Lesson 12

Section 145 – Qualified 501(c)(3) Bonds

Overview

Introduction

Lesson 12 begins the discussion of qualified 501(c)(3) bonds which is one type of qualified private activity bonds.

Purpose

This lesson provides a detailed overview of §145 requirements and a general understanding of Exempt Organization law pertaining to 501(c)(3) organizations.

Objectives

After completing this lesson you will be able to:

- Define a qualified 501(c)(3) bond as described in § 145
- Define an exempt organization and describe the exemption application process
- Describe the requirements of the private business use test
- Describe how unrelated trade or business activity affects the private business use test

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Overview, Continued

Objectives (continued)

- Identify the rules for the private payment and security test
- Define a qualified hospital bond
- Determine if non-hospital bonds meet the $150 million volume cap
- Determine if bonds used for residential rental property are qualified501(c)(3) bonds

Identify the private activity bond rules of other Code sections which apply to qualified 501(c)(3) bonds

Contents

This lesson contains the following topics:

Introduction

Definition of Qualified 501(c)(3) Bonds

Qualified 501(c)(3) bonds are private activity bonds issued under § 145 if:

(1) **all** property financed by the net proceeds of the bond issue is to be owned by an organization described in § 501(c)(3) (a "tax exempt organization") or a governmental unit, **and**
(2) such bond would not be a private activity if:
(A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying §513(a), and
(B) paragraphs (1) and (2) of § 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

Tax Exempt Organization

A tax exempt organization is exempt from Federal income tax under § 501(a). There are various types of tax-exempt organizations, but for purposes of this module, we will only discuss § 501(c)(3) organizations.

A 501(c)(3) organization is a corporation, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

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Introduction, Continued

Exemption Process

In general, an organization that desires to be exempt from Federal income tax under § 501(c)(3) must file a Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. (There are exceptions for churches, integrated auxiliaries of churches, and organizations that normally have annual gross receipts of not more than $5,000.) The organization sends the completed application, with attachments, to the Internal Revenue Service. If the organization meets the requirements for exemption, it is issued a Determination Letter.

Filing Requirements

Generally, organizations described in § 501(c)(3) are required to file an annual information return, either Form 990, Form 990-EZ, or Form 990-PF, along with certain schedules that may be required for their organization. Certain categories of organizations are excepted from filing Form 990 or Form 990-EZ, including churches and certain small organizations. Small organizations are not required to file Form 990 or Form 990-EZ if their gross receipts are normally $25,000 or less ($50,000 for tax years ending on or after December 31, 2010). For tax years beginning after December 31, 2006, however, these small organizations must submit an annual electronic notice using Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ. The e-Postcard can only be filed electronically; there is no paper version. Filing organizations with an outstanding tax-exempt bond issue in excess of $100,000 as of the last day of the tax year that was issued after December 31, 2002, must file Schedule K (Form 990) Supplemental Information on Tax-Exempt Bonds.

In addition, an exempt organization must file Form 990-T if it has $1,000 or more of gross income from an unrelated trade or business during the year. In general, the tax is imposed on income from a regularly carried-on trade or business that is not substantially related to the organization's exempt purposes (See IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations).

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Filing Requirements (continued)

For tax years beginning after December 31, 2006, if an organization is required to file an annual information return or annual electronic notice and fails to do so for three consecutive years, the organization will automatically lose its tax-exempt status as of the filing due date of the third year. For the organization to have its tax-exempt status reinstated, it must apply (or reapply) for tax-exempt status and pay the appropriate user fee.

Loss of Exempt Status

A 501(c)(3) organization can automatically lose its exempt status for failure to file its annual information return or annual electronic notice for three consecutive years or as a result of an examination by the Exempt Organizations Division. It can also lose its exempt status due to a change in its stated purpose or dissolution. (When an exempt organization dissolves, its assets must be distributed for exempt purposes pursuant to Regulations § 1.501(c)(3)-1(b)(4).) Since the organization must be a 501(c)(3) organization to be a qualified user of a qualified 501(c)(3) bond, loss of the organization's tax exempt status adversely affects the outstanding bond issues and the change in use rules under § 150 apply. These rules will be discussed in a later lesson.

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Example 1

Make a Joyful Noise v. Commissioner, TCM 1989-4: An exempt organization organized to provide camps for elderly citizens and disadvantaged children conducted bingo games to raise funds. It lost its state bingo permit due to a change in state law. The organization then leased its premises to other organizations. Certain leases provided that lessees would operate bingo games and that the exempt organization would receive a portion of the gross receipts from those games. Almost all of the exempt organization's receipts were derived from these arrangements. The exempt organization never implemented its plans to operate the camp. The court held that the operation of regularly scheduled bingo games constituted a trade or business that was unrelated to its exempt purpose, that such activities were not insubstantial, and therefore, that the organization was not operated exclusively for its exempt purposes. Accordingly, its 501(c)(3) status was revoked.

§ 145 Statutory Provisions

The specific requirements for qualified 501(c)(3) bonds are provided in § 145.

