

A Preliminary Exploration of the Differences  
between Two Financing Options for University Real Estate Projects  
under Public-Private Partnerships:  
A Case Study of 501(c)3 and 63-20 Tax-exempt Bond Processes

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University of Washington

## **Abstract**

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The thesis discusses the differences between two financing options for university real estate projects under Public-Private Partnerships: 501(c)3 and 63-20 tax-exempt bond processes. Prior to the case interviews, this thesis identifies and compares the differences between two tax-exempt bond programs, their historical backgrounds, conceptions, legal regulations and constraints. This thesis also formulates a project process model, a cash flow model, and a financing structure model for P3 practitioners using 501(c)3 and 63-20 tax-exempt bond financing. A series of interviews was designed and conducted with project managers, non-profit organization directors, financing professionals, and University Real Estate Office staff. These interviews compared financial outcomes, types of bond issuers, project types, capital limits, issuing duration, P3 party involvements, post-construction financials and ownership issues, as well as decision making processes for each bond program. Beyond the case studies, this paper summarizes the advantages and disadvantages of these two bond programs and provides financing suggestions for future P3 university real estate projects.

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## **1 Introduction**

This paper examines differences between two financing programs commonly used in Public-Private Partnership real estate projects: specifically the use of 501(c)3 bonds and 63-20 bonds. The paper will focus on university real estate projects.

Public-Private Partnerships (P3) is an innovative form of cooperation among university real estate staff and private service providers during the development and/or rehabilitation of University owned real estate projects. While there are many financing options for funding university real estate projects, 501(c)3 and 63-20 bonds, are widely used in Seattle and throughout Washington State. This thesis will define these programs and examine the pros and cons of using these two tax-exempt-bond programs. Four project case studies of the use of these programs is presented.

While 501(c)3 bonds and 63-20 bonds are two of the most common financing options for financing P3 University Real Estate projects in Washington State, they differ in many aspects. The thesis will explore and summarize these differences.

Chapter 1 introduces the general concepts of P3 Partnerships and defines 501(c)3 and 63-20 bonds programs. A summary of the research methodology, the scope of the thesis, and primary questions used for interviews with selected individuals involved in the four project case studies is also presented in Chapter 1. Chapter 2 provides a literature review of P3 Partnership and Tax-Exempt-Bonds programs. Chapter 3 discusses 501(c)-3 and 63-20 bonds, focusing on their different application, requirements, processes, limitations, benefits, outcomes, and closing strategies. This chapter also includes a preliminary overview of the

case studies. Chapter 4 outlines details of interviews with project managers, non-profit organization directors, financing professionals, and University Real Estate Officers. Moreover, a review and analysis section is also enclosed in this chapter. Chapter 5 identifies the findings from the comparison and analysis of the four project case studies, and suggests future research as a result of this study.

## **1.1 Purpose of Study**

City planners, universities, developers, and other stakeholders in both public and private sectors may have different goals when they initiate a real estate development or redevelopment project. Nevertheless, one common objective of all parties is to provide the maximum value with the resources available in a limited time. This can be used to explain national, or worldwide, trends in P3s which serve as long-term joint approaches for real estate development. In particular, for university real estate projects, the new financing possibilities, along with P3s, have been drawing people's attention in recent years. Bonds (including federal, state and municipal Bonds) have a long history of use in financing real estate development projects, and have created many opportunities for innovative financing.

However, given the many opportunities for P3 projects, many participants do not have a full understanding of P3 financing options. The purpose of this thesis is to explore the differences between 501(c)3 bonds and 63-20 bonds commonly used in financing P3 real estate projects, especially in university real estate development and rehabilitation projects.

This thesis addresses the following research questions:

- 1) What are bond financing programs used in P3 real estate projects?
- 2) What are the requirements and limitations of issuing 501 (c) (3) and 63-20 bonds ~~in~~ to finance these kinds of projects?
- 3) Based on their use in financing four project case studies, what are the main differences between the two bonds programs?
- 4) How does the use of these two bond financing programs influence the operating process, risks, and pay-off options?
- 5) Which characteristics of these programs affect the decision making process of P3 university real estate projects?
- 6) What are the advantages and disadvantages of using these two bond financing programs in P3 university real estate projects?

## **1.2 Methodology**

The thesis summarizes interviews used in gathering information on the use of 501(c3) and 63-20 bond programs to finance specific P3 university projects in the Seattle area. The interviews were designed to collect feedbacks from professionals about ~~P3~~ four projects and their use of these bond financing programs. The objective of interviews is to explore the differences between two bond financing programs used in P3 project processes. The interviewees were major stakeholders and participants in real estate projects, and include

project managers, non-profit organization directors, financing professionals, and University Real Estate Office staff.

## **1.3 Scope of Work**

### *Types of cases and/or projects*

There are different models of P3 Partnerships, and different types of P3 projects. Public and private sectors cooperate in various ways using multiple methods of finance. The research focuses specifically on university real estate projects, and both development and redevelopment projects are included. In each case study, a Public-Private Partnership contract was signed, and tax-exempt-bonds were issued using either 501(c)3 or 63-20 programs. The scale and type of university project case studies offer a defined political/legal environments and conditions supporting the research.

