

**FINANCING CAPITAL
PROJECTS FOR
NONPROFITS, USING
TAX-EXEMPT BONDS**

Presented by Bill Nusbaum

WILLIAMS MULLEN

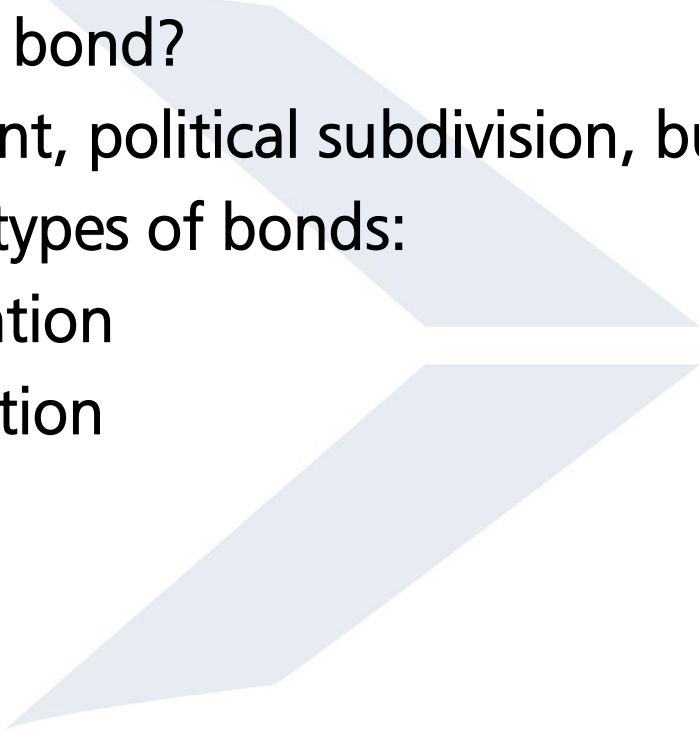
What is a bond?

- It's simply a written promise to repay a loan.

Who can issue a bond?

- Any government, political subdivision, business or nonprofit

There are many types of bonds:

- General Obligation
 - Limited Obligation
 - Conduit
 - Taxable
 - Tax-exempt
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What is an EDA or IDA, and why are they needed?

- An Economic (or Industrial) Development Authority is a political subdivision of the Commonwealth of Virginia, formed to make loans and provide other types of incentives to businesses and nonprofits, generally in its locality.
- The Virginia Constitution forbids localities from lending their credit (i.e., making loans) to private businesses, including nonprofits, but an EDA is allowed to do so.
- Because a loan by an EDA, such as a conduit bond, is being made by a political subdivision of the state, the interest on it may be exempt from federal & Virginia income taxation.

Why are tax-exempt bonds good for a borrower?

- If the purchaser of a tax-exempt bond (i.e., the lender) doesn't have to pay income taxes on the bond interest it receives, it doesn't have to charge as high an interest rate to get the same yield from the loan.
- The maximum federal corporate income tax rate is 21%, while the maximum Virginia corporate income tax rate is 6%, so the combined income tax rate for corporations in Virginia is 27%.

- To estimate the interest rate savings by using a tax-exempt bond instead of a conventional loan, just multiply 27% by the conventional interest rate at which you could borrow. For example, if you could borrow a conventional loan at 5%, $27\% \text{ of } 5\% = 1.35\%$, so your tax-exempt bond rate (for a fixed rate bond) would be $5\% - 1.35\% = 3.65\%$.
- So, as an example, if your nonprofit needed to borrow 3 million dollars, a 1.35% interest rate reduction would save your nonprofit \$40,500 in the first year, a figure which would slowly shrink as the principal balance of the bond is paid down. But there's a lot of savings to be had.

- Also, as your nonprofit looks for a lender to buy its bond, remember that the maximum federal income tax rate for individuals is much higher, at 37%, and the Virginia maximum income tax rate for individuals is 5.75%, for a maximum combined tax rate of 42.75%. So, if your nonprofit has a wealthy donor who is willing to buy your bond, the interest rate reduction from selling the bond to your donor could be much larger: $42.75\% \times 5\% = 2.1375\%$, resulting in a tax exempt rate of $5\% - 2.1375\% = 2.8625\%$. On that same 3 million dollar borrowing, the first year interest savings could be \$64,125 if you had an individual bondholder.