Regulations § 1.145-2(a) provides that §§ 1.141-0 through 1.141-15 of the Regulations are applicable to bonds issued under § 145(a).

Other requirements applicable to qualified private activity bonds that are also applicable to qualified 501(c)(3) bonds are provided in §§ 147-150. Under §146(g)(2), qualified 501(c)(3) bonds are exempt from the volume cap requirements of § 146.

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Use of Proceeds

Under § 145(a), ALL of the net proceeds of qualified 501(c)(3) bonds (bond proceeds less amount in the reasonably required reserve fund) must be used to finance property owned by a:

- 501(c)(3) organization, *or*
- governmental unit.

Unlike exempt facility and small issue bonds, proceeds of qualified 501(c)(3) bonds may be used to pay working capital, as well as capital expenditures. Note though, that certain arbitrage rules specifically apply to bonds issued to finance working capital.

See Regulations §§ 1.148-1(c)(4), 1.148-2(e)(3), and 1.148-6(d)(3).

Borrower

The borrower of qualified 501(c)(3) bonds that is not a governmental unit must be an organization described in § 501(c)(3) and have a favorable determination letter from the Service, if required. The organization must maintain its exempt status as long as the bonds are outstanding.

TAM 200006049 dealt with bonds intended to be qualified 501(c)(3) bonds the proceeds of which were loaned to Organization. Prior to issuance of the bonds, Organization received a 501(c)(3) determination letter. Subsequently, Organization's tax-exempt status was revoked retroactive to the taxable year in which the bonds were issued as a result of deliberate actions of the Organization taken during that year. More than 3 years after the end of the taxable year in which the deliberate actions were taken that resulted in revocation of 501(c)(3) status, the bonds were canceled and taken off the market. The Service ruled that the interest on the bonds was includable in the gross income of the bondholders beginning with the date of issuance of the bonds and cancellation of the bonds did not prevent interest on the bonds from being includable in the gross income of the bondholders because, as a remedial action, the action was not timely taken.

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Introduction, Continued

Election Out

Section 145(e) provides that issuers may elect NOT to treat a bond issue as qualified 501(c)(3) bonds if the bond issue is an issue of exempt facility bonds or qualified redevelopment bonds to which § 146 applies.

Private Use

As with other types of qualified private activity bonds, qualified 501(c)(3) bonds already have some inherent private business use - that of the 501(c)(3) organization itself. It is this private business use that differentiates these bonds from governmental bonds. However, § 145 considers use by a 501(c)(3) organization in its **related** activities as a government use.

The next section discusses the private activity bond tests.

Private Activity Bond Tests

Block Label

The private activity bond tests of § 141 will be discussed in detail in Lesson 4 of the Phase II Training. In this lesson, we will briefly discuss these tests and how they impact §145 and 501(c)(3) bonds.

In general, in order for a bond to be a private activity bond, it must meet either the private:

- business use test and the private security or payment test (the "private business tests"), **OR**

- loan financing test.

See § 141(b) and (c).

Since over five percent of the proceeds would generally be loaned to the 501(c)(3) organization/conduit borrower, the private loan financing test would be met, making these bonds private activity bonds from the outset. Remember, though, that the interest on private activity bonds can still be tax-exempt, if the bonds meet the special rules for a specific type of **qualified** private activity bonds, including qualified 501(c)(3) bonds.

However, § 145(a)(2) provides that in order for bonds to be considered qualified 501(c)(3) bonds, the bonds must NOT be private activity bonds, applying the requirements of § 141 as specifically modified in § 145(a)(2).

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Private Activity Bond Tests, Continued

Introduction (continued)

When applying the private business tests and private loan financing test under § 145, a 501(c)(3) organization with regard to its activities that are not unrelated trade or business under § 513 is treated as a governmental unit. This means that use of the bond-financed facility by a 501(c)(3) organization in related activities is NOT considered private business use for purposes of 501(c)(3) bonds. Also, a loan to a 501(c)(3) organization for use in related activities is not a private loan for this purpose.

In addition, § 145(a)(2)(B) provides that **five percent** is substituted for the **ten percent** limit in § 141(b). Also, **net proceeds** is substituted for **proceeds.**

Private Business Use Test

Because only unrelated use is considered private use, the first question to be answered generally relates to the amount of unrelated use of the bond financed facility. See the discussion below of unrelated trade or business use. No more than five percent of the net proceeds of the bond issue may be used for any private business use. Use by any 501(c)(3) organization in an activity that is unrelated trade or business under § 513 is considered private business use. For purposes of § 145(a)(2), costs of issuance are treated as private business use. Regulations § 1.145-2(c)(2).

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Examples

Examples of application of the private business use and unrelated trade or business use rules for purposes of the 5 percent limit:

Example 1: 501(c)(3) organization runs a rehabilitation center and leases 25% of its building to the local police department. Although the police department is a governmental person, leasing to a police department is unrelated to the exempt purpose of the 501(c)(3) organization and the unrelated use is counted toward the 5%.

