# Tax-Exempt Financing for Not-for-Profit Organizations

MINNESOTA
HIGHER EDUCATION
FACILITIES AUTHORITY

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## Contents

## Overview

Not-for-profit organizations who qualify under section 501 of the Internal Revenue Code are able to finance capital projects on a tax-exempt basis. Very few such organizations can directly access the tax-exempt market. Most not-for-profit organizations, including educational, health care and cultural institutions that are eligible for tax-exempt financing must do so through a local government unit or a state-wide agency that is authorized by state law to act as a "conduit issuer" of bonds. The tax-exempt status of the interest on the obligations provides a lower interest cost to the borrowers compared to conventional loans from commercial lenders.

The Authority derives its power to finance projects under Minnesota Statutes, Section 136A.25 to 136A.42 (the "Enabling Act"). The Authority is a "conduit issuer" and all financings of the Authority are "conduit" issues. That means that the Authority is the nominal issuer of the bonds and the nominal borrower of the debt. The Authority does not have any financial liability for repayment to bondholders. None of the Authority's bonds are a debt or pledge of the full faith, credit or moral obligation of the State of Minnesota. The real credit and beneficiary of the bonds is the Minnesota college or university that will receive the proceeds from the sale of the bonds. The Minnesota college or university is referred to as the "obligor."

The borrowers are generally private not-for-profit educational institutions authorized to provide education beyond high school. Eligible projects to be financed include facilities for housing, academic and administrative purposes, recreation or student athletics, parking, student centers and other buildings and equipment to be used for instruction, research, or operations.

Public colleges in the State are also eligible for Authority financing, but projects for them are limited to child-care, parking facilities or special projects authorized by specific legislation.

The financings include three general categories: revenue bond issues, private placement notes and financing leases. The most common form of financing is the revenue bond structure. Private placement notes and the financing lease structure are used when they are best suited to meet the needs of a borrower. Unless specifically noted herein, the term "bonds" includes bonds, notes and financing leases. The differences among the three types of financings are discussed within this document.

## About the Authority

The Authority was created in 1971 and consists of eight members appointed by the Governor with the advice and consent of the Senate. A representative of the Minnesota Office of Higher Education and the President of the Minnesota Private College Council, who is a non-voting member, are also members of the Authority.

The Authority has never received state appropriations or tax revenue for its operations. It has no taxing power. Its operating expenses are funded by annual fees paid by each borrower. The fee charged to each borrower is based upon the borrower's outstanding Authority-issued debt. It does not make grants and will not provide a guaranty, reserve or other security for its bonds.

A two-person staff, led by the Executive Director and assisted by its Operations Manager, provides borrowers with specific advice on tax-exempt financing. Borrowers receive periodic summaries of Authority debt issues. In addition, the Authority hosts an annual educational conference to highlight trends and issues in the municipal market and ongoing assistance with tax and securities law compliance. Further information is available at www.mnhefa.org.

## Constitutional Law

The Enabling Act was drafted to be consistent with the State Constitution that does not allow "public money or property [to] be appropriated or used to support schools wherein the distinctive doctrines, creeds or tenets of any particular Christian or other religious sect are promulgated or taught" (Minn. Const. Art. XIII Sec. 2). In particular, the Enabling Act excludes from financing "any facility used or to be used for sectarian instruction or as a place of religious worship nor any facility which is used or to be used primarily in connection with any part of the program of a school or department of divinity for any religious denomination".

The fact that a borrower is sponsored by a religious denomination does not by itself make the borrower a sectarian institution for this purpose. A test case was filed by the Authority to establish the legality of the bonds under the Enabling Act involving several schools affiliated with religious denominations. In Minnesota Higher Education Facilities Authority v. Hawk, 305 Minn. 97, 232 N.W. 2d 106, filed August 8, 1975, the Minnesota Supreme Court affirmed the constitutionality of issuing bonds for facilities used solely for nonsectarian educational purposes.