FIRST STEPS FOR YOUR BOND FINANCING



The rules that tax-exempt bonds must follow are complex, and are found in the federal tax code and regulations, and also in state law. But you don't need to tackle these rules on your own; a small group of attorneys known as "bond counsel" make a career of knowing these rules and helping their clients successfully navigate them. When you first start to consider using tax-exempt bonds for your project, you should hire bond counsel to assist you.

The first rule we'll discuss deals with your nonprofit's ability to reimburse itself for its capital expenditures before the bond is issued and sold.

FIRST STEPS FOR YOUR BOND FINANCING



- For a bond borrower to reimburse itself from the proceeds of a bond issue for capital expenditures incurred before the bonds are issued, there must be a “declaration of official intent” to make that reimbursement.
- This is done by an Official Intent resolution (sometimes called an Official Action, or Inducement, resolution).
- For a nonprofit, the Official Intent resolution may be adopted by a bond issuer, such as an EDA, or by the nonprofit’s Board of Directors.
- Once the Official Intent resolution has been adopted, capital expenditures incurred up to 60 days before the resolution’s adoption date can be reimbursed from the proceeds of the bond when it is issued.

FIRST STEPS FOR YOUR BOND FINANCING



- In addition, up to 20% of the bond proceeds can be used to reimburse certain preliminary expenditures, such as architectural, engineering, surveying, soils testing, etc., even if incurred more than 60 days before the Official Intent resolution's adoption.
- Thus, it is VERY important, when starting a capital project that you're considering bond financing, that you have your Board of Directors adopt an Official Intent resolution.

The next rule we'll discuss also relates to the beginning of your capital project.

FIRST STEPS FOR YOUR BOND FINANCING



- All tax-exempt bonds that finance “private activity” (i.e., not “governmental uses”) must go through a multi-step “public approval process” prescribed by both federal tax laws and regulations and Virginia law. New federal tax regulations were just issued, and will apply to the public approval of bonds occurring after April 1, 2019.
- The bond issuer (e.g., the EDA) must hold a public hearing on the bond’s proposed issuance. Virginia law requires the public hearing be advertised once a week for 2 weeks in a newspaper of general circulation in the locality where the project is located. The new federal regulations only require the public hearing be advertised once, 7 days in advance.

FIRST STEPS FOR YOUR BOND FINANCING



- But, for at least through the 2020 General Assembly, the state law rule of 2 weeks of advertising will control, since no bill was introduced in the current General Assembly session to conform the Virginia public approval law to the brand new federal public approval regulations.
- For decades, both federal regulations and Virginia law required advertisement of the public hearing in a local newspaper, which entailed significant expense.
- Starting April 1, the new federal regulations will only require posting the notice of public hearing on the website of the bond issuer or the locality on whose behalf the bond issuer operates.

FIRST STEPS FOR YOUR BOND FINANCING



- However, at least until July 1, 2020, Virginia law will still require you to go the more costly route of publishing the notice in a local newspaper.
- Your bond counsel will handle the drafting and submission of the notice of public hearing to the newspaper. It will need to be submitted 17-20 days before the public hearing.
- About the same time as the notice of public hearing first appears in print, you will need to submit a bond application package to the bond issuer. Most issuers have their own form that must be completed, and will ask for details and exhibits about your nonprofit's history, finances and organizational structure, and the proposed capital project.

FIRST STEPS FOR YOUR BOND FINANCING



- Other components of a typical bond application include the proposed resolution for the bond issuer to adopt, a one-page form called a Fiscal Impact Statement (which Virginia law requires), detailing the fiscal impact your project will have on the locality and its economy, and a proposed resolution for adoption by the locality's governing body, after the bond issuer approval.
- Your bond counsel will prepare these documents, assist you with the bond application and assemble and submit the completed bond application package on your behalf.

