Raising Capital for Not-For-Profit Organizations: Tax-Exempt Bond Financing

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I. Introduction

Tax-exempt bonds are available to 501(c)3 not-for-profit organizations looking to finance projects ranging from land and construction purchases to refinancing existing debt. Tax-exempt bonds typically trade 250 basis points below conventional financing, providing 501c3 organizations significant savings over the life of the issue (see attached interest rate graph). Interest earned by purchasers of tax-exempt bonds, typically a large institutional bond fund, will be exempt from federal income tax and the state gross income tax. These savings are passed on to the borrower as a below-market interest rate.

Since most organizations do not have a history of issuing debt into the tax-exempt market, a commercial bank will provide a Letter of Credit (LOC) to support a bond issue. The LOC provides the organization the strong credit rating of the bank and direct debt service payments to bondholders. Ultimately, the bank's credit rating determines how bonds trade in the marketplace. The same credit review and financial covenants that a bank would require for a conventional financing would apply to a tax-exempt bond issue.

The Internal Revenue Code defines the eligibility for tax-exempt bonds and requires the borrower to issue the debt through a conduit Governmental Issuer to receive tax-exempt status. In New Jersey the conduit issuer is the New Jersey Economic Development Authority (NJEDA). The NJEDA is a self-supporting, independent state financing and development agency serving New Jersey's business community. Since 1974, the NJEDA has provided nearly $14 billion to eligible businesses and not-for-profit groups. Some examples include: the Association for Retarded Children of Somerset, CPC Behavioral Healthcare, Catholic Community Services, Urban League of Hudson County, Pennington Montessori School and the Institute of Electrical and Electronics Engineers to name a few.
II. Requirements for 501(c)(3) Tax-Exempt Bond Issues

A) Federal

The Federal Government/Internal Revenue Service has specific requirements that must be met in order to issue tax-exempt debt. The federal requirements for tax-exempt financing are:

- **Qualifying Costs.** At least 95% of the bond proceeds must be spent on qualifying costs. Qualifying costs are generally capital expenditures such as land, building and equipment and other depreciable property owned by a 501c3 organization.

- **Issuance Costs.** No more than 2% of the bond proceeds can be spent on issuance costs (placement fees, legal fees and other issuance costs).

- **Maturity.** The average maturity of the bonds cannot exceed 120% of the average economic life of the facilities financed.

- **No Working Capital or Inventory.** Bond proceeds cannot be used to finance working capital or inventory.

- **Reimbursement.** From the date an organization starts spending hard dollars related to a Project, the organization has 60 days to obtain an Inducement Resolution from the NJEDA or an internal Board Resolution in order to reimburse itself with tax-exempt financing. Soft costs such as engineering and legal costs do not apply to this rule.

- **Bond Proceeds.** The organization has up to three years from the closing date on the bond issue to expend the proceeds for the qualified project. If there are any unspent proceeds after three years, bonds must be paid down.

B) State

The NJEDA requires an application to be completed by the borrower prior to NJEDA board
approval. However, the NJEDA does not have many formal requirements over and above the Federal requirements outlined above. One specific NJEDA requirement is that the prevailing wage, established by the New Jersey Department of Labor, be paid for labor as it relates to construction or renovation. In addition, the NJEDA requires the applicant to outline the number of jobs that will be created by the proposed project. Any increase in gainful employment in their communities will be sufficient for NJEDA approval. The majority of states have the same requirements as the NJEDA. Any potential project outside of New Jersey should contact the appropriate state conduit issuer to request additional information for tax-exempt bond financing.

III. Analysis of State Issuing Authorities

As discussed in Section II, a qualified 501(c) 3 borrower must issue tax-exempt bonds through a conduit issuer. One major difference between private corporations (manufacturing companies) that can also qualify for tax-exempt bonds and non-for-profit groups is the allocation situation for each state. Private corporations that qualify must rely on the tax-exempt allocation pool that is distributed by the federal government based on the per capita population for each state. Non-for-profit organizations have an unlimited pool of tax-exempt dollars and do not have to rely on a specified pool of allocation. Listed below is a table describing various issuing entities across the country and the benefits and disadvantages of issuing debt for not-for-profit organizations.

