Tax-Exempt Bond Essentials

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Tax-Exempt Bonds - In General

- Tax Reform Act of 1986 established current statutory rules for tax-exempt bonds by enacting Secs. 141-150
- Intended to encourage socially worthwhile projects by providing an indirect government subsidy in Sec. 103
- Sec. 103(a) provides an exclusion from gross income of interest on any state or local bond
- Exclusion from income will not apply to any bond that is a private activity bond which is not a qualified bond
- Seven types of 'qualified bonds', including Qualified Section 501(c)(3) Bonds and Governmental Bonds

Tax-Exempt Bonds - In General (cont.)

- Why use tax-exempt bonds?
  - Lower interest rates, primarily due to the exclusion from income under Sec. 103
  - Better transaction terms – availability of fixed interest rates, and bonds can be issued for a longer term
- Who uses tax-exempt bonds?
  - Charitable, educational, healthcare, cultural organizations
- Eligible uses of tax-exempt bond proceeds:
  - (1) capital expenditures
  - (2) refinancing prior debt
  - (3) reimbursing prior capital expenditures
  - (4) financing costs

Qualified Sec. 501(c)(3) Bonds (IRC Sec. 145)

- Prior to issuance, bonds must be approved by the governmental entity issuing the bonds (public approval requirement)
- Bond proceeds must be used to finance property owned by a Sec. 501(c)(3) organization
- Not more than 5% of the net proceeds of the bond issue can be used for any private business use
- The weighted average maturity of the bonds may not exceed 120% of the weighted average useful life of the capital assets being financed, excluding land (Sec. 147(b).

Private Business Use

- The 5% private business use limit is measured over the entire term of the bond issue, not annually
- Private business use (PBU) is use of tax-exempt bond-financed property by persons other than Sec. 501(c)(3) organizations or governmental entities
- Use by a related, non-501(c)(3) is PBU and a frequent trap
- In addition, use of bond-financed property by a Sec. 501(c)(3) organization in an unrelated trade or business will result in PBU
- PBU can be avoided if bond proceeds are allocated away from potential trouble areas

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