- The public hearing will be conducted by the bond issuer's board of directors, and typically begins with a senior officer of your nonprofit and your bond counsel describing your organization, the proposed capital project and the financing plans. You should bring at least one officer from your Board with you, who preferably is politically well-connected or knows some of the members of the bond issuer's board.
- After your presentation, members of the public will be given the chance to speak. Oftentimes, no members of the public appear, or if someone does, it will be a civic gadfly type who has something to say at all public meetings. You do not need to respond to criticisms from the gadflies.

FIRST STEPS FOR YOUR BOND FINANCING



- After the public hearing ends, the bond issuer will discuss and presumably adopt your resolution, which will also recommend to the locality's governing body that it grant "public approval" to your bond financing.
- To complete this public approval process, the bond issuer's staff will forward to the locality's governing body a summary of the public hearing, the Fiscal Impact Statement, the Official Intent resolution, the public approval resolution the governing body is being asked to adopt, and any other documentation the locality's standard procedures require.

FIRST STEPS FOR YOUR BOND FINANCING



- Your public approval resolution will typically be put on the agenda for the locality's governing body meeting about 3 to 4 weeks after the bond issuer's approval is obtained. This time period can be compressed, however, with cooperation by those in charge of approving agenda items; recently I had a bond deal approved by the issuer in the morning and by the locality's city council the same evening.
- You, a senior officer from your board and your bond counsel should attend the meeting, prepared to answer any questions members of the governing body may have. You should register with the Clerk of governing body before the meeting, indicating you'll speak only if there are questions.

FIRST STEPS FOR YOUR BOND FINANCING



- A note of warning – if you are seeking to finance projects in more than one locality, you can finance all the projects in one bond issue issued by one issuer, but you will, in most cases, still have to go through the “public approval” process in each locality where you’re using bond financing to fund a project.
- An alternative is to have your bonds issued by the Virginia Small Business Financing Authority, which has statewide bond issuing authority. Its public approval process requires that the notice of its public hearing be published in a newspaper where each financed facility will be located, but only one public hearing need be held, and the Governor provides the public approval, rather than the locality.

FIRST STEPS FOR YOUR BOND FINANCING



- Once all your public approvals have been obtained, your bond counsel will draft and circulate the bond documents for review and commenting by the other parties, and your real estate counsel will work with bank counsel or underwriters counsel on the satisfaction of all the required due diligence and closing conditions.
- When the bond documents are in substantially final form, your bond counsel will prepare a final bond resolution for adoption by the bond issuer, which resolution will authorize the execution and delivery of the bonds and all the bond documents that the bond issuer signs.

A third general rule that's important at the front end of a bond deal is the federal tax law that the nonprofit may not spend more than 2% of the money received from the bond issue on "issuance costs" – transaction costs directly related to the issuance of the bonds.

- Examples of issuance costs include an origination fee or underwriter's discount charged by the bond purchaser, most legal fees, a bond administrative fee charged by the bond issuer at the closing, printing costs if an official statement is required, and so on. Basically, if it's a cost that wouldn't exist in a conventional real estate loan, it's likely an issuance cost.

FIRST STEPS FOR YOUR BOND FINANCING



- Many closing costs for your bond issue, however, can be considered real estate transaction costs, and do not count against the 2% cap on issuance costs. Examples include recordation costs, title insurance, survey, environmental and other due diligence costs, and even legal fees directly related to real estate (rather than bond) matters.
- Any issuance costs exceeding 2% of the proceeds received from the bond issue, however, will have to be paid by the nonprofit, or financed by your lender in a separate conventional loan.

The last item to discuss for the period prior to or at closing is the bond administrative fee. Most bond issuers charge an administrative fee for issuing the bonds and carrying them on their books for years. Most issuers will allow borrowers to choose whether to pay the fee at closing or annually.

- Bond administrative fees paid at closing are generally $\frac{1}{2}$ of 1% of the bond amount or less, and are subject to the 2% cap on costs of issuance.
- If instead, the bond administrative fee will be paid annually, they are capped by federal tax laws and regulations at $\frac{1}{8}$ of 1% of the declining principal balance of the bond issue.