For decades, the Establishment Clause of the U.S. Constitution has been interpreted to prohibit a governmental entity from acting as conduit issuer for sectarian institutions, even if the proposed project is for nonsectarian educational purposes. This continues to be the prevailing view. However, several recent U.S. Supreme Court decisions have chipped away at the proposition that a borrower must be nonsectarian provided that the governmental assistance is for a secular purpose, such as textbooks and free lunches. These cases do not include situations where the governmental aid consists of a conduit bond issue to benefit a sectarian institution. At the lower federal court levels and in the state courts, there have been conflicting decisions as to whether conduit bond financing is permissible governmental assistance for both sectarian and nonsectarian institutions.

Until the prevailing legal interpretation changes, sectarian institutions will not be eligible for bond financing. The Application is intended to provide a record that the borrower is not sectarian, and the project is for nonsectarian educational purposes. In addition, the Application will highlight information needed to assure the tax-exempt status of the bonds.

## Tax Law

Lower overall borrowing cost for the borrower depends on the exclusion of the interest on the bonds from federal and State income of the bondholders. The tax-exempt status of the interest on the bonds depends on compliance with the Internal Revenue Code and related regulations. A few of the requirements are summarized below.

### Public Hearing

A public hearing is almost always required. The application process takes into account the information needed for the notice, the time needed to meet publication deadlines and the 14 days' notice period. The Authority will schedule the public hearing and arrange for publication in the State Register and the local newspaper.

### Arbitrage Rebate

The Internal Revenue Code contains restrictions related to the use of bond proceeds. Any investment earnings on unspent bond proceeds which exceed the yield on the bonds calculated without regard to underwriting discount and issuance costs (the "bond yield") is considered to be arbitrage profit and must generally be remitted to the federal government for the bonds to remain tax-exempt. The proceeds held for construction projects may be eligible for a special exemption as described below.

Bond issues may include a reserve fund for purposes of marketability. Whenever there is a reserve fund, arbitrage rebate reports must be prepared on five-year cycles and, if the reserve fund investments earn more than the bond yield, the difference must be remitted to the federal government. In addition, if the bond issue is secured by a direct or indirect pledge of endowment or similar funds, those funds are treated as bond proceeds for federal arbitrage rebate tax purposes. The excess earnings on those investments will also be subject to arbitrage rebate rules. Another risk is the availability of restricted gifts that might be treated as bond proceeds for federal tax purposes. The borrower's expectations for gifts should be carefully reviewed while planning the financing. The expected gifts may result in arbitrage rebate as well as other considerations relating to size, timing, repayment schedule and prepayment options for the bonds.

Under some circumstances, arbitrage rebate calculations must take into account interest that was not actually received by the borrower. For example, failure to invest bond proceeds or making investments at below market rates will generally give rise to imputed interest at the rates that could have been earned.

## Rebate Calculations

The bond trustee will ask the borrower to confirm compliance with the rebate obligation. In general, all arbitrage rebate calculations will be performed by the Authority's Financial Advisor at the expense of the borrower. By centralizing this function, the process has been more reliable and economical to the borrowers. Rebate payments are the responsibility of the borrower, payable every five years and when the entire bond issue has matured or redeemed. While not required, some borrowers find it prudent to make annual calculations and to reserve against any rebate liability.

## Exemption from Rebate for Construction Financing

An exemption may be available for certain bonds that are at least partly for construction purposes. The exemption is not available unless at least 75% of the bond proceeds (net of the amount deposited to the reserve fund) are to be used for construction. The portion of a bond issue used to refund prior bonds or for site or equipment acquisition cannot qualify for this exemption. In order to fit the exemption, the construction bond proceeds must be spent according to certain guidelines: 10% of the construction fund proceeds within six months, 45% within one year, 75% within 18 months, and 100% (100% less up to 5 percent for retainages) within two years (the retainages to be paid out within three years) from the bond closing.