Example 2: 501(c)(3) retirement facility that provides step care including critical care services leases office space to another 501(c)(3) organization that provides geriatric counseling services. The counseling services are related to the borrowing 501(c)(3)'s exempt purpose of running a retirement facility and to the second organization's exempt purposes. None of the use is counted toward the 5%.

Example 3: 501(c)(3) retirement facility that provides step care including critical care services leases office space to another 501(c)(3) organization that tutors children ages 6-12. The 501(c)(3) organization's purpose of tutoring is unrelated to the borrowing 501(c)(3)'s exempt purpose of running a retirement facility. Leasing to that organization is unrelated use that is counted toward the 5%.

Example 4: 501(c)(3) retirement facility that provides step care including critical care services leases office space to a doctor who gives geriatric medical care. The geriatric medical care is related to the borrowing 501(c)(3)'s exempt purpose of running a retirement facility, but the doctor's use constitutes private business use. Thus, the lessee's use is counted toward the 5%.

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Private Activity Bond Tests, Continued

Private Security or Payment Test

To be considered qualified 501(c)(3) bonds, no more than **five** percent of the payment of the debt service on the bonds may be directly or indirectly:

(A) secured by any interest in-
  (i) property used or to be used for a private business use, or
  (ii) payments in respect of such property, or

(B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used in a private business.

The private security or payment test relates to the nature of the security for and the source of the payment of debt service on the bond issue. The security for, and payment of debt service on the bonds is determined from the terms of the bond documents and any underlying arrangements.

A bond issue will not be a qualified 501(c)(3) bond issue if both the private business use test *and* the private security *or* payment test are met.

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Definition of Proceeds

According to Regulations § 1.141-1(b), "proceeds" are defined as the sales proceeds of an issue (other than those sale proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve or replacement fund (4R fund)), investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period) and disposition proceeds as provided under Regulations § 1.141-12. The Commissioner may treat any replaced amounts as proceeds.

Note: The above definition of "proceeds" is to be distinguished from the definition of proceeds under Regulations § 1.148-1(b).

Assume that Charity A (a 501(c)(3) organization) borrows $100M of bond proceeds from City B in order to build a hospital. The private business use test is calculated as follows:

Sales Proceeds	$ 100,000,000
Investment Earnings During Project Period	12,000,000
Rebate Amount During Project Period	(2,000,000)
Reserve Fund	(10,000,000)
Net Proceeds	100,000,000 x .05
	5,000,000 (can be used for "bad" costs)

If $2M (2 percent of $100M) is used for issuance costs, then the remaining "bad cost" is only $3M and that amount may be used for private business use.

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Definition of Proceeds (continued)

"Disposition proceeds" is defined under Regulations § 1.141-12(c)(1) as any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition of property (other than investments) financed with proceeds.

Regulations § 1.148-1(b) defines :

"Investment proceeds" as any amounts actually or constructively received from investing proceeds of an issue; and

"Sale proceeds" as any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriter's discount or compensation and accrued interest other than pre-issuance accrued interest. Sale proceeds also include, but are not limited to, amounts derived from the sale of a right associated with a bond (such as redemption rights, stripped coupons or tax credits) and amounts received on termination of certain hedges.

"Project Period" is defined in Regulations § 1.141-1(b) as the time from the issue date until the project is placed in service.

Definition of Net Proceeds

Section 150(a)(3) defines "net proceeds" as proceeds of an issue reduced by amounts deposited in a reasonable required reserve or replacement fund.

Working Capital

Issuers may finance working capital with qualified 501(c)(3) bond proceeds but such financing is subject to restrictions.

See Regulations § 1.148-6(d)(3) (proceeds-spent-last rule) and section entitled $150 Million Volume Cap for Non-Hospital Bonds below).

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Private Activity Bond Tests, Continued

Example 1

City X issues and sells $10 million principal amount of bonds at par. It loans the $10 million to Corporation Y, a 501(c)(3) organization, to be used to construct a nursing home. Corporation Y deposits $1 million in a reasonably required debt service reserve fund. Corporation Y earns investment proceeds of $1.5M during the project period and has negative arbitrage. Net proceeds are $10.5M.

Example 2

Same as the example above, except, Corporation Y uses $400,000 of the proceeds to construct an office building adjacent to the nursing home and sells the building to Partnership Z. Partnership Z will provide accounting services to Corporation Y. No portion of the proceeds of the bonds was used to pay costs of issuance. Although less than 5 percent of the net proceeds were spent on the office building, the bonds will not be qualified 501(c)(3) bonds because not **all** of the net proceeds were used to finance property **owned** by a 501(c)(3) organization or governmental entity.

Example 3

Same as Example 1, except, Corporation Y leases 3 percent of the space in the nursing home to Partnership Z for the entire term of the bonds. No portion of the proceeds was used to pay costs of issuance. The amount of bond proceeds used to construct this space was $425,000 (or 4% of net proceeds). Partnership Z will have its equipment and employees in this space and will provide accounting services to Corporation Y. Partnership Z will pay rent at fair market value and there is no relationship between Corporation Y and Partnership Z.