- If your bond will only be outstanding a few years, it may be cheaper to opt for the annual 1/8 of 1% fee. If the bond will have a longer term, and your nonprofit can afford the extra closing cost, you will save money by paying the administrative fee at closing.

Shifting our focus from early stage procedural concerns, let's now look at some of the other federal tax rules that dictate whether your capital project is suitable to be financed with tax-exempt bonds.

RULES GOVERNING 501(c)(3) BONDS



- First, all real estate or personal property bought or built with funds from a 501(c)(3) bond issue must be owned by the non-profit for whom the bonds are issued. A private landlord can't own any of the bond-financed assets. If your non-profit is a tenant under a long-term lease, though, and you want to finance leasehold improvements and other personal property which will remain the non-profit's property, those assets may qualify for bond financing.
- Next, 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.

RULES GOVERNING 501(c)(3) BONDS



- Now, I recognize this is pretty abstract, so here's a concrete example. About 20 years ago, when the Foodbank of Southeastern Virginia was moving to and renovating its present location on Tidewater Drive, I helped it obtain a \$1.5 million bond from the Norfolk EDA. The total \$2.8 million project cost was comprised of a roughly \$1.4 million purchase price for the 75,000 square foot warehouse and office facility and about \$1.4 million in renovation costs.
- However, at the time of the purchase, two warehouse sections totaling about 18,000 square feet (24% of the building) were leased to private businesses under leases which would continue, which would violate the 5% test.

RULES GOVERNING 501(c)(3) BONDS



- To avoid violating the 5% test, we allocated a portion of the Foodbank's \$1.3 million of equity, derived from its capital campaign, to the purchase price of the privately used sections of the building. As a footnote, even a lease to an unrelated 501(c)(3) organization will usually constitute private business use, subject to the 5% limit.
- A third rule, applicable only to non-profits using tax-exempt bonds for multi-family residential rental housing, requires that the project be new construction, or else be a substantial rehabilitation of the property. If you're one of those nonprofits, consult your bond counsel early in the deal to assure your deal complies with this rule.

RULES GOVERNING 501(c)(3) BONDS



- A fourth rule to beware impacts the capital campaign you're likely conducting for your capital project. The IRS considers capital campaign payments to be a type of bond proceeds called "replacement proceeds," and requires that any "available amounts" be applied to pay down the bonds during the first 90 days of each fiscal year of the nonprofit.
- Thus, once construction of the nonprofit's capital project has been completed, capital campaign payments subsequently received cannot be diverted to fund other expenditures; they must be applied to the prepayment of the bonds. The failure to do so can lead to losing the tax-exempt status of the bonds, retroactively to their issuance, and the increase of the bonds' interest rate to the taxable equivalent rate.

RULES GOVERNING 501(c)(3) BONDS



- Nonprofits may also, in theory, finance working capital with tax-exempt bonds, but the rules are very complex and hard to navigate, making such a deal a nightmare to complete. The best course is to keep any working capital financing as small as possible.
- One last limitation on bonds for nonprofits comes from a less likely source – the U.S. and Virginia constitutions. Tax-exempt bonds may not be used to finance places of worship and other pervasively religious facilities. They can be used to finance facilities which don't have a religious use, even if at a religiously-oriented institution.

RULES GOVERNING 501(c)(3) BONDS



- To illustrate, a 501(c)(3) private university such as Regent or Liberty University may use tax-exempt bonds for dorms, classrooms, academic offices and athletic facilities, but not for a chapel or like use.
- If you have a proposed building that will have a mix of uses, some of which aren't eligible for bond financing, whether due to private use (like the Foodbank example earlier) or a disqualified religious use, you may allocate funds from non-bond sources to the portions of the building which won't be eligible for bond financing. Examples of these sources include equity from your cash on hand, capital campaign payments and funds borrowed in a conventional loan.