## Private Business Use

If there is any expectation that a project financed with bonds will be owned, occupied or subject to management by any person or organization other than the borrower, then there is a possibility that all or part of the project is not eligible for tax-exempt financing. If the private use is greater than allowed under the Internal Revenue Code, the tax-exempt status of the bonds may be jeopardized.

## Securities Law

### Disclosure in the Official Statement

Borrowers should bear in mind that bonds are securities and are subject to securities law considerations. The Official Statement is the disclosure document used in offering the bonds for sale to investors. It includes the terms and conditions of sale, details of bond maturities, interest and redemption features, security provisions, and descriptive operating and financial information about the borrower. Drafts are circulated, reviewed and edited among the borrower, the Authority, the underwriter and other parties. The Official Statement must be complete and accurate as to all information that may be material to an investor in making the decision to purchase the bonds. Failure to meet the disclosure standard because of materially misleading statements or omission of material information is a violation of the securities laws.

### Secondary Market Disclosure

The Securities and Exchange Commission imposes an ongoing secondary market disclosure requirement on the municipal market. Borrowers must submit an annual report of financial and other operating information (generally the same type of information as presented in the Official Statement) to the Electronic Municipal Market Access (EMMA) system of the Municipal Securities Rulemaking Board. The Authority generally acts as the dissemination agent for participating borrowers and will send annual reminders and submit the reports to EMMA as a continuing service.

Even though the annual reports are theoretically available to all current and potential investors, institutional investors often seek out information directly from the borrowers. The information may be covered in the annual reports. Sometimes the investors ask for information that is not expected to be made public or will be made public at a later date. This situation gives rise to questions of fair access to market information, including insider trading concerns. The Authority recommends the borrower direct any such inquiries to the Authority. A borrower should also be cautious in "speaking to the market." The Chief Financial Officer should be aware of investor inquiries and not distribute non-public information.

## Making Choices

Each financing includes a number of structuring options and financial variables. The borrower must first determine the scope and approximate cost of the capital project, the construction timetable and sources of funds to pay the project cost, such as funds on hand, gifts and debt. The borrower must then decide how much to borrow and the preferred loan amortization schedule. Based upon those parameters, the Authority will assist the borrower in choosing from three options: revenue bonds, private placement notes and financing leases. If the best fit is a public offering of revenue bonds, then the borrower must decide whether to obtain credit enhancement and to choose between fixed or variable interest rates and between a negotiated or competitive sale. If a private placement is a better fit, then the borrower must choose between fixed or variable interest rates and select the placement agent and purchaser.

## Revenue Bond Option

This is the Authority's most common financing vehicle. Revenue bonds are sold by the Authority to one or more investment banking firms that, in turn, sell to various retail and institutional investors. Proceeds of the bonds are received by the Authority but simultaneously loaned to the borrower that will be responsible for loan payments that match the principal and interest due on the bonds. Each bond represents a promise to repay the principal amount on specific dates plus periodic payments of interest. A bond issue is comprised of one or more bonds.

### Repayment of Principal

Most commonly, a bond issue will include various principal amounts maturing on consecutive dates, usually annually, over a span of years. These are called serial bonds. If all the bonds mature on a single future date, they are called term bonds. The current trend is to include serial maturities in the first eight to twelve years, followed by one or more term bonds spaced several years apart.

### Interest Rates

The majority of issues sold by the Authority have fixed interest rates. Authority bonds have also been sold with variable interest rates. In that case, the rate is reset periodically (often weekly or monthly) based on then-current market parameters. Variable rate bonds are often paired with a demand (or tender) feature.

### Demand or Tender Bonds

Most variable rate bonds include the option for the owner to receive payment in full on short notice by tendering their bonds for payment. The notice period can be daily, weekly or a longer interval. The investor is willing to accept a lower interest rate and the flexible call provision because the tender feature allows more liquidity for the investor. These features have led a number of borrowers to employ this form of borrowing ("variable rate demand bonds") when they have a strong expectation of receiving gift moneys to repay the debt, but are uncertain about the timing of actual receipt of the gifts.