The use of the space by Partnership Z will not meet the private business use test because at least 95 percent of the net proceeds were used to finance a facility used by a 501(c)(3) organization. In addition, all of the net proceeds of the bonds were used to finance a facility owned by a 501(c)(3) organization. Therefore, the bonds will be qualified 501(c)(3) bonds.

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Private Activity Bond Tests, Continued

Use by General Public

Use of bond-financed facilities by private persons in their trade or business that is general public use is not private business use. To be considered use by the general public, the property must be reasonably available for use on the same basis by natural persons not engaged in a trade or business. Generally, use under an arrangement that conveys priority rights or other preferential benefits is not use on the same gasis as the general public. Long term arrangements are also not treated as general public use. A term of use longer than 200 days, including renewal options, is considered long-term use. *See Regulations § 1.141-3(c).*

The rules regarding general public use are the same for qualified 501(c)(3) bonds as for governmental bonds and are more fully described in Lesson 4. *See also Regulations§ 1.141-3(c).*

Unrelated Trade or Business

Use of bond proceeds or bond-financed facilities by a 501(c)(3) organization in an unrelated trade or business activity is considered private business use. Any such unrelated use is counted against the permissible 5 percent of net proceeds private business use. *See § 145(a)(2)(A).*

Whether an activity is an unrelated trade or business activity is determined in accordance with § 513. It does not matter that the 501(c)(3) organization may or may not pay any unrelated business income tax on the activity.

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Definition

Unrelated trade or business activity means any trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption. *See § 513(a); Regulations § 1.513-1(a).* A 501(c)(3) organization that has $1,000 or more gross income from an unrelated trade or business must file Form 990-T.

The term trade or business generally includes any activity carried on for the production of income from selling goods or performing services. Activities of producing or distributing goods or performing services from which gross income is derived do not lose their identity as trades or businesses merely because they are carried on within a larger framework of other activities that may, or may not, be related to the organization's exempt purposes. *See Regulations § 1.513-1(b).*

Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit. *Id.*

Business activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to, comparable commercial activities of nonexempt organizations. *See Regulations § 1.513-1(c).*

Determining whether a business activity is substantially related to the organization's exempt purposes requires examining the relationship between the activities that generate income and the accomplishment of the organization's exempt purpose. A trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related. *See Regulations § 1.513-1(d).*

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Definition (continued)

The use of a bond-financed property may be private business use for purposes of § 145 even when it is not used in unrelated business use under § 513. For example, in some cases the leasing of a medical office building connected to a hospital to physicians who are not employees of the hospital, but practice at the hospital, may not be an unrelated use under § 513. However, such use may be private business use for purposes of the 5 percent test.

Example 4

City X issues $12 million principal amount of bonds and loans the proceeds to Corporation A, a 501(c)(3) organization. Corporation A will use the proceeds to purchase an existing multi-family residential rental facility. Corporation A deposits $900,000 in a reasonably required reserve fund and uses $11,100,000 to acquire the facility. A portion of the facility has always been rented by City X and used to provide services to the residents of the community, including the facility. The use by City X is not unrelated to Corporations A's exempt purposes under § 513. City X will continue to rent this portion after Corporation A acquires the facility.

Because all of the net proceeds are used to acquire a facility owned by a 501(c)(3) organization and used by a 501(c)(3) organization and a governmental unit in activities that are not unrelated trade or business, the bonds are qualified 501(c)(3) bonds. The rental by City X will not disqualify the bonds.

Example 5

Authority X issues $15 million principal amount of bonds and loans the proceeds to Corporation M, a 501(c)(3) organization, to construct a clinic. After the clinic has been constructed, Corporation M realizes that it has too much space and rents 10 percent of the space in the clinic to a sole proprietor who will operate a pharmacy and a flower shop in the rented space. Even if the rental of the space by Corporation M is not considered an unrelated trade or business under IRC § 513, the bonds will not be qualified 501(c)(3) bonds. This is because more than 5% of the bond proceeds are used in a trade or business of a nongovernmental person.

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Example 6

Same as Example 5, except that Corporation M rents the space to Corporation Z, a 501(c)(3) organization. Corporation Z uses the space to train unemployed persons seeking employment. Assume that the rental to Corporation Z is considered an unrelated trade or business under § 513 with respect to Corporation M. Because Corporation Z is renting more than 5 percent of the bond-financed facility, the bonds will not be qualified 501(c)(3) bonds.

Management Service Contracts

A management contract with respect to bond-financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

See Regulations § 1.141-3(b)(4)(i).

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Definition

A management contract is a management, service or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility.