### *Limitations of Research*

The research is limited in geographic scope by the laws, regulations, and policies which can vary between different states and cities. For this paper, I am looking at the projects located in the Seattle Metropolitan Area, and the cases studied are limited to projects done P3 Partnerships done between the University of Washington and the National Development Council.

## 2 Literature Review

### 2.1 Previous Studies and Basic Concepts

The literature selected and compiled for this chapter is aimed to provide a conceptual background of tax-exempt bond and the legal and academic context of P3 projects, financing process, partnership types, performance indicators and success factors. Financing plays an important role in the entire P3 project procedure. Bond financing, with a long history of being used and researched, is a topic involved in a variety of academic works. A Tax Exempt Bond is stated and explained as a way of financing for P3 projects in such papers and books.

The previous literature provides a conceptual background on bonds, municipal bonds and tax-exempt bonds. E. R. Yescombe (2007) discussed P3 project financing sources and procedures in Chapter 9 of his book: *Public-Private Partnerships, Principles of Policy and Finance*. The author paid attention to *Bond Issues*, and summarized a number of detailed or technical pros and cons between loans and bonds.

#### *Public-private Partnerships*

No universal definition of public-private partnerships is found. The concept evolves with time and changes with different contexts. This paper adopts *the National Council for Public-Private Partnerships'* definition of P3. Under these arrangements, the agency may retain ownership of the public facility or system, but the private party generally invests its

own capital to design and develop the properties. <sup>1</sup>Typically, each partner shares in income resulting from the partnership. Such a venture, although a contractual arrangement, differs from typical service contracting in that the private-sector partner usually makes a substantial cash, at-risk, equity investment in the project, and the public sector gains access to new revenue or service delivery capacity without having to pay the private-sector partner

According to *the National Council for Public-Private Partnerships* reports, the typical types of public-private partnerships include:

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<sup>1</sup> "Public-Private Partnerships: Terms Related to Building and Facility Partnerships", Government Accounting Office, April 1999. The National Council for Public-Private Partnerships was a resource used in developing the GAO report. <http://www.ncP3.org/P3-basics/glossary-of-terms/>

Table 1: Typical Types of Public-Private Partnerships  
(Source: National Council for Public-Private Partnerships reports)

O&M: Operations and Maintenance
OMM: Operations, Maintenance & Management
DB: Design-Build
DBM: Design-Build-Maintain
DBO: Design-Build-Operate
DBOM: Design-Build-Operate-Maintain
DBFOM: Design-Build-Finance-Operate-Maintain
DBFOMT: Design-Build-Finance-Operate-Maintain-Transfer
BOT: Build-Operate-Transfer
BOO: Build-Own-Operate
BBO: Buy-Build-Operate
Developer Finance
EUL: Enhanced Use Leasing or Underutilized Asset
LDO or BDO: Lease-Develop-Operate or Build-Develop-Operate
Lease/Purchase
Sale/Leaseback
Tax-Exempt Lease
Turnkey

### 501 (c)3 bonds<sup>2</sup>

501(c)3 bonds are bonds that are exempt from federal income tax. Municipal and state agencies quasi-public authorities, issue them on behalf of a nonprofit organization to finance a capital project or for other purposes permitted by the federal Internal Revenue Code (IRC). Because the agencies issue bonds on behalf of other organizations, the bonds are often referred to as “conduit” or “pass through” bonds. Further, the organizations must repay the bonds, not the issuing agency or the state.

### 63-20 bonds<sup>3</sup>

63-20 bond financing is a bond issued by a nonprofit corporation on behalf of a public agency. 63-20 financings were first approved by the Internal Revenue Service in 1963. Under the 63-20 structure, 63-20 bonds are issued by a nonprofit corporation on behalf of the public agency pursuant to a trust indenture with a bank trustee. This issuance by the nonprofit differentiates the 63-20 financing from COPs<sup>4</sup>, where the public entity is the issuer. The 63-20 bond proceeds are deposited in a project fund held by the trustee and used to finance the capital improvements (undertaken by the nonprofit corporation) that are leased to the public agency.

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<sup>2</sup> John Rappa, 501 (c) (3) BONDS, OLR Research Report, April 19, 2012, visit at: <http://www.cga.ct.gov/2012/rpt/2012-R-0146.htm>

<sup>3</sup> State of Washington, Office of the State Treasurer, Reports on 63-20 Capital Projects Financing. Jan. 23, 2006

<sup>4</sup> A type of financing where an investor purchases a share of the lease revenues of a program rather than the bond being secured by those revenues. The authority usually uses the proceeds to construct a facility that is leased to the municipality, releasing the municipality from restrictions on the amount of debt that they can incur.

The 63-20 nonprofit corporation, often through a private development company, designs and builds the project. The 63-20 procedure is exempt from federal income tax. The project may be operated and maintained either by the public agency itself under the lease from the nonprofit corporation through a management contract with a private management firm. Title to the improvements is transferred to the public agency at lease maturity when the bonds issued by the nonprofit corporation are retired.<sup>5</sup>

## 2.2 Other Studies

The comparative studies found mostly focused on comparing public-private partnerships with the traditional processes. The cases selected in such studies are usually urban infrastructure projects rather than housing or real estate developments, and a narrative pattern was commonly used to survey and examine the P3 process. Other researchers, including both qualitative and quantitative methodologies, focused on risk analyses, applied different quantitative models and tool, such as fuzzy hierarchy evaluation model or regression model to assess the risks involved in P3 financing process/delivery system/partnership contracts. Additionally, several researchers chose to explore specific tax-exempt bonds. For example, Donijo Robbins and Joseph Vander Meulen<sup>6</sup> examined 63-20 financing from the financing structure aspect.

