



Tax-Exempt Financing by Universities and Colleges

Internal Revenue Code Sections
103(a), 141(b), 141(c), and 501(c)(3)

What is Tax-Exempt Financing?

When colleges and universities need capital to pay for new facilities or to expand or renovate existing facilities, they have six primary financing options that can be used individually or combined:

1. Pay as you go – finance the capital project from existing revenue;
2. Philanthropy – use charitable gifts, available endowment funds, and third party guarantees;
3. Grants – from federal, state, corporate, and private sources;
4. New Market Tax Credits or Historic Tax Credits – if applicable;
5. Taxable Financing – issue taxable bonds; or
6. Tax-Exempt Bonds – including governmental bonds and private activity bonds.

Tax-exempt bonds are often the preferred option. Compared to taxable debt, tax-exempt bonds often carry lower interest rates and more favorable terms, which reduces a university's overall borrowing costs.

What Kinds of Tax-Exempt Bonds Do Universities Use?

Under Internal Revenue Code (IRC) Section 103(a), the interest earned on tax-exempt bonds issued by state and local governments is generally exempt from tax. Because the interest income is excludable from taxable 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 typically carries a lower cost of capital for the beneficiary (i.e., the university).



Indiana University

State and local governments can issue two kinds of tax-exempt bonds:

1. Governmental Bonds

The proceeds of these bonds are primarily used to finance governmental functions (e.g., 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

These are bonds issued to finance a facility that will be used by a private party rather than a governmental entity. Unlike governmental bonds, they are not tax-exempt unless they are *qualified* private activity bonds.

Current law provides two tests for determining whether such a bond is in fact a “qualified” private activity bond: the *private business test* [IRC Section 141(b)] and the *private loan test* [IRC Section 141(c)]. Section 501(c)(3) bonds are a category of qualified private activity bond.

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Key Rules for Qualified 501(c)(3) Bonds

There are two basic requirements for a bond to constitute a qualified 501(c)(3) bond:

1. Ownership Requirement [IRC Section 145(a)(1)]

All property financed by the net proceeds of qualified 501(c)(3) bonds must be owned by a nonprofit or entity throughout the term of the bond.

2. Use Requirement [IRC Section 145(a)(2)]

At least 95 percent of the proceeds of the bond must be used by a 501(c)(3) organization engaged in exempt activities or by a state or local governmental unit. Use of bond proceeds in an “unrelated trade or business” [IRC Section 513(a)] violates this provision.

Key Compliance Issues for Qualified 501(c)(3) Bonds

Private Business Test [IRC Section 141(b)]

There are restrictions on how much bond-financed facilities may be used for private purposes. These restrictions apply throughout the terms of the bonds. Activities that might be deemed private business use include (among many others): sale or lease of university property; sponsored research; technology transfer and licensing agreements; clinical trial agreements; and joint ventures.

As noted above, public-private research partnerships are one of the most salient examples of where the complex private business use rules come into play.

The IRS in 2007 clarified (Revenue Procedure 2007-47) that research in tax-exempt financed facilities leading to the licensing of Bayh-Dole rights to private entities did not violate the private business use test.

Many universities believe that the remaining private use regulations are overly restrictive. As a result, some universities opt for taxable bonds or put a percentage of their own equity into the capital budget for facilities. These funds would otherwise qualify for tax-exempt financing so that they can engage in certain research with for-profit entities. Unfortunately, many universities are unable to make such equity investments, which limits their ability to conduct certain cooperative research.

Arbitrage Rules [IRC Section 148]

The IRC prevents a university, college, or other tax-exempt organization from issuing more tax-exempt financing than it needs for a specific project or purpose and then using the proceeds to invest in higher-yield investments. There are exceptions to this rule that depend primarily on how soon (ranging from six to 24 months) the university uses the bond funds for the intended purpose.

2017 Tax Law Implications

The Tax Cuts and Jobs Act prohibits private activity bonds known as advance refunding bonds, often used by public colleges and universities to lower building costs, from being used after 2017.

Additional Information

IRS Office of Tax Exempt Bonds

<https://www.irs.gov/tax-exempt-bonds/>

Tax-Exempt Bonds for 501(c)(3) Charitable Organizations, Publication 4077

<https://www.irs.gov/pub/irs-pdf/p4077.pdf>