For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract. *See Regulations § 1.141-3(b)(4)(ii).*

Certain arrangements generally are not treated as management contracts resulting in private business use. *See Regulations § 1.141-3(b)(4)(iii).* Several revenue procedures have been issued over the years to provide additional guidance on the use of management contracts. See Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39, 2001-2 C.B. 38, and amplified by Notice 2014-67, 2014-46 I.R.B. 822; Rev. Proc. 2016-44, 2016-2 C.B. 316; and Revenue Procedure 2017-13, 2017-6 I.R.B. 787. The procedures have periods of applicability based on the date of entry into the management agreement. Most of these revenue procedures can be found in Federal Taxation of Municipal Bonds.

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Safe Harbors

The IRS has provided safe harbors regarding management service contracts between a service provider and a qualified user (including a 501(c)(3) organization in its related activities) where the service is provided in connection with a bond-financed facility.

For management contracts executed, materially modified, or amended on or after May 16, 1997, the safe harbors are provided in Rev. Proc. 97-13, 1997-1 C.B. 632. Rev. Proc. 97-13 obsoleted Rev. Proc. 93-19, 1993-1 C.B. 526.

Rev. Proc. 2001-39, 2001-2 CB 38, modifies the definitions of capitation fee and per unit fee in Rev. Proc. 97-13 to permit automatic increases of those fees to certain objective external standards.

Notice 2014-67, 2014-2 C.B. 822, also created a new safe harbor for contracts with a term, including renewal options, of not more than five years which does not need to be terminable by the qualified user prior to the end of the term.

Notice 2014-67 applies to bonds issued on or after January 22, 2015, but also may be applied to bonds issued before January 22, 2015.

Revenue Procedure 2017-13, 2017-6 I.R.B. 787, applies to management contracts entered into on or after January 17, 2017. An issuer may apply this revenue procedure to any management contract entered into before January 17, 2017.

Management contracts are discussed in detail in Phase I, Lesson 4, Private Activity Bonds.

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Private Activity Bond Tests, Continued

Research Agreements

Certain agreements with respect to bond-financed facilities under which a nongovernmental person sponsors research by a qualified user (including a 501(c)(3) organization in its related activities) may result in private business use. *See Regulations § 1.141-3(b)(6)*

Private business use occurs if the sponsor is treated as the lessee (with certain exceptions) or owner of the bond-financed property for federal income tax purposes.

Rev. Proc. 2007-47, 2007-29 I.R.B. 108, provides safe harbors for research agreements for any research agreement entered into, materially modified, or extended on or after June 26, 2007. Rev. Proc. 2007-47 modified and superseded Rev. Proc. 97-14, 1997-1 C.B. 634.

Mixed Use and Multipurpose Facilities

Mixed use or multipurpose facilities are facilities that have multiple users, such as a 501(c)(3) organization and a private business user.

A mixed use or multipurpose facility may be financed in part with qualified 501(c)(3) bonds. The portion that is bond financed must be owned and used by the 501(c)(3) organization or by a governmental unit in furtherance of the 501(c)(3) organization's purpose.

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Private Activity Bond Tests, Continued

Allocations

The portion used by the private business user must be financed by sources other than tax-exempt bond proceeds.

In general, if two or more sources of funding are allocated to capital expenditures, those sources are allocated throughout that project to the governmental use and private business use in proportion to the relative amounts of those sources of funding spent on the project.

The allocations of the bond proceeds and other sources of funds, and the use of the facility by various parties, must be reasonable and consistently applied and allocations under §§ 141 and 148 must be consistent with each other.

Special allocation rules are provided for mixed-use projects in § 1.141-6(b). For these purposes, a mixed-use project is a governmentally owned project financed with proceeds of tax-exempt bonds and equity. These rules provide guidance for allocation of portions of a mixed-use project to governmental and private use. Equity is allocated first to the private business use, then to the governmental use, and proceeds are allocated first to the governmental use then to private business use, using the percentages of the mixed-use project financed with the respective sources and the percentages of the respective uses.

$150 Million Volume Cap for Non-Hospital Bonds

Introduction

Qualified 501(c)(3) bonds are NOT subject to the state volume limits of §146. However, § 145(b) limits the aggregate outstanding face amount of certain qualified 501(c)(3) bonds allocated to a 501(c)(3) organization, which is a test-period beneficiary, to $150 million.

If the bonds are qualified hospital bonds, this limit does NOT apply. Nor does it apply to bonds issued on or after August 5, 1997, as part of an issue 95 percent or more of the net proceeds of which are to finance capital expenditures incurred after August 5, 1997.

Non-Hospital and Qualified Hospital Bonds

Therefore, one determination to be made is whether the bonds are hospital or non-hospital bonds.

Non-Hospital Bonds

We refer to all qualified 501(c)(3) bonds that are not qualified hospital bonds as non-hospital bonds.

Qualified Hospital Bonds

A qualified hospital bond means any bond issued as part of an issue at least 95 percent of the net proceeds of which are used with respect to a hospital.

See § 145(c).

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$150 Million Volume Cap for Non-Hospital Bonds, Continued

Definition of a Hospital

A hospital is a facility that:

- is accredited by the Joint Commission on Accreditation of Healthcare (JCAH), or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of the governmental unit are essentially equivalent to JCAH;
- is primarily used to provide, by or under the supervision of physicians, to in-patients diagnostic services and therapeutic services for medical diagnosis, treatment and care for the injured, disabled or sick persons (including those who are mentally ill);
- has a requirement that every patient be under the care and supervision of a physician; AND
- provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or a registered nurse on duty at all times.