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<sup>5</sup> State of Washington, Office of the State Treasurer, Reports on 63-20 Capital Projects Financing. Jan. 23, 2006

<sup>6</sup> Donijo Robbins and Joseph Vander Meulen, An Examination of 63-20 financing, School of Public & Nonprofit Administration, Grand Valley State University, Grand Rapids, Michigan. September 2009.

Furthermore, researchers have interests in the success factors and key performance indicators of P3 projects. Different success factors are studied from different perspectives, and for different purposes. G. Mladenovic, N. Vajdic, B. Wündsche, and A. Temeljotov-Salaj (2012) studied the critical factors for P3 projects from five aspects: (1) Project preparation, development and structuring; (2) Transparency/competition; (3) Risk allocation; (4) Partners-good relationship and selection and expertise of private partner; (5) Quality and short construction period. Michael Geddes (2005) focuses on successful partnerships and summarized four categories of characteristics showed in Table 2.

Table 2: Characteristics of Successful Partnerships

(Source: Michael Geddes (2005))

Purpose and objectives	Clear objectives
	Specific added value
	Long-term commitment
Leadership quality	Prominent political
	Strong interpersonal skills
	Consistency
Partnership values	Openness and trust
	Integrity and fairness
	Mutual support
	Shared belief in cultural change
Management	Through planning
	Balanced membership
	Agreed accountability
	Clear business plans
	Regular performance reviews
	Excellent working relationships
	Continuity of resource

## **3 Comparative Analysis of 501(c)3 and 63-20 Bond Financing Processes**

### **3.1 Historical background**

#### *Governmental Bonds and Revenue Bonds*

Historically, any state or local governmental bond was tax exempt. Prior to World War II there was one kind of bond, a government purpose bond, issued by the government and backed by the full faith and credit of the government.<sup>7</sup> Such bonds were as secure as the governments that issued them because they were backed by tax revenues or revenue from other government sources. During World War II the direct link between the government, the purpose of the bond, and the user of the bond proceeds became attenuated. Quasi-governmental authorities that could not issue government bonds because they did not have the taxing power to back them up, discovered that investors would buy bonds that were just secured by the revenue generated by the facility being built. These new bonds were called revenue bonds (limited obligation security instruments). Bondholders could no longer look to the taxing power of the issuing governmental unit, only the revenue generated by the facility supported the payments to the bondholders.

#### *Conduit Bonds and Conduit Revenue Bonds*

Conduit bonds were developed as a kind of bonds that issued by municipalities for the use of private parties instead of the use of the municipality itself. After a while then the

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<sup>7</sup> Debra Kaweck and Marvin Friedlander, 501(c)3 BONDS – A Mini-Text

conduit bonds and revenue bonds combined to be a new type of bonds called “conduit revenue bonds” which we can see on the bonds market nowadays.

#### General Tax-exempt Bond Issuance Process

To finance a P3 project by using a tax-exempt bond, the project owner needs to join hands with an exempt organization to be able to issue the tax-exempt bonds on behalf of the government. This is what we call the “63-20” process. In another scenario, a government authority issues bonds directly and lends the bonds to an exempt organization to finance its projects. In this case, the government authority is the “conduit borrower”, which is also the lender of bond funds to the project owner. The conduit borrower (bondholder) will not pay federal tax on the bond earnings, and will be paid interest by the revenue generated from the project. This scenario can be applied to 501(c)3 bond programs.

#### Arbitrage

In terms of the tax-exempt characteristics, the tax-exempt bonds generally bear a lower interest rate than taxable debt. Taking advantage of the difference in the interest rates is called "arbitrage". Arbitrage involves bonds which are used directly or indirectly to acquire higher yielding investments or to replace funds which were so used.<sup>8</sup> In the P3 world, the exempt organization serves as a role that can access tax-exempt funds to finance the whole project with a lower interest rate.

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<sup>8</sup> Debra Kaweck and Marvin Friedlander, 501(c)3 BONDS – A Mini-Text

### Governmental Bonds and Private Activity Bonds

Under the Tax Reform Act of 1986, historical government bonds are treated differently than conduit revenue bonds. Conduit revenue bonds are termed "private activity bonds" by the Act.<sup>9</sup> Governmental bonds are tax-exempt, subject to general requirements, and derive their exemption from IRC 103(a).<sup>10</sup> IRC 103(a) also defines the term "state or local bond", as any obligation of a State or political subdivision including those issued on behalf of a government entity. Under IRC 103(a), the state or local bonds are treated as governmental bonds as well, the interest of which is not included in the bond gross income. However, the interest on private activity bonds is only tax exempt if the bond is a "qualified private activity bond" as described in IRC 103(b).<sup>11</sup> Governmental bonds are generally used by a governmental unit for governmental purposes, such as schools, government buildings and roads.

