What is It?

- When colleges and universities need capital to finance expansion or renovation of existing facilities, they have four basic options:
  1. Pay as you go – finance the capital project from existing revenue and/or available endowment, if any;
  2. Obtain financing in the commercial marketplace;
  3. Issue taxable bonds; or
  4. Obtain or issue tax-exempt bonds through a state or local governmental entity.

- The fourth option is generally the preferred option because tax-exempt bonds usually carry lower interest rates and more favorable terms, thereby reducing a university’s overall borrowing costs.

Current Law

- Under Internal Revenue Code (IRC) Section 103(a) the interest earned on tax-exempt bonds issued by state and local governments is excludable from gross income for purposes of federal income taxes. Because the interest income is excludable from income, investors are generally willing to receive a lower rate of return on the investment than they might otherwise accept on a taxable investment. Consequently, the bond carries a lower cost of capital to the beneficiary (i.e. the university) of the bond proceeds.

- States can issue two kinds of tax-exempt bonds:
  1. Governmental bonds – the proceeds are used to finance governmental functions (i.e. build public schools or roads) or the proceeds are repaid with governmental funds. Most public colleges and universities are eligible for this type of funding for construction, renovation, and some operational costs.
  2. Private activity bonds – the state or local government serves as the conduit for obtaining and providing the tax-exempt bond financing to certain nongovernmental entities, including private colleges and universities as qualifying 501(c)(3) organizations.

Key Issues Involving Tax Exempt Financing

*Private use* – Public and private universities seek to qualify for qualified 501(c)(3) bonds [IRC sections 141(b) and (c)] because they provide favorable financing terms and costs. However, qualified private activity bonds come with strings attached. First, facilities financed with qualified 501(c)(3) bonds are required to be owned by a nonprofit or
governmental entity. Secondly, there are restrictions on the amount of use of such facilities for private purposes (as defined by IRS regulations), varying between five and 10 percent of total use. These restrictions apply throughout the term of the bonds.

Joint use agreements with industry on sponsored research or joint commercial/education projects with developers are two examples where the complex private use regulations come into play. While the IRS in 2007 clarified (Revenue Procedure 2007-47) that research in tax-exempt financed facilities that led to the transfer of Bayh-Dole rights to private entities did not violate the private use test, most university bond counsels believe that the remaining private use regulations are overly restrictive. Consequently, some universities opt to issue taxable bonds or put a percentage of their own equity into the capital budget for facilities that would otherwise qualify for tax-exempt financing so that they can engage in some research with for-profit entities. This is particularly true in biomedical research facilities. Many universities are not in a position to make such equity investments, thereby limiting their ability to conduct certain cooperative research.

Exemption from volume cap – Qualified 501(c)(3) bonds are not subject to several restrictions that apply to other qualified private activity bonds. For example, Congress has put in place a state by state volume cap to restrict the total volume of such tax exempt bonds for private activities. Beginning in 1986 and until 1997, however, Congress limited the amount of outstanding bonds that a nonprofit could benefit from to $150 million. There are some narrow categories where the cap still applies to the issuance of non-hospital qualified 501(c)(3) bonds [see IRC Section 146].

Arbitrage rules – The tax code prevents a university, college, or other tax-exempt organization from issuing more tax-exempt financing than is actually needed for a specific project or purpose and using the proceeds to invest in higher yielding investments. There are exceptions to this rule that depend primarily on how soon (ranging from six to 24 months) the bond funds are used for the intended purpose.

Additional Information


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