REFINANCING OR MODIFYING YOUR BOND ISSUE

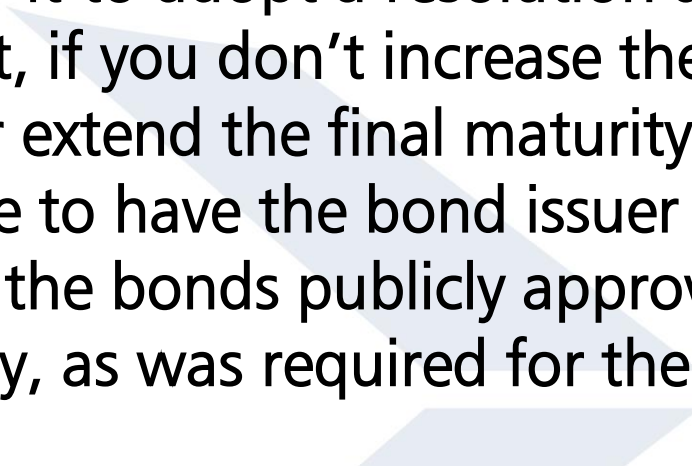


Sometimes your tax-exempt bond will need to be refinanced or modified, either due to a change in your nonprofit's banking relationship or because you or your current bondholder wants to change some of the financial terms of your bond. In bond world, when one bond is refinanced with another bond, it is called a "refunding."

- Some reasons for refunding a bond issue include lowering the interest rate, eliminating restrictive lending covenants, extending final maturity or borrowing new money and rolling an outstanding financing, whether conventional or tax-exempt, over into the refunding bonds.

REFINANCING OR MODIFYING YOUR BOND ISSUE



- To refund a bond issue, your nonprofit must go back to the bond issuer for it to adopt a resolution approving the refunding. But, if you don't increase the amount of bonds outstanding or extend the final maturity date of the bond, you won't have to have the bond issuer hold a new public hearing or get the bonds publicly approved by the locality's governing body, as was required for the original bond issue.
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REFINANCING OR MODIFYING YOUR BOND ISSUE



- On occasion, a nonprofit may fail to adopt or obtain an Official Intent resolution within 60 days of buying its facility, and instead take out a conventional loan to fund the purchase, but later decide it wants to refinance using tax-exempt bonds. In fact, I have such a deal working right now.
- A rarely used and little known rule allows you to treat the conventional loan as if it were a tax-exempt loan, with the nonprofit's board's approval of the original loan effectively being treated as an Official Intent resolution, and to treat the subsequent tax-exempt bond issue as a refunding bond. This can be extraordinarily helpful in salvaging the deal!

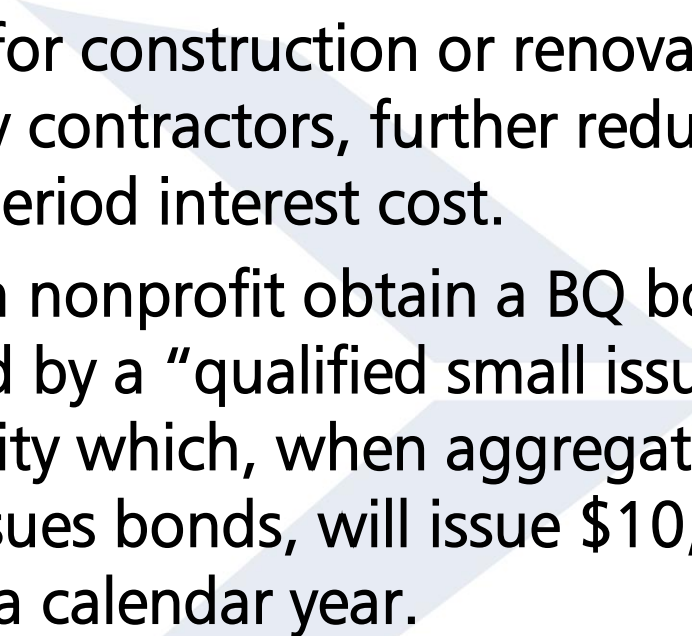
“BANK QUALIFIED” 501(c)(3) BONDS



- A knowledgeable leader of a nonprofit will likely inquire about their Bank’s interest in buying a “bank-qualified” or “BQ” bond. Generally, taxpayers are not allowed to deduct the interest on borrowed funds if the funds are used to buy a tax-exempt bond. A BQ bond is an exception to that rule, and the bank’s ability to deduct a portion of the interest on the borrowed funds it uses to buy a BQ bond allows it to set an even lower bond interest rate for the nonprofit.
- Also, the documentation on a BQ bond sold to a bank is usually simpler and involves fewer parties, and thus results in lower legal fees and costs than a bond issue sold through an underwriter to institutional lenders or retail investors.