### Economic Market Statistics

From an economic market perspective, prior to the 1980s, most bonds were general obligation bonds, those backed by the full faith and credit of the government, and paid for using tax revenue. In fact, in the 1970s general obligation bonds comprised about 60 percent of the municipal bond market.<sup>12</sup> When economic stress weakens the tax base and revenue decline, governments are forced to cut operating budgets over debt service. By the early 1980s, when the prevailing trend was economic stress, revenue bonds surpassed general obligation

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<sup>9</sup> 501(c)3 Bonds – A Mini Text, pp268

<sup>10</sup> See Appendix

<sup>11</sup> See Appendix

<sup>12</sup> Petersen, J.E. (1991). Debt markets and instruments. In Petersen, J.E. & Strachota, R. Local Government Finance: Concepts and Practices, pp.293-320. Chicago, IL: Government Finance Officers Association, p.296. National Association of Counties. Certificates of Participation: An Innovative Financing

bonds in market share because they are not limited to debt limits; they are not tied to taxes but rather user charges and fees, and revenue bonds are more expedient—no public vote or approval is necessary.<sup>13</sup>

Tax-exempt bonds issued by State and local governments are classified as either “governmental” or “private activity,” depending on whether the proceeds are used and secured by public or private entities and resources.<sup>14</sup> Between Calendar Years 2009 and 2010, the total amount of tax-exempt bonds issued by State and local governments decreased 5.7 percent, from \$446.2 billion to \$420.7 billion.<sup>15</sup> For 2010, governmental bonds accounted for \$293.6 billion (69.8 percent) of total tax-exempt bond proceeds, a decrease of 13.8 percent from \$340.7 billion issued in 2009. Private activity bonds accounted for the remaining \$127.1 billion (30.2 percent). When a tax-exempt bond is issued, the issuer is obligated to repay the borrowed bond proceeds at a specified rate of interest, by some future date. For federal income tax purposes, investors who purchase governmental bonds and certain types of private activity bonds are able to exclude the bond interest from their gross incomes.<sup>16</sup>

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<sup>13</sup> Petersen, J.E. (1991), p.296.

<sup>14</sup> Municipal Bonds, 2010, statistics of Income Bulletin | Spring 2013

<sup>15</sup> For Calendar Year 2009 data, see Barnes, Aaron, “Municipal Bonds, 2009,” Statistics of Income Bulletin, Fall 2011, Volume 31, Number 2.

<sup>16</sup> (1) In addition, for State income tax purposes, most States allow for the exclusion of interest on bonds issued by government agencies within their own States, thus increasing the benefit to the bondholder.

(2) The extent of exclusion of interest income can vary with taxpayer characteristics. For example, banks and insurance companies may be limited as to how much tax-exempt interest they can exclude.

### **3.2 Basic characteristics and requirements**

This part of the paper provides a detailed comparable analysis on the basic characteristics and eligible requirements of issuing two bonds.

For 501(c)3 bonds, there are three key components for an organization to be exempt from federal income tax under section 501(c)3 of the IRC. A not-for-profit (i.e., nonprofit) organization must be organized and operated exclusively for one or more exempt purposes.<sup>17</sup> On the other hand, under the 63-20 structure, a non-profit corporation is able to issue tax-exempt bonds on behalf of Constituted Authorities<sup>18</sup>. These financing vehicles allow P3 projects to be financed through tax-exempt bond programs and save costs from federal tax rebates.

Tax-exempt bonds, including governmental bonds, lose their tax-exempt status if they are arbitrage bonds under section 148 of the Code. In general, arbitrage is earned when the gross proceeds of an issue are used to acquire investments that earn a yield materially higher than the yield on the bonds of the issue. The earning of arbitrage does not, however, necessarily mean that the bonds are arbitrage bonds. Two general sets of requirements under the Code must be applied in order to determine whether governmental bonds are arbitrage bonds: yield restriction requirements of section 148(a); and rebate requirements of section 148(f).<sup>19</sup>

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<sup>17</sup> Applying for 501(c)3 Tax-Exempt Status, <http://www.irs.gov/pub/irs-pdf/p4220.pdf>

<sup>18</sup> Rev. Proc. 82-26, 1982-1 C.B. 114

<sup>19</sup> Form 8038-T

To explore more features and detailed requirements of two bond programs, this paper creates Table 3, quoting and/or summarizing relative legal documents and academic publications to compare two bonds used in P3 projects.

Table 3: A Comparison of Two Bond Programs – From Legal and Academic Perspectives

Category	501(c)3 Bond	63-20 Bond
Exemption Requirements Category	501(c)3 Bond Financing Program	63-20 Bond Financing Program
Roles Involved in the Bond Issuance Process	Bond investor, Commercial banks/other financial institute); Conduit issuer; Project owner; Exempt Organizations (Project owner, qualified partner companies/organizations) Financial advisor, broker, appraiser, underwriter, government officer, etc.	Bond purchaser/investor; Banks/other financial institute); Government issuer (public entity); Project owner; Exempt Organizations (Project owner, qualified partner companies/organizations) Financial advisor, broker, appraiser, underwriter, government officer, etc.
Additional Borrowing Costs (Issuance Fee, etc.)	Issuance costs, paying to the conduit borrower, financial consulting agency, banks.	Costs of issuance and ongoing fees on 63-20 financings are significantly higher than those on conventional financings and the borrowing typically bears higher interest rates. <sup>20</sup>