<table>
<thead>
<tr>
<th>State</th>
<th>More Restrictive</th>
<th>Less Restrictive</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Jersey</td>
<td></td>
<td>✓</td>
<td>The main authority is the New Jersey Economic Development Authority (NJEDA). Although the NJEDA has a prevailing wage requirement as it relates to labor costs, they have been extremely flexible in allowing projects (mostly 501c3) to complete the project and refinance the construction loan through a tax-exempt bond issue. There are other authorities that do have the ability to issue debt, but the NJEDA is the most commonly used organization. NJEDA requires a bond counsel that is on their approved list. The NJEDA fee is 50% of the principal amount of bonds.</td>
</tr>
<tr>
<td>State</td>
<td>More Restrictive</td>
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</tr>
<tr>
<td>Pennsylvania</td>
<td></td>
<td>√</td>
<td>Most counties have their own individual authority. There is a state authority called PEDFA, but this is mostly used for larger pooled transactions. Most county authorities just have the standard hiring guidelines, but no other restrictions. Fees range from 1% of the principal amount of bonds to .125%. No requirements as far as bond counsel.</td>
</tr>
<tr>
<td>Connecticut</td>
<td>√</td>
<td></td>
<td>Controlled by state issuing authorities. The Connecticut Development Authority (CDA) will only allow for the issuance of manufacturing companies. Non-for-profits must issue debt through the Connecticut Higher Education Finance Authority (CHEFA). Unfortunately, the project size must exceed $8 million in order for a bond issue to make sense. This is mostly due to the authorities costly fees.</td>
</tr>
<tr>
<td>Delaware</td>
<td></td>
<td>√</td>
<td>One state authority, the Delaware Economic Development Authority, however they typically only focus on manufacturing projects. Most counties have a local authority, which can be very flexible in issuing debt for a non-for-profit.</td>
</tr>
<tr>
<td>Maryland</td>
<td></td>
<td>√</td>
<td>Two state authorities have the ability to issue debt for 501c3 organizations, but typically projects go through the local county authorities. The county authorities vary by location, but typically the fees are less expensive than the state authority.</td>
</tr>
<tr>
<td>New York</td>
<td></td>
<td>√</td>
<td>Non-for-profits have the ability to issue through a variety of authorities in New York. Typically the state authorities are more expensive than the local issuing entities, however, sometimes they can be competitive on pricing.</td>
</tr>
<tr>
<td>Massachusetts</td>
<td></td>
<td>√</td>
<td>One central state authority and they require using one specific bond counsel. Fees are expensive and the process is typically lengthy.</td>
</tr>
<tr>
<td>Rhode Island</td>
<td></td>
<td>√</td>
<td>Two choices of state authorities. Both are extremely flexible and fees are reasonable.</td>
</tr>
<tr>
<td>North &amp; South Carolina</td>
<td></td>
<td>√</td>
<td>State authority is extremely flexible and reasonable fees. Most county authorities don’t have the ability to issue debt.</td>
</tr>
<tr>
<td>Kentucky</td>
<td></td>
<td>√</td>
<td>State authority as well as county authorities. Project location would really determine which entity to use, but fees are extremely reasonable.</td>
</tr>
<tr>
<td>Tennessee</td>
<td></td>
<td>√</td>
<td>State authority as well as county authorities. Project location would really determine which entity to use, but fees are extremely reasonable.</td>
</tr>
<tr>
<td>Georgia</td>
<td></td>
<td>√</td>
<td>State authority as well as county authorities. Project location would really determine which entity to use, but fees are extremely reasonable.</td>
</tr>
<tr>
<td>Florida</td>
<td>√</td>
<td></td>
<td>More political than most southern states. Various choices but most issues are completed by county or local authority. Fees are reasonable but they are more expensive than most southern states.</td>
</tr>
<tr>
<td>Illinois</td>
<td>√</td>
<td></td>
<td>Most issues are completed through local or county authorities, but state authorities are available. Most authorities are expensive in issue through and require the use of specific counsel. Most authorities favor the larger size projects.</td>
</tr>
<tr>
<td>California</td>
<td></td>
<td>√</td>
<td>Most issues are completed through local or county authorities, but state authorities are available. Most authorities are expensive to issue through and require the use of specific counsel. Most authorities favor the larger size projects and politically connected organizations. Process is extremely lengthy.</td>
</tr>
<tr>
<td>Indiana</td>
<td></td>
<td>√</td>
<td>State authority as well as county authorities. Extremely flexible and very easy to work with in the process. Reasonable fees at both levels.</td>
</tr>
<tr>
<td>Ohio</td>
<td></td>
<td>√</td>
<td>Most issues are completed at the local level, however two state authorities have the ability to issue debt for a 501c3 project. Very reasonable fees at both levels.</td>
</tr>
<tr>
<td>Utah</td>
<td></td>
<td>√</td>
<td>Aside from California, probably the most restrictive state to issue tax-exempt debt. They have one state authority which actually makes the project justify receiving tax-exempt allocation. Lengthy process and fees are expensive mostly due to the restrictions of the state authority. Avoid Utah if you can.</td>
</tr>
</tbody>
</table>
Arizona

Local issuers as well as a state authority. Typically, projects issue through the local level. Most rural counties are reasonable and extremely cooperative. Urban issuers are more difficult, but overall willing to work with the borrower.

