IRS Clarifies Tax-Exempt Bond Availability for Nonprofits

New rules open opportunities for nonprofits to benefit from tax-exempt financing. Here are the details.

BY LLOYD MACAULEY RICHARDSON

A new ruling by the Internal Revenue Service has increased opportunities for nonprofits engaged in research for the federal government to issue tax-exempt bonds to finance their facilities. (Examples of facilities typically financed by a nonprofit are office space, research facilities, expansion space, and parking.) Nonprofits that are savvy enough to recognize these financing opportunities can enjoy substantial savings in their capital costs and may be able to leverage endowment funds to increase their investment earnings.

> *Savvy nonprofits can enjoy substantial savings in their capital costs.*

What Do the New Rules Let Nonprofits Do?

The Internal Revenue Code gives nonprofits many opportunities to issue tax-exempt bonds. Until this new ruling, however, a major obstacle prevented nonprofits from financing research facilities used in connection with a federal (but not a state or local) government contract. Under applicable IRS regulations, the existence of the research contract with the federal government was generally thought to result in "private business use" that would make such facilities unfinanceable on a tax-exempt basis.

Now, the IRS has indicated that such financings are possible under certain circumstances. The facts on which this ruling are based are set forth in IRS's Private Letter Ruling (PLR) 199914045. Under the ruling, nonprofits may finance research facilities used in connection with a federal government contract under the following circumstances:

- The nonprofit's purpose must be to perform "scientific research in the public interest" for various governmental users and nonprofits.
- The nonprofit must have no affiliation with the federal government.
- Substantially all of the nonprofit's research must enter the public domain through scientific and technical publications and presentations or through the nonprofit's providing services to its clients.
- The nonprofit's research must be performed under numerous research contracts, including those with the federal government, with terms ranging from six months to five years. The typical contract should have a term of no longer than one year. No research contract may contain any provision requiring the client to renew the contract, and continued funding mustn't be ensured.
- In a typical year, the nonprofit may generate over 80% of its revenues from federal contracts.
- The federal research contracts must not grant ownership rights to the federal government in any intellectual property developed or discovered in the course of the nonprofit's research. Under applicable contracting principles, other federal agencies may receive a non-exclusive, royalty-free license in the new property (technical data, software, patents) resulting from the nonprofit's research.
- The federal government must receive the use of any new property on the same terms and at the same price as users other than the federal government.

Nonprofit World • Volume 18, Number 1 January/February 2000
Published by the Society for Nonprofit Organizations
6314 Odana Road, Suite 1, Madison, WI 53719 • (608) 274-9777

Why Tax-Exempt Bonds?

Tax-exempt bonds are obligations of a state or a political subdivision of a state. They are "tax-exempt" in that investors are allowed to exclude the interest from gross income for federal income taxation. Nonprofit organizations may not issue tax-exempt bonds directly but are allowed under the Internal Revenue Code to benefit from tax-exempt financing in much the same way as a state or local government entity. This is possible through a "conduit" structure in which a governmental issuer (such as a state or local industrial development authority) issues tax-exempt obligations and loans the proceeds of those obligations to the nonprofit entity. The nonprofit agrees to repay the loan in a way that permits the governmental issuer to make payments on the bonds that it has issued to investors. The governmental issuer is referred to as a "conduit" because it has no economic interest in the transaction and is obligated to make payments to investors only out of amounts received from the nonprofit.

Section 145 of the Internal Revenue Code places certain limitations on how a nonprofit may use the proceeds of tax-exempt financing:

- The facilities provided by the proceeds of the bonds must be owned by the nonprofit.
- The facilities must not be used in activities that constitute an unrelated trade or business for the nonprofit, as determined under Section 513(a) of the IRS Code.
- The bonds must not be used for private business use, nor may they be secured by private property or private payments.

When all these limitations are met, the bonds are deemed to be "qualified 501(c)(3) bonds" for which tax-exempt status is available, just as it would be for bonds issued by a state or local government.

Private use of facilities financed by a 501(c)(3) organization can arise in many ways, not just under research contracts. For purposes of these rules, the federal government is treated like a private business, on the theory that the benefits of tax-exempt financing, which are intended to support activities of state and local government (including nonprofits), should not flow to the federal government any more than to private persons.