### Length of Repayment Term

The final maturity of a bond issue is usually thirty years or less. The maturities usually relate to market demand and the useful life of the assets being financed. The Internal Revenue Code imposes a limitation on the maximum maturity of not more than 120% of the useful life of the financed asset. A borrower may be induced to shorten the total maturity because of anticipated gifts to repay the bonds or a generally conservative debt policy.

## Prepayment

Most long-term bonds include a provision for prepayment (also called "redemption" or "call"), at the borrower's option. Since the option is likely to be exercised if rates fall, bond purchasers generally demand a no-call period of 8-10 years. In some cases, a premium for early call is built into the transaction. In the case of variable rate bonds, very flexible call provisions are common.

Extraordinary redemption provisions are often included in a bond financing to accommodate special circumstances. For example, if a facility were to be destroyed by fire and the borrower chose not to rebuild, all parties are likely best served if the insurance proceeds are used to retire the bonds. Most Authority bonds now also include a provision for the bonds to be redeemed if for any reason the bonds lose their tax-exempt status.

## Security

Bonds of the Authority are not an obligation, moral or otherwise, of the Authority or of the State of Minnesota. Security for repayment depends on the credit of the borrower and, in some cases, the credit enhancement arranged by the borrower. In most cases, the bonds will bear a credit rating provided by a national credit rating agency.

Bond issues may be secured by a debt service reserve. A portion of the original bond proceeds (often the lesser of 10% or the maximum annual debt service) is set aside and held by the trustee in the event of any shortfall of payments from the borrower. The bonds are sometimes secured by a mortgage lien or a security interest in certain property.

Certain covenants designed to increase security for the bondholder are included. Typically, a borrower is required to maintain certain fund balances and to operate on a balanced-budget basis. There may be covenants that limit the incurrence of additional debt.

## Credit and Liquidity Enhancement

In certain cases, the borrower may decide to enhance the credit strength of a bond offering by obtaining an external credit enhancement, such as a letter of credit from a bank or bond insurance. In this case, the bonds will be rated based on the higher external credit and expected to bear lower interest rates. The lower interest rates and sometimes even the very marketability of the debt may justify the added expense of the credit enhancement.

Liquidity enhancement in the form of a line of credit or standby bond purchase agreement is usually required in order to market variable rate demand bonds. Because the holder has the right to demand payment in full on just a few days' notice, the borrower must have the ability to have cash in the full principal amount of an issue at any time. Most borrowers are unlikely to have such liquidity available from their own resources and so arrange some form of bank liquidity agreement.

Credit enhancement and liquidity enhancement can be arranged together or separately. The provider must be selected and terms and conditions (including price) must be negotiated. The provider usually has its own requirements for borrower covenants or other security provisions. Adding credit or liquidity enhancement will generally lengthen the time needed to complete negotiations and to accurately document the terms.

## Competitive or Negotiated Sales

Revenue bonds are ultimately sold on the public market to retail or institutional customers and are therefore sold in a "public offering". Bonds in a public offering can be sold through either a competitive sale or a negotiated sale.

In a competitive sale, all preparations are made for the sale on a given day and hour. Eligible bond underwriting firms are invited to submit a bid for the full offered amount of bonds. Their bids are couched in terms of the interest rate for each maturity, and the total price they offer to pay for the full principal amount of bonds. The bids are evaluated and the one offering the lowest total cost to the borrower is awarded the bonds. The winning bid may be one firm or syndicate of firms that will offer the bonds in the open market. Regardless of the results, it is committed to purchase all the bonds on the terms specified in the bid. In this Guide, the winning bidder is usually referred to as the "purchaser".

In a negotiated sale, an investment banking firm (or group of firms) is selected long before the bond sale date. The investment bankers in a negotiated sale are usually referred to as an "underwriter". The underwriter participates in the financing process to make the bonds attractive for sale in the public offering. At the time of sale, interest rates and the purchase price are negotiated between the underwriter and the issuer/borrower team, based on the underwriter's actual marketing of the bonds. The pricing period ranges from a few hours to a couple of days.