<sup>20</sup> [http://www.tre.wa.gov/documents/sfc\\_GuidelinesUse63-20FinancingContracts.pdf](http://www.tre.wa.gov/documents/sfc_GuidelinesUse63-20FinancingContracts.pdf)

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
Useful IRS Publications	<p>Internal Revenue Code: Sec. 145. Qualified 501(c)3 bond</p> <p><u>556</u> Examination of Returns, Appeal Rights, and Claims for Refund</p> <p><u>3755</u> Tax Exempt Bonds—Filing Requirements</p> <p><u>4077</u> Tax-Exempt Bonds for 501(c)3 Charitable Organizations</p> <p><u>4078</u> Tax-Exempt Private Activity Bonds</p> <p><u>4079</u> Tax-Exempt Governmental Bonds</p>	<p>Rev. Proc. 82-26, 1982-1; Rev. Rul. 63-20, 1963-1; Rev. Rul. 54-296; Rev. Rul. 59-41.</p>

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
Legal Definition	<p>Qualified 501(c)3 bonds are bonds issued under IRC § 145<sup>21</sup> to finance property OWNED BY:</p> <ul style="list-style-type: none"> <li>• an organization described in IRC § 501(c)3 (an “exempt organization”),</li> <li>OR</li> <li>• A governmental unit.</li> </ul> <p>Except as otherwise provided in this section, the term "qualified 501(c)3 bond" means any private activity bond issued as part of an issue if –</p> <p>(1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)3 organization or a governmental unit, and</p> <p>(2) such bond would not be a private activity bond if –</p> <p>(A) 501(c)3 organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and</p> <p>(B) paragraphs (1) and (2) of section 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.<sup>22</sup></p>	<p>Nonprofit corporations may issue tax-exempt bonds “on behalf” of state and municipal entities by following the requirements outlined in Revenue procedure 82-26 of the U.S. Treasury (the “Revenue Procedure”). These bonds are commonly called “63-20 bonds”, a reference to Revenue Ruling 63-20, which is an early ruling updated by the Revenue Procedure.</p> <p>63-20 bonds have financed public buildings on behalf of Washington state agencies, counties, and cities. Projects have included administrative, student housing, research and other facilities.</p> <p>These entities have used 63-20 bonds to achieve capital project objectives, while preserving the benefits of tax-exempt financing and maintaining governmental control of the facility.</p> <p>Specifically, governmental entities have employed 63-20 bonds to shift construction and other risks to a private development team and to have more flexibility (than may be available under traditional public bidding requirements) to select a private development team well positioned to assume these risks.<sup>23</sup></p>

<sup>21</sup>TITLE 26 - INTERNAL REVENUE CODE

Subtitle A - Income Taxes

CHAPTER 1 - NORMAL TAXES AND SURTAXES

Subchapter B - Computation of Taxable Income

PART IV - TAX EXEMPTION REQUIREMENTS FOR STATE AND LOCAL BONDS

Subpart A - Private Activity Bonds

<sup>22</sup> Sec. 145. Qualified 501(c)3 bond

<sup>23</sup> Fifty Years of 63-20 Financing: Revisiting an Alternative Development Tool - for Washington State Agencies and Municipalities; [http://www.mrsc.org/artdocmisc/m58-63\\_20.pdf](http://www.mrsc.org/artdocmisc/m58-63_20.pdf)

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
Eligible Organization	<p>501(c)3 Organizations:                      The most common types of 501(c) 3 organizations are charitable, educational, and religious. This paper focuses on the <b>Educational organizations</b> which include:</p> <ul style="list-style-type: none"> <li>- schools such as a primary or secondary school, a college, or a professional or trade school</li> <li>- organizations that conduct public discussion groups, forums, panels, lectures, or similar programs</li> <li>- organizations that present a course of instruction by means of correspondence or through the use of television or radio</li> <li>- museums, zoos, planetariums, symphony orchestras, or similar organizations</li> <li>- nonprofit day-care centers</li> <li>- youth sports organizations</li> </ul>	<p>63-20 Organizations:                      "63-20 corporations" are formed under state nonprofit law for purposes of issuing obligations on behalf of a political subdivision. Five criteria will be met for purposes of obtaining an advance ruling (that obligations will be considered obligations of a state or a political subdivision) from the Service. The criteria/requirements that need to be met as a 63-20 organization are stated below in the Bond Issuer section.</p> <p>For the real estate industry, this non-profit corporation causes the project to be designed and built, typically through a fixed-price contract with a private real estate development company. The real estate development company contracts with the architect and federal contractor to deliver a building that meets the specifications set by the public agency. <sup>24</sup></p>

<sup>24</sup> [http://www.tre.wa.gov/documents/sfc\\_GuidelinesUse63-20FinancingContracts.pdf](http://www.tre.wa.gov/documents/sfc_GuidelinesUse63-20FinancingContracts.pdf)