Texas

Most issues are completed at the local level, although a state authority has the ability to issue debt for not-for-profits as well. Fees are high and process is lengthy compared to other states. Larger sized projects are typically favored.

In conclusion, state issuing authorities are more flexible with not-for-profit organizations compared to for-profit corporations. Although the federal government is less restrictive on a not-for-profit issuing tax-exempt debt, the state or county issuing entity ultimately determines whether tax-exempt bonds make economic sense. Specific areas that typically serve as a disincentive for a project would be the completion of the financing (lengthy compared to conventional financing) and excessively high issuance costs.

IV. Questions and Answers Regarding Bond Financing Process

Serving as the investment banker on various tax-exempt bond issues, I have developed four questions listed below to survey clients. The questions were posed to five clients that completed tax-exempt bond issues. All of the clients were not-for-profit organizations. The purpose of the survey was to find any similarities or differences in the process of tax-exempt bond financing. The five individuals questioned were Comptroller or Chief Financial Officer (CFO) for the not-for-profit organization that completed the bond issue and were directly involved in the financing.

Questions:

1. Overall how would you view the tax-exempt process?
2. Do you have any complaints about the process or the Authority?
3. What alternatives would be available if tax-exempt financing was not an option?
4. What advice would you offer another 501(c) 3 exploring tax-exempt bonds as a financing alternative?

Responses:

1. Overall how would you view the tax-exempt process?

Three of the respondents discussed the large amount of documentation required and the other two respondents only mentioned the low interest rate. One factor that might have contributed to the complaint about documentation was the legal representation. All of attorneys representing the three respondents complained about the amount of documentation involved. Two respondents retained bond counsel who were experienced in bond financings. All of the respondents did mention that they were very satisfied with the low interest rate.

To summarize the responses to question one, most of the clients discussed the large amount of documentation required to complete a tax-exempt bond issue. However, all respondents agreed that the low interest rate achieved far outweighs the amount of documentation or work required for completing a tax-exempt bond issue.

2. Do you have any complaints about the process or the Authority?

A common complaint among the respondents was the amount of fees associated with closing a tax-exempt bond issue. Although the fees are typically higher than a conventional bank loan, the initial interest rate is approximately 250 basis points lower. All of the respondents did mention higher fees, but they all recognized that even with the fees amortized over the life of the loan the all-in-interest rate for a bond issue was more favorable than a conventional loan. In addition, all of the respondents mentioned little interaction with the Authority or conduit issuer.
All respondents agreed that the fees associated with a bond issue were high. However, the low interest rate provided significant savings when compared to a conventional loan. The common client response as it relates to the Authority was very little or no interaction with the Authority during the course of the bond issue. This response supports the fact that the federal tax code, not the state Authority, ultimately determines the status of tax-exempt bonds for not-for-profit organizations. State Authority's simply serve as a conduit issuing entity to receive tax-exempt status for a project.

3. What alternatives would be available if tax-exempt financing was not an option?

The overwhelming response was a conventional bank loan. These loans are typically priced at a spread over 1-month LIBOR (London Inter Bank Offering Rate), which is a commonly used bank index. Some of the respondents mentioned the ability to borrow internally from an Endowment Fund. Although this may be a viable option for a larger not-for-profit entity, this is not reality for most organizations. As mentioned previously, tax-exempt bond financing versus conventional financing will provide significant savings to an organization over the life of the issue.

4. What advice would you offer another 501(c) 3 considering tax-exempt bonds as a financing alternative?

Most of the responses to this question were very similar. Respondents highlighted the fact that tax-exempt bond financing is very complicated for most unsophisticated not-for-profit board members to comprehend. All respondents agreed that an experienced finance team plays a major role in successfully completing bond financing. A corporate or company counsel that has experience with tax-exempt bond issues will be very valuable to an organization that has never completed a bond transaction.
Another common response was the variable interest rate feature. The majority of the respondents were initially too conservative to take the interest rate exposure with the variable rate bonds when the financing closed. However, since the bond issue closed and having a history of how the variable rate trades over time, all of the respondents agreed that perhaps a portion of their debt should have been left in the variable rate mode.

V. Bond Structure

Variable Rate Demand Bonds (VRDB) is a long-term tax-exempt revenue bond designed to take advantage of the short-term end of the yield curve. Variable Rate Demand Bonds can be converted to a long-term fixed rate bond whenever market conditions become favorable (further discussed under Fixed Rate “Swap” Option).