While the method of sale is chosen on a case-by-case basis, all Authority financings for the past few years have been completed as negotiated transactions. To enhance competition and lower costs in negotiated sales, the Authority strongly recommends the underwriter be selected through a competitive request for proposal process.

## Mechanics of the Sale of Bonds

In the competitive model, the Financial Advisor circulates the Official Statement and notice of sale to a wide spectrum of potential underwriting firms, nationwide. The Official Statement is posted on the website of the Financial Advisor, as well as the website of the Authority. The sale is also listed in The Bond Buyer, the daily trade newspaper of the municipal bond community. Interested bidders either post a good faith deposit or contract for a surety bond for that purpose. On the appointed day and hour, bids are received electronically and checked for accuracy by the Financial Advisor, then evaluated for lowest cost, on a present value basis. Based on the recommendation of the Financial Advisor, the Authority, in consultation with the borrower, awards the sale of all the bonds to the best bidder. Bids may be rejected if none of the bids are acceptable. The successful purchaser then proceeds to market the bonds. The evaluation and award of bids must be handled on a very rapid turnaround, to protect the bidders from swings in the market that could hurt the purchaser in its marketing effort. Assuming award is made, the financing team moves toward the settlement (or closing) date.

In a negotiated sale, the chosen underwriter, or syndicate, circulates the preliminary Official Statement among its sales offices and then to potential purchasers of the bonds approximately seven to ten days before the scheduled pricing date. On the morning of pricing, or late the day before, the underwriter prepares a set of proposed rates and prices for the bonds and submits it to the Authority and the borrower. Upon consultation with the Financial Advisor, that team either accepts the proposed preliminary pricing or may negotiate adjustments. When agreement is reached, the proposed pricing scale is released by the underwriters to its sales force for a "selling period". The selling period can range from a few hours to a few days, depending on market conditions, size of the issue and other factors.

At the end of the selling period (or before the end, if circumstances warrant), the underwriter will report to the Authority, the borrower and the Financial Advisor on its progress with sale of bonds. The underwriter may suggest adjustments to the pricing terms (up or down) depending on that progress. The borrowing team will again consult with the Financial Advisor as to any adjustments. Selling periods may be extended or terminated early, again depending on sales progress. At a point when the underwriting firm determines it has enough of the bonds sold to make a commitment, it will make a firm offer to purchase all the bonds on a given set of terms. If the offer is accepted by the Authority, with the borrower's concurrence, the sale will then move toward the closing date.

## Private Placement Note Option

Although the revenue bond option is most often the recommended financing vehicle, the Private Placement Note option has been used with increasing frequency. Under this program, notes are either purchased by a commercial bank and structured as a loan or sometimes a security. In addition, the Note may be privately placed by the bank to one or a handful of high net worth or sophisticated investors rather than sold through a public offering. In a private or direct placement process, typically there is no credit enhancement or a credit rating. A private placement memo or selected financial and operating information will be sent to potential investors instead of an Official Statement. Security for the issue would be the general obligation of the borrower. A mortgage or debt service reserve is rarely required. There is no trustee and debt service payments are made to the note holders. The simplified terms reduce the document preparation time and the legal and advisor costs.

The notes program addresses short to medium term borrowing needs, especially for unexpected opportunities. For example, the acquisition of a nearby commercial or residential building to be converted to college use is a good candidate. Capital projects consisting solely of equipment acquisitions may be better suited for the lease program. It is usually advantageous to combine several projects including equipment, construction and renovation into a single long-term revenue bond financing rather than to enter into a series of note and lease financings. Any significant borrowing should be under the lowest possible interest rate with maximum flexibility in principal repayments, prepayment options and other terms in line with a comprehensive debt policy.

## Lease Financing Option

The Authority can finance projects on a tax-exempt lease basis. Contact the Authority for additional information about this option.