“BANK QUALIFIED” 501(c)(3) BONDS



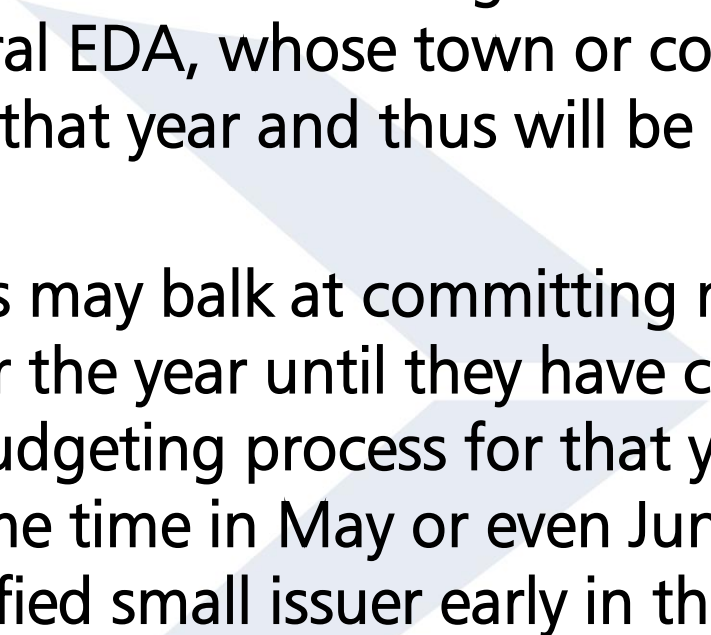
- In addition, a BQ bond, unlike a bond sold to an underwriter, can be structured to let the nonprofit draw down money for construction or renovation costs only as it needs it to pay contractors, further reducing its construction period interest cost.
 - So how does a nonprofit obtain a BQ bond? A BQ bond must be issued by a “qualified small issuer.” That is an issuing authority which, when aggregated with the locality for which it issues bonds, will issue \$10,000,000 or less in bonds during a calendar year.
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“BANK QUALIFIED” 501(c)(3) BONDS

- Some non-EDA local bond issuers, such as the Norfolk Airport Authority, the Portsmouth Port & Industrial Commission and redevelopment and housing authorities, don't have to be aggregated with their locality because the IRS regards them as a sovereign body, because they have both the power to condemn and the police power. As a result, these authorities can issue BQ bonds in years in which they'll be a qualified small issuer, without having to be lumped in with their respective cities for compliance with the \$10 million limit.

“BANK QUALIFIED” 501(c)(3) BONDS



- But if there's no local qualified small issuers in an area, then the nonprofit will need to arrange for its BQ bonds to be issued by a rural EDA, whose town or county won't be issuing bonds that year and thus will be a qualified small issuer.
 - Many localities may balk at committing not to issue their own bonds for the year until they have completed their own capital budgeting process for that year, which often takes until some time in May or even June, so it can be hard to find a qualified small issuer early in the year.
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“BANK QUALIFIED” 501(c)(3) BONDS



- Typically, bond counsel assumes the responsibility for locating a qualified small issuer for the BQ bonds. This must be done BEFORE the public approval process is begun, because the qualified small issuer must conduct the public approval process.
- If the BQ bonds will be issued by an issuer outside of the jurisdiction where the nonprofit’s project will be located, the public approval process may cost a bit more, because the law requires public hearings and public approval in both the qualified small issuer’s jurisdiction and the “host” jurisdiction where the financed assets will be located.

FINANCING STRUCTURES FOR 501(c)(3) BONDS



Let's turn now to the three main financing structures for tax-exempt bonds used by nonprofits.