Rest or nursing homes, day care centers, medical school facilities, research laboratories, and ambulatory care facilities (e.g. surgicenters) are NOT hospitals.

See H.R. Conf. Rep. No. 841, 99th Cong., 2d Session, at 725.

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$150 Million Volume Cap for Non-Hospital Bonds, Continued

Bonds Taken into Account for the $150 Million Limitation

Sections 145(b)(2)(B) and (C) provide that for purposes of applying the $150 million limitation to a test-period beneficiary, the aggregate outstanding amount of the following bonds is included any:

- qualified non-hospital 501(c)(3) bonds;
- bonds issued under the Internal Revenue Code of 1954, if (I) such bonds would have been industrial development bonds had the 1954 Code not treated 501(c)(3) organizations as exempt persons, and (II) such bonds were not exempt facility, industrial park, or small issue bonds under the 1954 Code.

A bond shall be taken into account only to the extent that the proceeds of the issue of which such bond is a part are not used with respect to a hospital. However, if 90% or more of the net proceeds of an issue are used with respect to a hospital, no bond which is part of such issue shall be taken into account.

Note: Special rules apply to refunding bonds. (See "Refunding Bonds" section below.)

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$150 Million Volume Cap for Non-Hospital Bonds, Continued

Example 7

Corporation X, a 501(c)(3) organization plans to borrow proceeds of $150 million principal amount of qualified 501(c)(3) bonds to construct a rehabilitation facility to be issued in June 1997. In 1994, Corporation X borrowed $75 million principal amount of bonds to construct a new wing of a hospital. In 1993, Corporation X borrowed $32 million principal amount of bonds to construct a retirement facility. In 1987, Corporation X borrowed $16 million principal amount of bonds to acquire three skilled-care nursing facilities. In 1985, Corporation X borrowed $20 million principal amount of bonds to acquire six nursing homes. All of the bonds are currently outstanding.

In determining the outstanding bonds to be taken into account for purposes of § 145(b)(2)(B), Corporation X will include the 1993 bonds, the 1987 bonds and the 1985 bonds, but not the 1994 bonds. Because these outstanding bonds total $68 million, the maximum Corporation X can borrow of the 1997 bonds is $82 million.

Bonds Taken into Account for the $150 Million Limitation

Section 145(b)(4) provides that rules similar to the rules of subparagraphs (C), (D), and (E) of § 144(a)(10) apply to this subsection.

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$150 Million Volume Cap for Non-Hospital Bonds, Continued

Test Period Beneficiary

A test-period beneficiary is any person who is:

- an owner, OR
- a principal user of the bond financed facilities at any time during the test-period.

See § 144(a)(10)(D)

Test Period

The test-period is a three-year period beginning on the later of the date the:

- financed facility is placed in service, OR
- bonds are issued.

See § 144(a)(10)(D).

Aggregation Rule

Section 144(a)(10)(E) provides that all persons who are related within the meaning of § 144(a)(3) are treated as one person. Section 144(a)(3) provides that a person is related to another person if: (A) the relationship between such persons would result in a disallowance of losses under §§ 267 or 707(b), or (B) such persons are members of the same controlled group of corporations (as defined in § 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein.

For example, a university and all related persons (as defined in § 267), including related entities engaged in unrelated trades or businesses, are treated as one person in determining whether they are principal users of bond-financed property.

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Common Management or Control

Further, § 145(b)(3) provides that for purposes of determining the $150 million limitation, two or more organizations under common management or control shall be treated as one organization. Any 501(c)(3) organization will be treated as related to another person if the two have (a) significant common purposes and substantial common membership, or (b) directly or indirectly, substantial common direction. For example, a local chapter of a national organization may be treated as related to the national organization.

In PLR 8822043, the Service found that a local corporation ("Local X") and a national council were not under common management and control for purposes of § 145(b)(3). County will issue bonds to finance improvements for Local X, a 501(c)(3) member of a national council, itself a 501(c)(3) entity that promotes worldwide fellowship with a particular religious worldview. The Service ruled that because Local X controls its own programs, has its own financial resources, cannot be dissolved by the national council, selects its own board and contributes less than one percent of its revenues to the national council, it is not under common management or control.

Bonds Allocated to Test Period Beneficiary

All owners of bond-financed facilities during the 3-year test period are allocated that portion of the issue that is equivalent to the portion of the facilities that they own. Additionally, all principal users of the facilities during the 3-year test period are allocated a portion of the face amount of the issue equivalent to that portion of the facility used by them. (In certain cases, this may result in all or part of an issue being allocated to more than one 501(c)(3) organization.) *See § 144(a)(10)(C).*

H.R. Rep. No. 426, 99th Cong., 1st Session, at 540, states that, once a portion of an issue is allocated to a 501(c)(3) organization, that allocation remains in effect as long as the bonds are outstanding. This is true even if the organization no longer owns or uses the property financed with the bonds. Similarly, the fact that a person stops being related to an owner or principal user of the property after an allocation is made does not alter the allocation to that person as long as the bonds are outstanding.

