

# Tax-Exempt Bonds – Issues for Nonprofit Borrowers

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# Tax Exempt Bonds

. . . .Nothing (much) to fear



# Tax Exempt Bonds

## WHAT ARE TAX EXEMPT BONDS?

- Specialized debt available to limited # of borrowers
- Requires adherence to prescribed Internal Revenue Code regulations and provisions
- Imposes substantive and procedural limitations

## BENEFIT TO QUALIFIED CLIENTS

- LONG-TERM SAVINGS!

# Who Can Issue Tax-Exempt Bonds?

- ▶ Tax-exempt bonds, or “municipal bonds,” must be issued by a state or local governmental unit:
  - ✓ on its own behalf **or**
  - ✓ as a “conduit issuer” for a qualifying borrower that is not a state or local government unit.
- ▶ New Hampshire’s 501(c)(3) conduit issuer:
  - ✓ New Hampshire Health and Education Facilities Authority (“NHHEFA”)



# What Can and Cannot Be Financed?



## Capital Projects

- Schools
- Healthcare providers
- Senior Living Facilities
- Colleges and Universities
- Other charitable facilities (e.g., social service providers and cultural institutions)



## Working Capital (limited amounts)



# Certain Financing Issues

- ▶ Tax Exempt Bonds result in lower tax revenues to the government
- ▶ Therefore, the government imposes certain requirements in structuring the transaction to ensure the bonds are not issued for purposes for which other funds of the borrower are available.  
Specifically:

- ✓ Limits the extent to which a borrower can reimburse itself for expenditures made from its own funds
- ✓ Limits on refinancing of existing indebtedness
- ✓ Limits on financing projects for which capital campaign contributions are being solicited
- ✓ Limits on security interests and testing of liquidity



# Basic Tax Issues

▶ What do we mean by “tax-exempt” financing?

▶ Terminology

- Borrower
- Issuer
- Proceeds
- Bond Counsel
- Borrower’s Counsel

▶ Conduit Structure



# Basic Tax Issues

- ▶ 501(c)(3) Status
- ▶ 501(c)(3) Ownership
- ▶ Arbitrage
- ▶ Private Use
  - Certain Uses by Third Parties
  - Management Contracts
- ▶ Reissuance Concerns



# Written Post Issuance Compliance Procedures



- ▶ IRS Focus
- ▶ Benefits
- ▶ Contents
- ▶ Follow through

# Preliminary Expenditures Reimbursement

Borrowers may reimburse themselves for moneys paid out of their own funds provided:

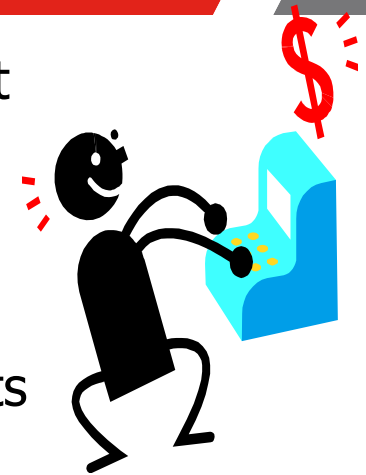


Borrower adopts an "intent" or "reimbursement" resolution, evidencing its intent to finance such costs (soft costs have no such limits) within 60 days after the first hard cost reimbursement is sought.



Each such expenditure must be reimbursed by:

- the later of (i) 18 months after the expenditure or (ii) the date the improvement was completed; and
- in any event, no later than 3 years following the expenditure



# Refinancing Existing Indebtedness

Tax-Exempt Bonds may be used to refinance existing indebtedness incurred to finance **qualifying capital expenditures** provided:

The existing debt has been in **continuous existence** from the initial financing of the capital expenditure. Any **break** in the financing will **extinguish** this ability

Consequently, if a borrower is seeking to use a line of credit for this purpose, **any pay downs may result in breaking the continuous existence requirement** for part, or all, of the financed expenditures

# Capital Campaigns

**ISSUE:** Borrower conducts a capital campaign to raise funds for the same facilities it wishes to finance with Tax-Exempt Bonds

**RISK:** Inability to finance the facility or the need to refund part, or all, of the bonds used to finance the facility

## GUIDELINES TO PROTECT FINANCING

1. Designated Contributions + Bond Proceeds  $<$  or  $=$  Total Cost of Facility
2. Preferred Solution:
  - Receive unrestricted donations to the extent possible
  - Requires proper wording of campaign literature and pledge forms



# Limits on Security Interests/Liquidity Tests

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"I don't make the rules, folks — I just carry them down the mountain."

## IRS Position:

1. If a borrower can give a security interest in its cash and investments as security for a bond issue, the borrower could use those assets to finance the improvements being financed with bond proceeds
  - This restriction does not apply to the revenue stream which results in the cash/investments, allowing a borrower to give a Gross Receipts pledge
2. If a borrower is consistently required to maintain a certain level of liquidity (days cash on hand, cash/investments to debt, etc.), then it could have used those funds to finance the improvements being financed with bond proceeds

## Limits on Security/Liquidity (continued)

- ▶ Internal Revenue Code regulations provide two basic rules:
  1. Liquidity, as per the agreement, may be tested twice in each calendar year
  2. Between testing dates, the Borrower must have the unfettered ability to spend its cash/investments, subject only to meeting the required level(s) bi-annually
  