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
Bond Issuer	<p>The borrower of qualified 501(c)3 bonds must be a section 501(c)3 organization. IRC section 150(a)(4) provides that a 501(c)3 organization is any organization described in section 501(c)3 and exempt from tax under section 501(a). The organization must maintain its exempt status as long as the bonds are outstanding.</p> <p>To be tax exempt, an organization must have one or more exempt purposes, stated in its organizing document.</p> <p>The exempt purposes set forth in section 501(c)3 are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. The term charitable is used in its generally accepted legal sense and includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.<sup>25</sup></p>	<p>Under the 63-20 structure, tax-exempt bonds can be issued by a non-profit corporation on behalf of Constituted Authorities<sup>26</sup>, or by 63-20 Corporations.</p> <p>Constituted Authorities criteria:</p> <ol style="list-style-type: none"> <li>(1) the authority is a public benefit corporation organized under state law by a municipality;</li> <li>(2) the issuance of bonds must be authorized by a specific state statute;</li> <li>(3) the bond issuance must have a public purpose (which includes promotion of trade, industry, economic development);</li> <li>(4) the governing body of the authority must be controlled by the political subdivision;</li> <li>(5) the authority must have the power to acquire, lease, and sell property and issue bonds in furtherance of its purposes;</li> <li>(6) earnings cannot inure to the benefit of private persons;</li> <li>(7) Upon dissolution, title to all bond-financed property must revert to the political subdivision.</li> </ol> <p>63-20 Corporations criteria:</p> <ol style="list-style-type: none"> <li>(1) the corporation must engage in activities which are essentially public in nature;</li> <li>(2) the corporation must be one which is not organized for profit (except to the extent of retiring indebtedness);</li> <li>(3) the corporate income must not inure to any private person;</li> <li>(4) the state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon retirement of such indebtedness; and</li> <li>(5) The corporation must have been approved by the state or a political subdivision thereof, either of which must also have approved the specific obligations issued by the corporation.<sup>27</sup></li> </ol>

<sup>25</sup> [http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Exempt-Purposes-Internal-Revenue-Code-Section-501\(c\)3](http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Exempt-Purposes-Internal-Revenue-Code-Section-501(c)3), Page Last Reviewed or Updated: 2013-01-14

<sup>26</sup> Rev. Proc. 82-26, 1982-1 C.B. 114

<sup>27</sup> Internal Revenue Service, Revenue Ruling (Rev. Rul. 63-20) 1963-1 C.B. 24; Module B- Introduction to Federal Taxation of Municipal Bonds, [http://www.irs.gov/pub/irs-tege/teb\\_phase\\_1\\_course\\_11204\\_-3module\\_b.pdf](http://www.irs.gov/pub/irs-tege/teb_phase_1_course_11204_-3module_b.pdf)

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
Bond Volume Cap Limit	<p>There is a \$150,000,000 limitation on bonds other than hospital bonds. In general, a bond (other than a qualified hospital bond) shall not be treated as a qualified 501(c)3 bond if the aggregate authorized face amount of the issue (of which such bond is a part) allocated to any 501(c)3 organization which is a test-period beneficiary (when increased by the outstanding tax-exempt nonhospital bonds of such organization) exceeds \$150,000,000.<sup>28</sup></p>	<p>No volume cap allocation restrictions: bonds issued with a 63-20 structure are not subject to the state's constitutional debt limit as they are issued by a non-profit corporation, not by state.<sup>29</sup></p> <p>In Washington State, 63-20s appear to be used to avoid constraints imposed by the public works laws on a state agency if it uses the state's approved contracting methods. The limitations often identified were: 1) inability to choose a design-build-finance (also known as lease-developer) project delivery method; 2) time constraints imposed by legislative cycle; and 3) lack of certainty about the funding of ongoing building maintenance costs.<sup>30</sup></p>

<sup>28</sup> For outstanding tax-exempt nonhospital bonds

(A) In general

For purposes of applying paragraph (1) with respect to any issue, the outstanding tax-exempt nonhospital bonds of any organization which is a test-period beneficiary with respect to such issue is the aggregate amount of tax-exempt bonds referred to in subparagraph (B) - (i) Which are allocated to such organization, and (ii) Which are outstanding at the time of such later issue (not including as outstanding any bond which is to be redeemed (other than in an advance refunding) from the net proceeds of the later issue).

(B) Bonds taken into account

For purposes of subparagraph (A), the bonds referred to in this subparagraph are - (i) Any qualified 501(c)3 bond other than a qualified hospital bond, and (ii) Any bond to which section 141(a) does not apply if -

(I) such bond would have been an industrial development bond (as defined in section 103(b)(2), as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) if 501(c)3 organizations were not exempt persons, and (II) Such bond was not described in paragraph (4), (5), or (6) of such section 103(b) (as in effect on the date such bond was issued).

(C) Only nonhospital portion of bonds taken into account

(i) In general, (A) Bond shall be taken into account under subparagraph (B) only to the extent that the proceeds of the issue of which such bond is a part are not used with respect to a hospital. (ii) Special rule If 90 percent or more of the net proceeds of an issue are used with respect to a hospital, no bond which is part of such issue shall be taken into account under subparagraph (B)(ii).

