan.

2) What or who is an "issuer?"

The common term for giving a bond to evidence a repayment obligation is to "issue" the bond, therefore the party doing so is often called the "issuer." Bond issuers can be a business like General Motors, or a government or political subdivision, such as the U. S. Government, the Commonwealth of Virginia or a local industrial or economic development authority, or EDA, for short.

3) Can the Commonwealth or a City make your non-profit a loan?

No, under the Virginia Constitution, the Commonwealth and its localities cannot make loans to private for-profit businesses and non-profit charities. But this prohibition does not extend to a locality's EDA.

4) Why is the interest on some bonds exempt from taxation?

The exemption from federal income taxation of the interest on some bonds comes from the Internal Revenue Code. The premise behind this tax exemption is that Congress wanted to make it cheaper for state and local governments to borrow money, so it exempted the interest on their bonds from federal income taxation. Many states, including Virginia, feel the same way, and also exempt the interest on bonds issued by states, local governments and other political subdivisions from state income taxation, giving rise to the often-heard phrase that a bond is "double tax-exempt." The reason it's cheaper to borrow money using tax-exempt bonds is that the bondholder won't require as high an interest rate to induce him or her to purchase the bond if the interest won't be taxed.

5) Are there limits as to how tax-exempt bond proceeds can be spent?

Over the past 30 years, Congress and the IRS have greatly limited what tax-exempt bond proceeds can be spent on, how they can be invested until they're spent, and how fast they must be expended. As a result, there are now numerous restrictions on how non-profits can use tax-exempt bonds; the Internal Revenue Code calls those which meet all the restrictions "qualified 501(c)(3) bonds."

6) What are some of the key rules?

- All real estate or personal property acquired or constructed with the money raised from an issue of qualified 501(c)(3) bonds must be owned by the non-profit for whom the bonds are issued.
- Not more than 5% of the bond-financed assets can be used for any private business purpose, nor may more than 5% of the principal of the bonds or 5% of the interest payments be secured by property used in a private business.
- You cannot spend more than 2% of the money you get from the bond issue on "issuance costs," which are transaction costs related to the issuance of the bonds. Any issuance costs which exceed 2% of the bond proceeds will have to be paid from your equity contribution, or else from a conventional loan.
- Closing costs - such as recording costs, title insurance costs, and even legal fees related to real estate matters - can be considered as real estate transaction costs, and not subject to the 2% cap on issuance costs.

7) Are there any restrictions on working capital?

No. A 501(c)(3) bond borrower can finance working capital, if its bond purchaser is willing for it to do so.

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8) What are the time-critical rules governing the commencement of the project?

- For your non-profit to be able to reimburse itself from bond proceeds for project capital expenditures incurred before the bonds are issued, your board of directors or an authorized board committee must officially declare your intent - typically by the adoption of a resolution - to make that reimbursement.
- All tax-exempt bonds for non-profits, except for bonds which refinance outstanding bond issues without extending their final maturity date, must go through a multi-step “public approval process” prescribed by both federal tax laws and regulations, as well as Virginia law.
- The EDA to which you apply for the issuance of bonds must hold a public hearing on the proposed issuance, after first advertising it in a local newspaper once a week for 2 weeks, beginning 14 days before the date of the hearing.
- Also before the public hearing, you will need to file with the EDA its bond application, a resolution of intent for the EDA to approve after the public hearing, and a Fiscal Impact Statement, which shows the employment and tax revenues, if any, that your project will generate.

9) What will happen at the public hearing?

The public hearing will be conducted by the EDA’s Board of Directors. At the start of the public hearing, you will be asked to tell the EDA about your proposed project. After the public hearing and your presentation, the EDA Board will discuss - and presumably adopt - your inducement resolution. The resolution will recommend to the City Council (or County Board of Supervisors, if the project is in a county) that it grant “public approval” of the proposed bond financing.

10) What happens in the public approval process?

EDA staff will forward to the City Council or County Board a summary of the public hearing, the adopted inducement resolution, the Fiscal Impact Statement and any other documentation which that locality’s standard procedures require. Typically, it will be 2 to 3 weeks before your proposed bond issue gets onto the governing body’s docket. You must attend this meeting, too.

11) How will the bonds be sold?

- The EDA can issue just one bond, in the full amount that you seek to borrow, and, in accordance with your instructions, sell it to just one bond purchaser.
- If you work with several banks and each wants to make a portion of your loan, you can have the EDA issue several bonds - one to each lender.
- It may be desirable for you to arrange for the bond to be issued as a “bank qualified” bond, which can result in lower transaction costs and a lower interest rate. You need to make this determination before you begin the public approval process. Wells Fargo Bank, Bank of America (on a limited basis), SunTrust, BB&T, TowneBank, Old Point National Bank, Heritage Bank and Virginia Company Bank have all advised that they are interested, in principle, in purchasing a BQ bond to fund a charity’s capital project.
- For a larger financing, you may be able to access the public bond market and sell your bonds through an underwriter or placement agent to institutional lenders (such as bond funds) and to retail bond purchasers who purchase them through their brokers.

12) How is a bond “refunded?”

Tax-exempt bonds can also be refinanced from time to time - the technical term is they can be “refunded.” To refund a bond issue, you must go back to the EDA for it to adopt a resolution approving the refunding. Reasons for refunding your bonds include lowering the interest rate, eliminating restrictive lending covenants, extending final maturity or borrowing new money and rolling an outstanding financing over into the new one.

13) Are bonds cost-effective for your project?

A common rule of thumb is that if you’ll recover the difference in transaction costs from using tax-exempt bonds in your first three years of debt service savings, then it’s worth using bond financing.