- "Direct Placement" Bonds. Bonds of less than five million dollars typically need to be bought "in house" by a bank or a small number of wealthy individual investors found by the either the business or the non-profit or by an investment banker or placement agent hired by the business or non-profit, because the transaction costs for obtaining "credit support" in the form of a bank letter of credit or a bond insurance policy are too costly for a project of less than \$5,000,000. Larger deals can also be structured as direct placement bonds if a bank so wishes.

FINANCING STRUCTURES FOR 501(c)(3) BONDS

- Direct Placement bonds become more attractive to a bank if they are BQ Bonds or if, due to the nature of a nonprofit's work, the bonds would qualify for Community Reinvestment Act credit. Banks' Treasury Department will typically be evaluating continually whether the bank has an appetite for buying tax-exempt bonds, and that appetite can fluctuate during the year. The legal costs of these deals include borrower and bond counsel (usually one firm), bond issuer counsel and bond purchaser's counsel (usually the bank's counsel, unless the bonds are sold to a few individuals). Aside from legal fees, a bank's origination fee (rarely more than 1%), and the issuer's administrative fee if paid at closing, there are usually no other material issuance costs.

FINANCING STRUCTURES FOR 501(c)(3) BONDS



- “Public” or “Underwritten” Bonds. Projects requiring bonds of \$5,000,000 or more can be economically financed with credit support from a bank letter of credit or an insurance policy provided by a bond insurer, or in some cases, based solely on the creditworthiness of the conduit borrower. Bank letters of credit were a common source of credit support, especially when used in the “low floater” financing structure until low floaters became problematic at the onset of the Great Recession in 2008. These bonds are sold by underwriters or a placement agent wholesale to financial institutions such as municipal bond funds and large corporations, and sometimes are also retailed to individuals through brokerage firms.

FINANCING STRUCTURES FOR 501(c)(3) BONDS

- The legal and financing costs of these deals include legal fees for borrower and bond counsel (usually, but not always, one law firm), bond issuer's counsel, letter of credit bank or bond insurer's counsel, underwriters'/placement agent's counsel, bond trustee's counsel, fees charged by the underwriters or placement agent, the credit support provider, the remarketing agent, the bond trustee, the rating agencies and the financial advisors. The annual recurring costs usually total 1.5% to 2.0% per year, and should be added to the projected interest rate to calculate the "all-in" annual cost of the bond issue.

FINANCING STRUCTURES FOR 501(c)(3) BONDS



- “Seller Financing” Bonds. A third, creative, but much less common, financing structure is the seller-financing tax-exempt bond. If the seller’s property is debt-free or nearly so, the seller can take back a tax-exempt seller-financing note, which can create a better yield for the seller (especially compared to reinvesting after a cash sale), plus the seller gets installment sale treatment and only must recognize capital gains as principal payments are received.
- These benefits to the seller increase the yield to the seller, and may enable your nonprofit to negotiate down the purchase price in exchange for providing these benefits.

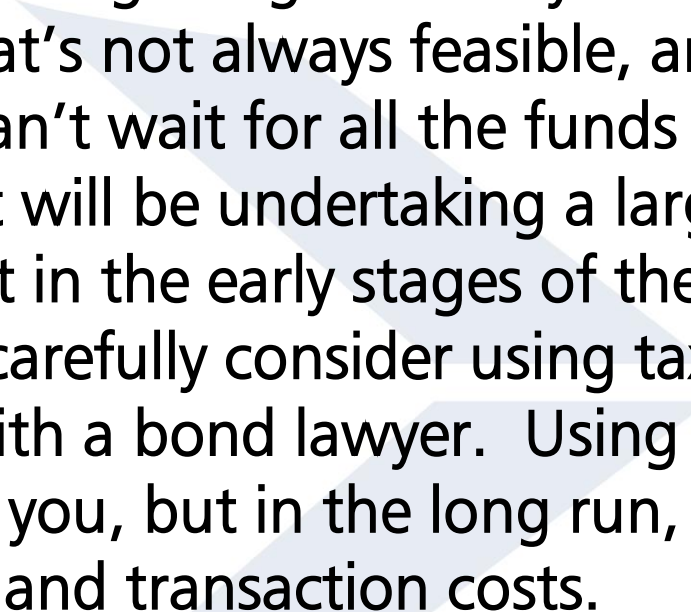
DOES A BOND ISSUE MAKE FINANCIAL SENSE FOR YOUR NONPROFIT?