<sup>29</sup> [http://www.tre.wa.gov/documents/sfc\\_GuidelinesUse63-20FinancingContracts.pdf](http://www.tre.wa.gov/documents/sfc_GuidelinesUse63-20FinancingContracts.pdf)

<sup>30</sup> State of Washington, Office of the State Treasurer, Reports on 63-20 Capital Projects Financing. Jan. 23, 2006

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
Exemption outcome	The benefits of having 501(c)3 status include exemption from federal income tax and eligibility to receive tax-deductible charitable contributions.	Interest received from such obligations is excludable from gross income under the provisions of section 103(a)(1) of the Internal Revenue Code of 1954. <sup>31</sup>
Yield Restriction Requirements <sup>32</sup> (for 501(c)3: tax-exempt governmental bonds)	<p>The yield restriction rules of section 148(a) of the Code generally provide that the direct or indirect investment of the gross proceeds of an issue in investments earning a yield materially higher than the yield of the bond issue causes the bonds of that issue to be arbitrage bonds.</p> <p>However, the investment of proceeds in materially higher yielding investments does not cause the bonds of an issue to be arbitrage bonds in the following three instances: 1) during a temporary period (i.e., generally, 3-year temporary period for capital projects and 13 months for restricted working capital expenditures); 2) as part of a reasonably required reserve or replacement fund; and 3) as part of a minor portion (an amount not exceeding the lesser of 5% of the sale proceeds of the issue or \$100,000).</p>	<p>The rules for determining whether the governmental unit has the requisite "beneficial interest" in the nonprofit corporation are :</p> <p>The governmental unit must have exclusive beneficial possession and use of at least 95 percent of the fair market value of the facilities; or</p> <p>If the nonprofit corporation has exclusive beneficial use and possession of 95 percent of the fair market value of the facilities, the governmental unit appoints 80 percent of the members of the board of the corporation and has the power to remove and replace members of the board; or</p> <p>The governmental unit has the right at any time to get unencumbered title and exclusive possession of the financed facility by defeasing (paying off or providing for payment of) the bonds.<sup>33</sup></p>

<sup>31</sup> Internal Revenue Service, Revenue Ruling (Rev. Rul. 63-20) 1963-1 C.B. 24

<sup>32</sup> Form 8038-T

<sup>33</sup> [http://www.fhwa.dot.gov/ipd/p3/defined/dbfo\\_shadowtoll.htm](http://www.fhwa.dot.gov/ipd/p3/defined/dbfo_shadowtoll.htm)

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
<p>Rebate Requirements<sup>34</sup> (for 501(c)3: tax-exempt governmental bonds)</p>	<p>The rebate requirements of section 148(f) of the Code generally provide that, unless certain earnings on non-purpose investments allocable to the gross proceeds of an issue are paid to the U.S. Department of the Treasury, the bonds in the issue will be arbitrage bonds. The arbitrage that must be rebated is based on the excess (if any) of the amount actually earned on non-purpose investments over the amount that would have been earned if those investments had a yield equal to the yield on the issue, plus any income attributable to such excess. Under section 1.148-3(b) of the Treasury regulations, the future values (as of the computation date) of all earnings received and payments made with respect to non-purpose investments are included in determining the amount of rebate due. There are, however, two broad exceptions to the general rebate requirements applicable to governmental bonds: the small issuer exception; and the spending exceptions.</p>	<p>The bonds are repaid from net revenues of the facility and, if the governmental entity is the lessee of the facility, from lease payments sized to cover debt service on the bonds. Under the Revenue Procedure, the governmental entity must have a beneficial interest in the nonprofit corporation during the term of the bonds. There are a number of ways to meet this requirement, including by providing the governmental entity with the right to obtain unencumbered fee title to the project by defeasing the bonds and by providing the governmental entity with the exclusive option to purchase the project in the event the nonprofit defaults on its bond obligations.<sup>35</sup></p>

<sup>34</sup> Form 8038-T

<sup>35</sup> Fifty Years of 63-20 Financing: Revisiting an Alternative Development Tool - for Washington State Agencies and Municipalities; [http://www.mrsc.org/artdocmisc/m58-63\\_20.pdf](http://www.mrsc.org/artdocmisc/m58-63_20.pdf)

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
<p>Management Team/Partners Regulations; * Eligible organization details<sup>36</sup></p>	<p>A 501(c)3 organization must be organized as a corporation, trust, or unincorporated association. An organization's organizing documents (articles of incorporation, trust documents, articles of association) must: limit its purposes to those described in section 501(c)3 of the IRC; not expressly permit activities that do not further its exempt purpose(s), i.e., unrelated activities; and permanently dedicate its assets to exempt purposes. Because a substantial portion of an organization's activities must further its exempt purpose(s), certain other activities are prohibited or restricted including, but not limited to, the following activities. A 501(c)3 organization: (1) must absolutely refrain from participating in the political campaigns of candidates for local, state, or federal office; (2) must restrict its lobbying activities to an insubstantial part of its total activities; (3) must ensure that its earnings do not inure to the benefit of any private shareholder or individual; (4) must not operate for the benefit of private interests such as those of its founder, the founder's family, its shareholders or persons controlled by such interests; (5) must not operate for the primary purpose of conducting a trade or business that is not related to its exempt purpose, such as a school's operation of a factory; and (6) may not have purposes or activities that are illegal or violate fundamental public policy.</p>	<p>The public agency (issuer organization) is allowed to engage a private developer/manager who oversees the project, accepts certain construction risks and guarantees a fixed price. In some cases, the 63-20 structure can shorten the construction period and can reduce the risk of cost increases.<sup>37</sup></p>

