

Can our school project qualify for tax-exempt finance?

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TAX-EXEMPT FINANCING can be a great solution for financing your school's project. However, not all projects and situations make sense or qualify for this financing vehicle. There are certain requirements that need to be met in order for a project to qualify. This article discusses the parameters of a project that can qualify for this very low interest rate solution.

With tax-exempt bonds, bond investors don't pay income tax on the interest payments they receive from the school borrower – thus, interest rates are lower than conventional taxable financing. The “savings,” so to speak, of tax-exempt bonds is really the lost tax revenue that the federal government recognizes when this type of borrowing structure is used. The federal government views tax-exempt bonds as an indirect subsidy to nonprofit borrowers and, therefore, is interested in ensuring that bonds are only used to finance the assets that Congress had in mind when the federal tax-exempt bond statutes were written. This article explores the types of facilities for nonprofits that qualify for tax-exempt bond financing, with a focus on facilities for faith-based independent schools.

Assets that qualify for tax-exempt bond financing

What can be financed with tax-exempt bonds? The answer depends on the answers to two additional questions – first, what is permitted under federal tax law? Second, what is permitted under the state bond statute pursuant to which the tax-exempt bonds are issued?

Tax-exempt bond financing is a creature of the federal tax code. 501(c)(3) organizations can use tax-exempt financing for projects so long as (i) capital expenditures are being financed, (ii) the financed facilities are owned by a 501(c)(3) organization and (iii) the financed facilities are used in furtherance of the 501(c)(3) organization's exempt purpose (i.e., not used for unrelated trade or business). Capital expenditures that can be financed with tax-exempt bonds include:

- classroom buildings
- administrative office buildings
- land acquisition
- site work
- cafeteria, “commons” areas
- student/faculty housing
- athletic facilities
- renovations of existing facilities
- equipment purchases

- infrastructure improvements
- vehicles (e.g., school buses)
- “soft costs” related to capital expenditures (e.g., architect, engineering fees)

Debt incurred by a school for these types of capital expenditures can also be refinanced with tax-exempt bonds in most cases.

Schools can also use tax-exempt bonds to fund: capitalized interest (interest payable on the bonds) for a period of up to three years, certain debt service reserve funds, and costs of issuing the tax-exempt bonds. Generally NOT financeable with tax-exempt bonds are non-capital expenditures, such as payroll, working capital and operating expenses.

State bond statutes also need to be considered to determine what can be financed with tax-exempt bonds in a particular state. For bonds to be tax-exempt, they must be issued by a governmental entity. The governmental entity issues the bonds, and loans the proceeds to the nonprofit borrower, but the governmental entity has no repayment liability – only the borrower has the responsibility for repaying the bonds. Because the bonds are issued by a governmental entity, the types of facilities that can be financed in a particular state will be limited to those permitted under the relevant state bond statutes. Such state bond statutes

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may be more restrictive than federal tax law, and may set forth additional criteria for what can and cannot be financed with tax-exempt bonds. For example, even though federal tax law allows capitalized interest to be funded for a three-year period, some state bond statutes only permit capitalized interest to be funded through the completion of construction of a building project.

Use of bond-financed facilities for religious education or worship

Recent federal and state case law developments have generally expanded the availability of tax-exempt bond financing to faith-based organizations. However, whenever a governmental “benefit” is provided to a faith-based organization, “church/state” issues need to be analyzed. Fortunately, the courts are moving away from a “pervasively sectarian” analysis (under which the religious nature of a school would determine such school’s eligibility for tax-exempt financing), and moving toward an analysis that focuses on the assets being financed, even if such assets are owned by a “pervasively sectarian” school.

Facilities with “religious use” that generally cannot be financed with tax-exempt bonds include:

- Dedicated worship space, such as a sanctuary, chapel or church
- Administrative office space and common areas allocable to the dedicated worship space (e.g., pastor’s office)
- Religious education classrooms not integrated into a broader, more “secular” educational program (e.g., classrooms in a church building that are only used for Bible study and Sunday school)

Facilities with “religious use” that generally can be financed with tax-exempt bonds include:

- Classrooms in which religious education occurs – if religious education is part of a

broader, more “secular” educational program (i.e., full-time day school program)

- Religious education classrooms are also OK if education is part of a broader, more “secular” educational program

Facilities with “religious use,” a portion of which MAY be able to be financed with tax-exempt bonds, include:

- Auditorium, gymnasium or other space that is used by the school during the week and by the church for worship services or devotional activities

> If space is used a majority of the time by the church for worship, none of the space can be financed.

> If space is used a majority of the time by the school for educational use (even religious educational use), then an “allocation” calculation is performed – based on time and space used, allocating the space between “church” use and “school” use – permitting the tax-exempt financing of the school-use portion.


Financing a school that is not separately incorporated, but operated as a ministry of a church

Many faith-based schools are not separately incorporated, but rather, operate as a ministry of the church. So, in a tax-exempt bond financing, the “church” corporate entity would be the borrower of the bond proceeds (it would need to be, since the school is not itself a separate corporate entity). This organizational structure is generally not a problem. Under federal tax law, a church is still a 501(c)(3) entity and therefore qualifies for tax-exempt financing. Some churches, for reasons unrelated to bond financing (such as liability protection) form separate corporations or limited liability companies to operate their schools. These

entities, if also 501(c)(3), would qualify for tax-exempt financing.

Whether a church corporation qualifies under state bond statutes will vary from state to state. Some states require that a borrower be an “educational institution,” and some bond issuers have interpreted that to exclude church-run schools where schools are not separately incorporated. There is typically a way to structure financing to accommodate more restrictive state laws. For example, a church could form a single-member limited liability company (LLC), and have the LLC be the “borrower” of the bond proceeds. If the LLC were organized to support the educational activities of the church (i.e., to support the school), the LLC would be considered an “educational institution” for purposes of some states’ statutes. The LLC would not need to file for 501(c)(3) status, because with a single-member LLC you can “look through” the LLC to the single member’s 501(c)(3) status.

Financing church ministries other than schools

As noted previously, many faith-based school facilities can be financed with tax-exempt bonds, and most dedicated worship space cannot be financed with tax-exempt bonds. There are other facilities that may be owned and operated by a faith-based organization, including social service programs, outreach ministries and multipurpose buildings used for fellowship, group meeting space, etc., and many of these may also qualify for tax-exempt bond financing. In general, the more such facilities are used by the public (e.g., community meeting space) or are used for more “secular” activities (day care, food pantry, etc.), the more likely it is that such facilities will qualify for tax-exempt financing. 

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