

## **FREQUENTLY ASKED QUESTIONS ABOUT TAX EXEMPT FINANCING FOR NON-PROFIT ORGANIZATIONS**

### **1. Can a private, non-profit school or other non-profit organizations ("the borrower") borrow on a tax-exempt basis?**

- Yes. A borrower that is a 501(c)(3) corporation under the Internal Revenue Code can borrow money on a tax-exempt basis through bonds or other obligations issued on its behalf by a government agency ("the Issuer"), such as the City of Los Angeles or its Industrial Development Authority.
- This method of tax-exempt borrowing is commonly known as "conduit revenue bond financing" or "501(c)(3) bonds."
- This information sheet provides an overview of 501(c)(3) bond financings.
- There are additional requirements of the Issuer and under Federal and State law.

### **2. What are 501(c)(3) bonds?**

- 501(c)(3) bonds are a method for a borrower to finance capital projects. Under Federal tax law, only government agencies can issue tax-exempt bonds. 501(c)(3) bonds are authorized and sold by the Issuer, which then loans the bond proceeds to the borrower.
- The borrower is responsible for repayment of the bonds from the borrower's revenue. The Issuer itself has no repayment obligation or liability on the bonds. Thus, the credit worthiness of a 501(c)(3) bond is based on the credit of the borrower and the collateral provided by the borrower. The financial terms of the bonds and the required covenants are based on the credit of the borrower.

### **3. What are the benefits of 501(c)(3) bonds?**

- 501(c)(3) bonds benefit both the borrower and the bondholders.
  - The borrower is able to finance capital projects at an interest rate lower than available through a conventional (taxable) borrowing from a bank because the interest paid to the holders of the bond is exempt from Federal and California income taxes.
  - The bondholder is able to make a tax-exempt investment, because interest received from a 501(c)(3) bond is not included in income.

### **4. Who is eligible to finance using 501(c)(3) bonds?**

- Any corporation that has been determined by the Internal Revenue Service to be a Section 501(c)(3) organization under the Internal Revenue Code is permitted to finance using 501(c)(3) bonds. Organizations operated exclusively for educational, healthcare and other charitable purposes are eligible to obtain from the I.R.S. a determination of their 501(c)(3) status. (The Federal law requirements to be a 501(c)(3) organization are beyond the scope of this information sheet.)

## **5. What can 501(c)(3) bond proceeds be used for?**

- A borrower can use the proceeds from 501(c)(3) bonds to finance construction and equipment of new facilities (the "Project") including: educational facilities, administration buildings, dormitories, dining halls, student unions, libraries, laboratories, research facilities and health care facilities. 501(c)(3) bonds can also be used to finance planning and architectural costs, capitalized interest, debt service reserves and costs of issuance.
- 501(c)(3) bonds can be used to refund existing bonds (including existing 501(c)(3) bonds), mortgages, or other borrowings for Projects described above.
- There are a number of requirements under Federal tax law that must be satisfied to issue 501(c)(3) bond financing. These include: the Project must be owned and used only by the borrower, by another 501(c)(3) organization or by a governmental entity; and the Project must be used only in the charitable activities of the borrower.

## **6. What 501(c)(3) bond proceeds cannot be used for:**

- 501(c)(3) bond proceeds cannot be used to finance facilities used for sectarian purposes or as a place of worship.
- 501(c)(3) bond proceeds generally cannot be used for working capital or for operating costs.

## **7. How much can be borrowed?**

- 501(c)(3) bonds may be issued in principal amounts from \$2 million up. There is no upper limit on the principal amount and the law permits 100% of capital costs of a Project to be financed.

## **8. What financing structures may be used?**

- A 501(c)(3) bond financing can be structured as fixed-rate bonds (with or without credit enhancement), or as variable rate bonds.
- Fixed-rate bonds have their interest rate established at time of issuance, and that rate remains fixed until maturity of the bonds.
  - A borrower may obtain a lower interest rate by purchasing credit enhancement for the bonds, such as bond insurance or a letter of credit from a rated bank.
- Variable rate bonds have interest rates that are re-set on a periodic basis (such as weekly), based on then-prevailing market interest rates. A borrower must obtain credit enhancement to use variable rate bonds.
  - A variable rate bond financing can provide the borrower greater flexibility with financial and operating covenants. This flexibility is available because these covenants can be contained in an agreement between the borrower and the

provider of the credit enhancement, which permits the borrower to negotiate directly with the credit provider for amendments, waivers, or other changes to the covenants without having to obtain consents for amendments of the bond documents from the bond trustee and from the Issuer.

### **9. How are the bonds sold?**

- 501(c)(3) bonds can be sold either through a public underwriting or through a negotiated private sale.
- The borrower arranges for the sale of the bonds by either engaging an underwriter to purchase the bonds, or a placement agent to find a purchaser for the bonds.

### **10. What are the fees and how does a borrower apply for a 501(c)(3) financing?**

- Fees vary for each transaction, depending on the principal amount of the bonds and the complexity of the transaction. For more information on fee schedules, or to apply for 501(c)(3) Bond financing, contact the Issuer representative.
- The borrower should consult with a law firm that is expert on 501(c)(3) bond financings (called a "bond counsel who is on contract with the City of Los Angeles") concerning additional Federal and state law requirements for 501(c)(3) bonds.

### **11. Can a borrower use 501(c)(3) bonds and also have a capital fund drive?**

- Yes. However, the borrower should consult with bond Counsel on how to conduct the capital fund drive to provide maximum flexibility for the 501(c)(3) bond financing. There are financial benefits to the borrower not soliciting donations that are restricted for the Project being financed with 501(c)(3) bonds. Instead, donations should be solicited to expand the borrower's general endowment funds, the earnings from which can be used to support the borrower's programs and capital facilities (including the Project financed with 501(c)(3) bonds).

For more information, please contact (213) 744-7111  
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