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$150 Million Volume Cap for Non-Hospital Bonds, Continued

Refunding Bonds

In determining whether the $150 million limitation has been exceeded, bonds that are redeemed by a later issue (other than advance refunding bonds) are not taken into account. *See IRC § 145(b)(2)(A)(ii).*

Transition Rules

Special rules apply to bonds that refund bonds issued prior to the effective date of Tax Reform Act of 1986 (the "1986 Act"). The $150 million limit was added by the 1986 Act. Section 145(b) does not apply to current refunding bonds (or a series of bonds) the proceeds of which are used exclusively to refund a tax-exempt bond to which that the limit did not apply if the:

- (1) amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds;
- (2)(a) weighted average maturity of the refunding bonds does not exceed 120 percent of the weighted average reasonably expected economic life of the facilities financed with the refunded bonds, or
- (2)(b) last-maturing bond in the refunding issue matures no later than 17 years after the issue date of the refunded bonds; **and**
- (3) net proceeds of the refunding bond are used to redeem the refunded bond within 90 days of the issuance of the refunding bond.

See § 1313(c)(2) and (3) of the 1986 Act.

However, even if the limit does not apply because of this special transition rule, such refunding bonds are counted as outstanding bonds for purposes of determining whether subsequent new money or advance refunding bonds may be issued.

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$150 Million Volume Cap for Non-Hospital Bonds, Continued

Transition Rules (continued)

Advance refunding bonds are counted in determining whether the $150 million limitation is exceeded. However, § 1313(b)(3)(G) of the 1986 Act permits one advance refunding after March 14, 1986, of a bond issued before January 1, 1986, even if this refunding results in the test-period beneficiary having more than $150 million of outstanding bonds allocated to it.

Again, however, such advance refunding bonds are counted as outstanding bonds for purposes of determining whether subsequent new money or advance refunding bonds may be issued.

Note that tax-exempt advance refunding bonds were eliminated by the Tax Cuts and Jobs Act and many not be issued after December 31, 2017.

Example 8

On April 7, 1991, Corporation Y, a 501(c)(3) organization, is a beneficiary of $120 million principal amount of non-hospital bonds. On this date, Corporation Y wants to borrow $60 million face amount of advance refunding bond proceeds to advance refund bonds issued on December 12, 1985. These advance refunding bonds will not be included in calculating the $150 million limitation allocated to Corporation Y.

Example 9

On August 15, 1987, Corporation Y borrows $20 million face amount of bonds to construct a nursing home. On May 10, 1992, Corporation Y wants to advance refund the 1987 bonds by borrowing $19.7 million face amount of bonds. The 1987 bonds and the 1992 refunding bonds will be included in the calculation of the $150 million limitation allocated to Corporation Y.

Loss of Tax Exemption

If an issue of qualified 501(c)(3) bonds causes the $150 million limitation to be exceeded, only the issue that causes the limitation to be exceeded is taxable.

If the $150 million limitation is violated with respect to an issue by a change of owners or principal users of bond-financed facilities at any time during the three-year test period, the interest on that issue is taxable from the date the bonds were issued.

Residential Rental Facilities

General Rule

Section 145(d)(1) provides that proceeds of qualified 501(c)(3) bonds may not be used, directly or indirectly, to finance residential rental property for family units.

Exceptions

Section 145(d)(2) excepts from the general rule the following scenarios if the:

- first use of the bond-financed facility is as a residential rental property for family units;
- facility is a qualified residential rental project, as defined in § 142(d); or
- bond financed property will be substantially rehabilitated beginning within the two-year period ending one year after the date of acquisition of the property.

First Use Rule

Section 145(d)(3)(A) permits residential rental facilities to be treated as if the first use of it is residential rental even if that were not the case if:

- the first use of the facility was pursuant to taxable financing;
- at the time of the taxable financing there was reasonable expectation that the taxable financing would be replaced with tax-exempt bonds; and
- the taxable financing is replaced with tax-exempt financing within a reasonable period after the taxable financing is provided.

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Residential Rental Facilities, Continued

Special Rule Regarding First Use

In addition to the above, § 145(d)(3)(B) provides that if, at the time of the first use of the property, there was no operating state or local program permitting use of tax-exempt bonds to finance a residential rental facility, the first time a property is financed with tax-exempt bonds is treated as first use of the property.

Example 10

In 1987, Corporation X, a 501(c)(3) organization, wanted to acquire an existing residential rental project located in County A. County A's local ordinance prohibited use of tax-exempt bonds to finance residential rental units. Corporation X acquired the facility with a taxable loan from a bank. In 1990, County A realized the increased need for low-income housing in its jurisdiction and amended its ordinance to permit issuance of tax-exempt bonds and established a housing authority to issue such bonds.