The benefits of tax-exempt financing are substantial. As an example, a nonprofit that wants to finance a $10 million facility might be able to obtain conventional financing at 7%. In most markets, tax-exempt rates are about 2% lower than conventional rates. Instead of paying 7%, the nonprofit might get the same loan for 5%. This results in a savings of $200,000 for each year that the full amount of the loan is outstanding. In a tax-exempt structure, the nonprofit may also be able to extend the financing term to 20 years or more (rather than the seven to 10 years it would need to pay off a conventional loan), thus improving the nonprofit's cash flow.

Finally, if the nonprofit has any endowment-type funds, it can invest those funds at much higher rates than it is paying for its tax-exempt debt. Thus, the nonprofit can increase its earnings on investments as well.

In these circumstances, the IRS concluded that (1) use of the bond-financed facilities to provide services to the federal government according to the research contracts doesn't constitute private business use under applicable regulations, and (2) payments by the federal government under the research contracts don't cause the bonds to be federally guaranteed for purposes of those regulations.

Why Is This Ruling So Significant?

This ruling is important for several reasons. The most crucial result is practical. Now, an association that conducts policy research for the Justice Department, a hospital commissioned to conduct drug testing for the National Institutes of Health, or a college that performs research for the Department of Defense may have new opportunities to benefit from tax-exempt financing.

But the ruling is significant for technical reasons as well. It is the first ruling issued under the current tax code that provides any insight at all into how to analyze research contracts with respect to private use. Until now, practitioners have had to make do with the applicable regulations and the two safe harbors issued under them. The safe harbors set forth in the regulations are as follows:

Corporate-Sponsored Research. A research agreement relating to property used for basic research supported by a sponsor won't result in private business use if the following conditions are met: (1) The sponsor must pay a competitive price for the license or other technology resulting from the research, with the price determined at the time the technology becomes available. (2) The price paid by the sponsor for the technology must be no less than the price that would be paid by any non-sponsoring party for those same rights (although the nonprofit needn't give any non-sponsor access to the technology).

Cooperative Research. A research agreement relating to property used in connection with a joint industry-governmental cooperative research arrangement won't result in private business use if the following conditions are met: (1) Multiple, unrelated sponsors agree to fund basic research. (2) The research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research) is determined by the qualified user. (3) Title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user. (4) Sponsors are entitled to no more than a nonexclusive, royalty-free license to use any product of that research.

The safe harbors themselves are not new. They are referenced in the legislative history of the Internal Revenue Code, as enacted in 1986. But practitioners agree that those safe harbors address such unusual situations that they don't provide much guidance.

The new ruling, while issued under the safe harbor for corporate-sponsored research, sheds light on a number of points relating to the safe harbors generally. First, it's clear that the nonprofit discussed in the ruling is involved in basic research as required by the safe harbor. That had previously been unclear. The ruling also supports the view that the federal government isn't generally using its research for a "specific commercial objective."

This is also the first guidance on how to apply the safe harbors where research isn't intended to result in concrete technology such as a patent. Much of the research conducted by nonprofits for the government in this day and age is in areas other than the traditional physical sciences. Today, research may take the form of studies relating to information systems, the effects of social policy, or similar matters. The ruling makes clear that the safe harbors can apply in these instances.

The ruling also makes clear that a research sponsor can retain certain rights in the resulting technology, such as the right to a non-exclusive, royalty-free license for itself and its affiliates, without losing the protection of the corporate-sponsored-research safe harbor. While these are rights that can be retained under the cooperative-research safe harbor, it wasn't clear that the corporate-sponsored research safe harbor would likewise allow sponsor-retained rights.

Pricing of the new technology has also been an issue. Where no separate price was charged for the license to use the technology, it wasn't clear how those rights were to be valued. In the new ruling, the IRS has clarified this point by distinguishing the price for conducting the research from the price of any license that might result from the research.

Finally, the ruling tells us that a federal research contract isn't likely to result in a federal guaranty for purposes of IRS regulations. This is also an area of the law where there has been little guidance in the past.

In summary, the ruling represents an important step forward for nonprofits that have contractual relationships with the federal government. One can hope that this ruling will mark the beginning of a series of similar rulings that will liberalize this area of the law, making it possible for these types of nonprofits to spend less on financing their facilities and more on advancing their nonprofit purposes. ■

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