- ▶ If security interest or liquidity rules are not met:
  - Borrower's cash/investments become "yield restricted", meaning they cannot earn yield in excess of the yield on the Tax-Exempt Bonds. This outcome is not typically in the lender's or borrower's interests
  
- ▶ Despite these rules, the right of set-off against moneys in borrower accounts held by a lender is permitted

# Private vs. Public Offerings

Trend has been toward negotiated private placements of bonds with banks as opposed to public offerings

▶ **Advantages:**

- Cheaper - no underwriter or trustee fees
- Limited disclosure
- Negotiated transaction with bank or other financial institution
- No rating required

▶ **Drawbacks:**

- Shorter term borrowings – typically 5 to 10 years
- Operating/financial covenants similar to commercial loan
- Reissuance concerns



## Reissuance Concerns

- ▶ Most direct bank placements have a relatively short life compared to the length of the bond issue
- ▶ Unless the parties take appropriate steps, the bonds may be considered reissued at the end of the initial purchase period
  - Provide for remarketing or conversion of the bonds following the initial purchase period
  - Include at the outset one or more quantitative formulas to determine the new interest rate and period
- If reissuance occurs and the tax laws have changed, the bonds can **lose** their tax-exempt status





# Certain Structuring Issues

## Basic Financing Documents

- Loan Agreement/Bond Indenture
- Loan and Security Agreement
- Master Trust Indenture
- Security Agreement
- Mortgage
- Tax Regulatory Agreement



## Use of Interest Rate Swaps

- ISDA Master Agreement
- Schedule
- Confirmation
- Credit Support Annex

## Certain Structuring Issues (continued)

### Master Trust Indenture Structure

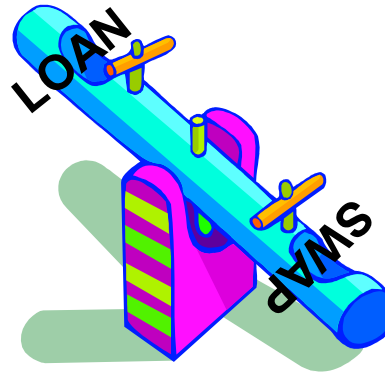
- Obligated Group
- Fundamental covenants/security at MTI level
- Cross-guarantee/collateralization at MTI level
- Specific covenants/security at Loan Agreement level

### Uses of Master Trust Indenture

- Healthcare systems
- Continuing care retirement communities
- Multi-organization entities

# Interest Rate Swaps - Fundamentals

- ▶ Interest rate swaps are agreements separate from the loan documents
  - No need for an identity between the swap and loan providers
- ▶ Although interest rate swaps are intended to provide interest rate certainty, there are potential differences between the swap and loan documents (e.g. the basis on which payments are made)
  - Many existing tax-exempt bond issues are based on the Securities Industry and Financial Markets Association (SIFMA) index while many existing tax-exempt swaps are based on a percentage of LIBOR

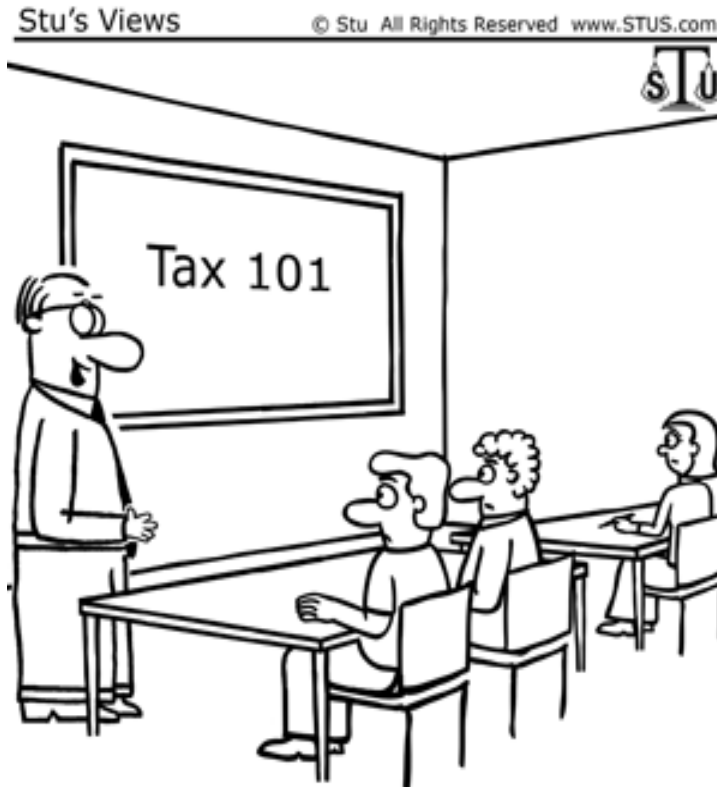




- ▶ Term sheets raise critical issues about the “deal”
  - Certain matters, such as cross-default levels, are subject to negotiation as the transaction progresses
  - However, all primary economic, reporting and operating covenants should be in the term sheet (and final commitment), rather than leaving those to later discussion, including:
    - Debt service coverage ratios, leverage and liquidity covenants (including unfinanced capital expenditures)
    - Additional indebtedness and liens; dispositions and acquisitions of assets
    - Material Adverse Change/Effect clauses
    - Most favored nation clauses
    - Other quantitative affirmative and negative covenants

# Tax Exempt Bonds . . . . We're here to help!

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The Internal Revenue Code is absurdly complex or, as we lawyers say, a goldmine.