In 1991, Corporation X requested the housing authority to issue tax- exempt bonds, the proceeds of which were to be used to refinance the bank loan by Corporation X.

Although Corporation X already owned the facility and has been operating it, the use by Corporation X will be considered first use of the facility for purposes of the 1991 tax-exempt bonds.

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Example 10 (continued)

In PLR 9516027, the Service ruled that based on the facts and circumstances, the taxable interim construction financing qualified under § 145(d). After City gave preliminary approval for future issuance of bonds for 501(c)(3) corporation's project, Bank provided Corporation with a two-year taxable construction loan. City, later that year, issued the bonds and deposited the proceeds into an escrow account to be held by the bond trustee until certain conditions were met. Subsequently, the construction ran into difficulties, and as a result, the conditions for release of the escrow were not met and the bond trustee used the proceeds to redeem the bonds. Bank extended and increased its loan. After the project was finally completed, Corporation proposed a new issue of tax-exempt bonds to replace the taxable loan. The Service ruled that, provided the bonds were sold within 90 days and issued within 120 days of the ruling, the new bonds would "represent a replacement of . . . taxable financing within a reasonable period" for purposes of determining whether the first use of property is pursuant to tax-exempt financing under § 145(d)(3).

Qualified Residential Rental Project

A bond issue may be a qualified 501(c)(3) bond issued to acquire a residential rental project, if the residential rental project meets the requirements for a "qualified residential rental project" under § 142(d).

Rev Rul 98-47, 1998-2 C.B. 399, describes which components of a continuing care retirement community constitute a "qualified residential rental project" within the meaning of §§ 142(d) and 145(d).

Section 142(d) provides the requirements for qualified residential rental projects with respect to exempt facility bonds. These requirements will be described in Lesson 6 of Phase II Training.

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Substantial Rehabilitation

Rules similar to the rules under § 47(c)(1)(B) are used to determine if the project has been substantially rehabilitated.

To be considered substantially rehabilitated, § 47(c)(1)(B)(i) provides that the qualified rehabilitation expenditures during the specified two- year period must exceed the greater of the adjusted basis of the project and its structural components or $5,000. Section 47(c)(1)(B)(ii) does not apply, but the Secretary may extend the two-year period in § 47(c)(1)(B)(i) where appropriate due to circumstances not within the control of the owner.

Other Applicable Private Activity Bond Rules

Applicable Rules

The following private activity bond rules are applicable to qualified 501(c)(3) bonds. These rules are discussed in other modules of this text.

- Section 147(b)(1) places a limit on the average maturity of qualified 501(c)(3) bonds.
- Section 147(b)(4) provides special rules for qualified 501(c)(3) bonds, the proceeds of which are borrowed by two or more unrelated 501(c)(3) organizations or governmental units.
- Section 147(e) prohibits the use of qualified 501(c)(3) bonds to finance certain facilities—with the exception of health club facilities. *See § 147(h)(2).*
- The notice and public approval requirements of § 147(f) are applicable to qualified 501(c)(3) bonds.
- The limitation on costs of issuance under § 147(g) is applicable to qualified 501(c)(3) bonds.
- The arbitrage and rebate rules of § 148 apply to qualified 501(c)(3) bonds.
- Qualified 501(c)(3) bonds, like governmental bonds, may not be advance refunded with tax-exempt bonds issued after December 31, 2017. Section 149(d) provides the rules regarding advance refundings.
- Certain other provisions of § 149 also apply to qualified 501(c)(3) bonds.
- Section 150(b)(3) provides rules regarding the change in use of a facility financed with qualified 501(c)(3) bonds which continues to be owned by a 501(c)(3) organization after the change. Section 150(c) contains exceptions to the general rule in § 150(b)(3).

Summary

Review of Lesson 12

Lesson 12 completes the discussion of qualified 501(c)(3) bonds as described in § 145.

Regulations §§ 1.145-0 through 1.145-2 also provide rules for qualified 501(c)(3) bonds, but generally state that the private activity bond rules under Regulations §§1.141-0 through 141.15 apply to qualified 501(c)(3) bonds.

Specific requirements of qualified 501(c)(3) bonds are:

- All of the net proceeds must be used to finance property OWNED BY a 501(c)(3) organization or a governmental unit.
- Use by a 501(c)(3) organization in its related activities is treated as governmental use with respect to the private business tests.
- The bonds must NOT meet the private business use test AND the private security or payment test, using **five percent** instead of **ten percent** and **net proceeds** instead of **proceeds.**
- Use of bond proceeds or bond-financed facilities by a 501(c)(3) organization in an unrelated trade or business activity is considered private business use.
- Qualified 501(c)(3) bonds that are not qualified hospital bonds may be subject to a $150 million volume cap.
- With certain exceptions, the proceeds of qualified 501(c)(3) bonds may not be used to finance residential rental property for family units.

Qualified 501(c)(3) bonds are also subject to the general private activity bond rules provided by §§ 147 through 150.

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