Variable Rate Demand Bonds have a nominal long-term maturity, not to exceed 120% of the weighted average economic life of the assets being financed. During the floating rate period, the bondholder has the option to tender the Bonds for purchase at par upon notice. The notice period is usually not less than seven days and coincides with the frequency of the setting of the interest rate by our remarketing agent. The bonds tendered are re-sold by our remarketing agent on a best efforts basis in the secondary market. This structure allows the lender to achieve short-term borrowing costs on a long-term liability.

Generally, the purchasers of VRDBs restrict their investments to issues that are rated A-1 or P-1 for short-term, and "A" or better for long-term. In order to satisfy the investors, VRDBs are secured by letters of credit for two purposes: to provide liquidity in the event the remarketing agent is unable to remarket any tendered bonds; and to secure a higher rating on the bonds which translates to a lower interest rate.
Benefits:

1. **Ability to Prepay.** VRDBs can be prepaid at any point without premiums, compared to fixed rate financing which typically required a lengthy call protection period (3 years minimum) followed by prepayment premiums starting at 2 to 3%.

2. **Long-Term Financing.** VRDBs can have maturates up to 120% of the economic life of a project.

3. **Lower Costs.** VRDBs allow you to access capital markets and fund at the shortest end of the tax-exempt yield curve. Due to the credit enhancement, the VRDB becomes a very liquid asset for which the investor is willing to accept a low money market rate. In addition, upfront placement costs are much lower with a privately placed transaction than with a fixed rate public offering.

4. **Fixed Rate Option.** The fixed rate option gives you the flexibility to lock in a favorable rate when rates have bottomed out.

5. **Availability of Hedging.** Interest rate insurance products can provide either fixed rates or rate ceilings against the possibility of an increase in interest rates. These products can be entered into at any time after the bond transaction closes.

6. **No Financial Disclosure.** Since VRDBs are traded based on the support of the credit enhancement, there is no financial disclosure required.

Fixed Rate "Swap Option" is a fixed rate hedge designed to eliminate the exposure of a borrower's variable rate debt. A borrower can lock in a fixed rate replacing the floating rate term debt by entering into a fixed rate hedge contract with a financial institution. Under the contract, the borrower would pay the financial institution a fixed rate for the life of the transaction. In return, the
financial institution would pay the (VRDB) floating rate, matching the floating rate required on the bond. Whether VRDB rates rise or fall, the borrower will continue to pay the fixed rate for the life of the contract. As long as the hedge and floating rate bond remain in place, the borrower has an obligation that replicates a traditional fixed rate bond.

**Benefits of Fixed Rate Hedges**

The Fortune 500 marketplace has used the hedging technique described above as an alternative to fixed rate bonds since the early 1980’s. Fortune 500 companies universally recognize that the strategy of borrowing from banks on a floating rate basis and using a separate hedge to fix the interest rate risk is superior to imbedding a fixed rate in a bank loan. By decoupling the hedge and the bond into two separate contracts, the borrower benefits in three different ways:

1. **Two-way Prepayment:** The borrower will, in general, receive a gain on the hedge if it cancels the contract when market fixed rates are higher than the original fixed rate. On the other hand, should fixed rates be lower at that time, the borrower would pay an unwind fee which is similar to, but in general smaller than, a standard prepayment penalty on a fixed rate bank loan.

2. **Flexible Risk Management:** Subject to any hedging requirements under the bond, the borrower can enter into a fixed rate hedge at any time, for any term, on any portion of its variable rate debt. This feature allows the borrower to specifically tailor its hedge to match any amount and time frame the borrower deems appropriate. Subject to credit approval, the borrower can even use a hedge to lock in a rate in advance of its bond closing. In contrast, on a fixed rate loan, the borrower must choose either a fixed or variable rate on the loan closing date.
3. **Transferable Hedges**: The borrower can use the hedge with any of its debt since the hedge contract is separate from the bond contract. Remember, the financial institution reimburses the borrower VRDB and in return the borrower pays the financial institution the fixed rate. The hedge can be used for any financing with similar pricing and terms.

As with any hedging transaction, if floating rates stay low or fall over the life of the hedge, then it would have proven better—-with hindsight—-not to have hedged against rising interest rates.

**VI. Additional Information**

Organizations interested in exploring tax-exempt bond financing can obtain more information by contacting their financial institution or a representative from their state economic development authority. In New Jersey, contact Lawrence Cier at the NJDEA phone (609)-292-0192.

**VII. Recommendation**

Tax-exempt financing should always be examined for any sizable capital expenditure for a not-for-profit organization. The only disadvantage to a tax-exempt bond issue for a 501c3 organization would be the size of the issue. Although the base interest rate is dramatically lower when compared to conventional financing, there are additional fees associated with a bond issue. Any issue below $1,000,000 may not make economic sense for a tax-exempt bond issue.