## Role of Financial Advisor

The Authority has historically retained an independent financial advisory firm to perform a number of functions. The Financial Advisor is available to assist borrowers during the pre-application stage by calculating the debt repayment capacity of the borrower, identifying the potential for interest savings through refunding, assessing the marketability of the bonds and comparing the three financing alternatives (revenue bonds, private placement notes and financing leases) for the most cost-effective method.

After submission of an Application, the Financial Advisor will make an initial analysis of the Application for credit-worthiness. The results of this initial analysis will be included in the Application Review and submitted to the Authority board for review and action.

After this preliminary assessment of feasibility, the Financial Advisor will prepare a Plan of Finance. The Plan of Finance will outline the financing in terms of size, repayment of principal (the bond maturity schedule), method of sale, timing, security provisions and general covenants. The Plan of Finance is then presented to the Authority board for review and action.

Using the Plan of Finance as a roadmap, the Financial Advisor coordinates the financing process, prepares the Official Statement, manages the bidding process in competitive sales, manages the selection of underwriters, trustee, credit enhancement provider and private placement agent, coaches the borrower during the rating review process and represents the borrower during pricing in negotiated sales. The Financial Advisor can oversee the rate negotiation and provide advice to the Authority and borrower as to the fairness of the all-in cost of financing.

With others on the team, the Financial Advisor reviews the legal documents.

Even when not working on a pending financing, the Financial Advisor is available to advise the borrower on matters such as arbitrage rebate matters, maintaining the credit rating and planning for the next capital project or refunding of existing debt.

The advisory fee is based upon the principal amount of the bonds issued, subject to a maximum, and is payable at closing. The Financial Advisor's role in private placement note and lease financings will vary with the needs of the borrower and the scope of the work. As a result, the fee may be based upon the hourly rates of the personnel involved. The fees and all out-of-pocket expenses are the borrower's responsibility.

## Role of Bond Counsel

The bonds are not marketable unless there is an accompanying legal opinion delivered by a law firm that the bonds are validly issued and the interest payable thereon is exempt from state and federal income tax. Bond counsel plays the central role in preparation of the bond documents, including certain sections of the Official Statement and manages the settlement process. In order to be able to render its unqualified opinion at settlement, bond counsel must analyze and guide the financing through the maze of state and federal laws, including constitutional, tax and securities requirements.

As a state agency, the Authority receives general legal services from the Minnesota Attorney General's office. The Attorney General has authorized the Authority to work with five firms that have been previously approved by the Attorney General's Office to provide state agencies with specialized legal services, such as bond counsel services. The bond counsel must be nationally recognized as having an understanding of the tax-exempt financing or the bonds will not be marketable. Bond counsel makes an independent judgment when issuing the opinion even though the borrower is responsible for the fees.

Bond counsel fees (including legal assistants) are based on discounted hourly billing rates that have been preapproved by the Attorney General's Office. The fees and all out-of-pocket expenses are the borrower's responsibility.

## Typical Documents

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| Trust Indenture | The agreement between the Authority as issuer of the bonds and the trustee, acting on behalf of the bondholders, specifying the terms and conditions of the bonds, establishing accounts and flow of funds and other matters. |
| Loan Agreement | The agreement between the borrower and the Authority, documenting the loan of bond proceeds to the borrower and its agreement to repay the Authority so that it can fulfill its agreement with the bondholders. In addition, there are covenants relating to the use of the project and other terms. |
| Official Statement | The document which explains to the potential purchaser the terms and conditions upon which the bonds are offered and identifies the security provisions and risk factors of investing in the bonds. There is an extensive description of the borrower's operations and financial condition included in the Official Statement. |
| Bond Purchase Agreement | The document that lays out the terms and conditions for actual sale of the bonds by the Authority to the purchaser. In a competitive sale, the document is called the Bond Sale Agreement. |

Other documents and certificates are required, relating to tax-exemption of the bonds, reporting responsibilities over time, any external credit enhancement and other matters. The documents and certificates will be organized by bond counsel into a transcript, in both paper and electronic form and delivered to all parties.