- A good rule is to add up all the up-front costs of the bond financing, compare the resulting total to the cost of using a conventional loan, and then calculate, using the interest rate savings from using bond financing, how long it will take your nonprofit to recover the additional costs of using bond financing.
- If the additional costs of a bond issue can be recovered in not more than 3 or 4 years, then the extra cost of the bond financing is probably worthwhile.
- Given the transaction costs associated with even a direct placement bond issue, if the initial amount of a bond would be less than 2.5 million dollars, it will be challenging to keep the transaction costs low enough to recover them with the first 3 or 4 years of interest savings.

DOES A BOND ISSUE MAKE FINANCIAL SENSE FOR YOUR NONPROFIT?



- Using cash from your nonprofit's capital campaign, and avoiding borrowing altogether may still be the preferred choice, but that's not always feasible, and sometimes projects just can't wait for all the funds to be raised. So, if your nonprofit will be undertaking a larger capital project, make sure that in the early stages of their planning process, you and they carefully consider using tax-exempt bonds, and consult with a bond lawyer. Using bonds may entail extra work for you, but in the long run, it can be well worth the extra time and transaction costs.
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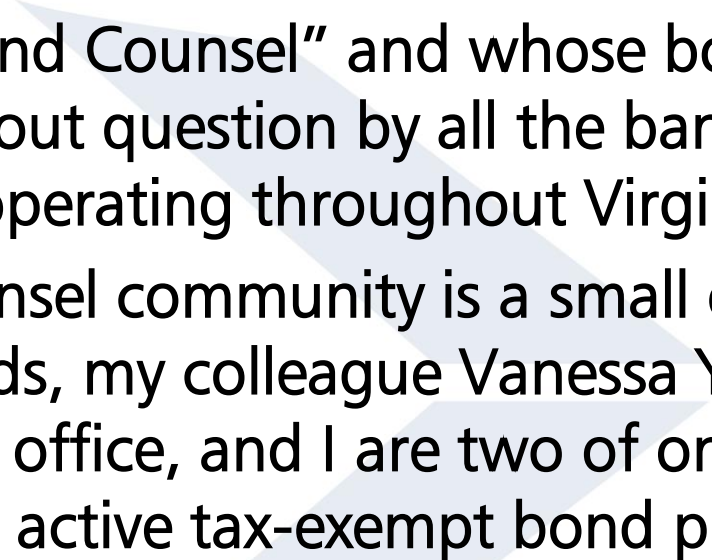
THE ROLE OF BOND COUNSEL



- One of the most crucial parts of a bond issue is the issuance by Bond Counsel of its opinion that the interest on the bond will not be included in the gross income of the owner of the bond for federal and Virginia income tax purposes.
- Because the rules governing tax-exempt bonds are so complex and require a great deal of training, only very few attorneys specialize in this field, and bondholders have come to rely heavily on receiving an “unqualified opinion” from a Bond Counsel who is recognized in the community and in a national publication listing recognized bond lawyers.

THE ROLE OF BOND COUNSEL



- Williams Mullen is proud to have attorneys in both Hampton Roads and Richmond who are “nationally recognized Bond Counsel” and whose bond opinions are accepted without question by all the banks and underwriters operating throughout Virginia.
 - The Bond Counsel community is a small one; here in Hampton Roads, my colleague Vanessa Yearick, in our Virginia Beach office, and I are two of only a handful of attorneys with active tax-exempt bond practices.
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THANK YOU!

- It would be our pleasure to represent your nonprofit as Bond or Borrower's counsel on your bond financing. And anytime you have any questions about tax-exempt bonds, don't hesitate to call or e-mail me, I'll be happy to help – regardless of whether it leads to business for me. Please consider me a resource, and within reason – a free one!

THANK YOU!



QUESTIONS?

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