<sup>36</sup> Applying for 501(c)3 Tax-Exempt Status, <http://www.irs.gov/pub/irs-pdf/p4220.pdf>

<sup>37</sup> [http://www.tre.wa.gov/documents/sfc\\_GuidelinesUse63-20FinancingContracts.pdf](http://www.tre.wa.gov/documents/sfc_GuidelinesUse63-20FinancingContracts.pdf)

Table 3 Continued

Category	501(c)3 Bond	63-20 Bond
Financing Structure	Can fund up to 100% of the project cost, based on a purpose of public use. (need to be confirmed)	Can fund up to 100% of the acquisition and development. Soft Costs and Entitlement Costs are reimbursed at closing.
Average Maturity (Years of Amortization)	Typically 30 years.	Typically 30 years or shorter. The governmental unit has the right at any time to get unencumbered title and exclusive possession of the financed facility by defeating (paying off or providing for payment of) the bonds.
Ownership Reverse Regulation	Not required	Building ownership is required to revert to the university after debt repayment

### **3.3 Financing Process and Conceptual Cash Flow Model**

The P3 process allows the public and private (non-profit) sectors to share the returns, costs, risks and responsibilities by using tax-exempt bond financing. In this section, a project process model is created to illustrate the project life cycle – from the pre-financing phase, bond issuance, design and development, operation, rent collection and bond repayment, to the end when the bond is paid off. In this conceptual process model, the two bonds are not differentiated; this is because the common feature of a real estate project. Figure 1 shows this process model. Based on this model, a conceptual cash flow model (Figure 2) is also developed in order to show the capital structure for such processes. Although the two bonds share a similar timeframe and similar cash flow stream, there are variances in the way projects are financed and the bonds are issued and reimbursed. As a results, two graphs are depicted to explain the different financing mechanisms of 501(c)3 and 63-20 bonds for university real estate projects under P3 structure.

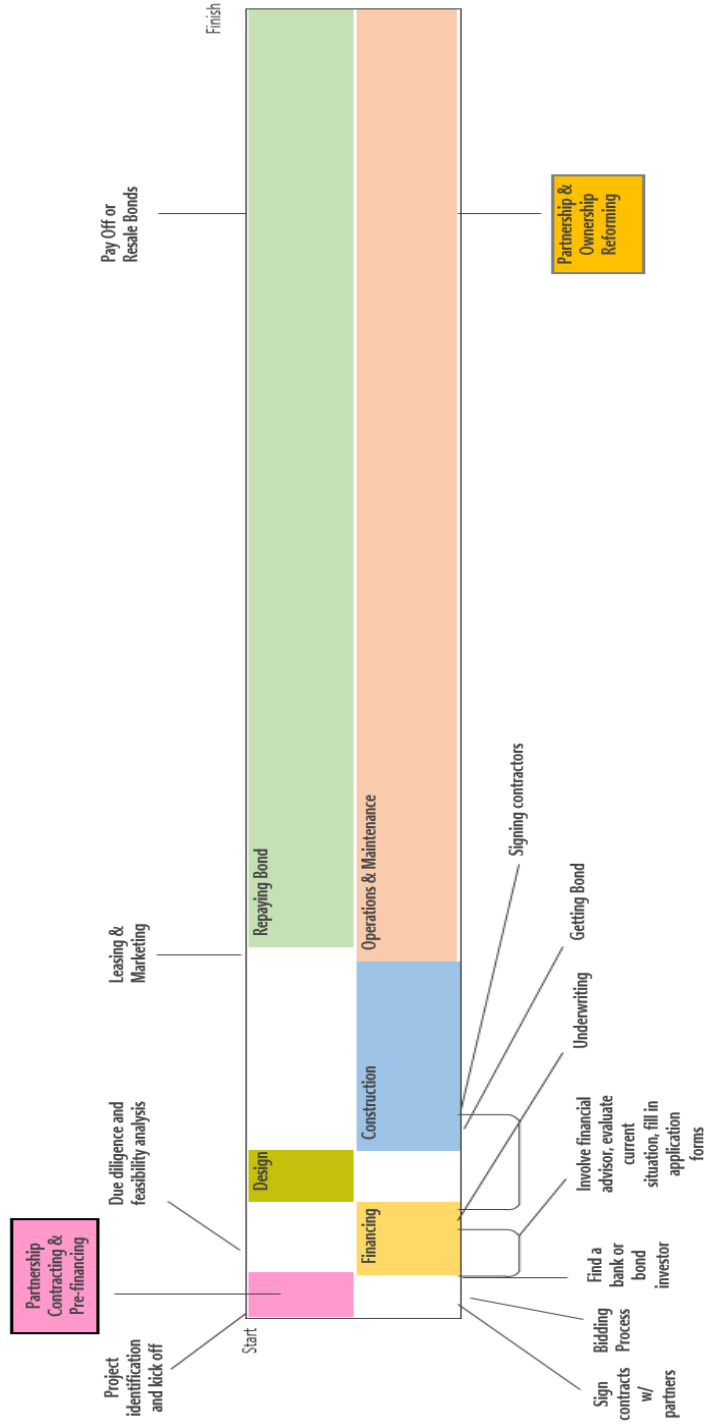


Figure 1: Project Process Model

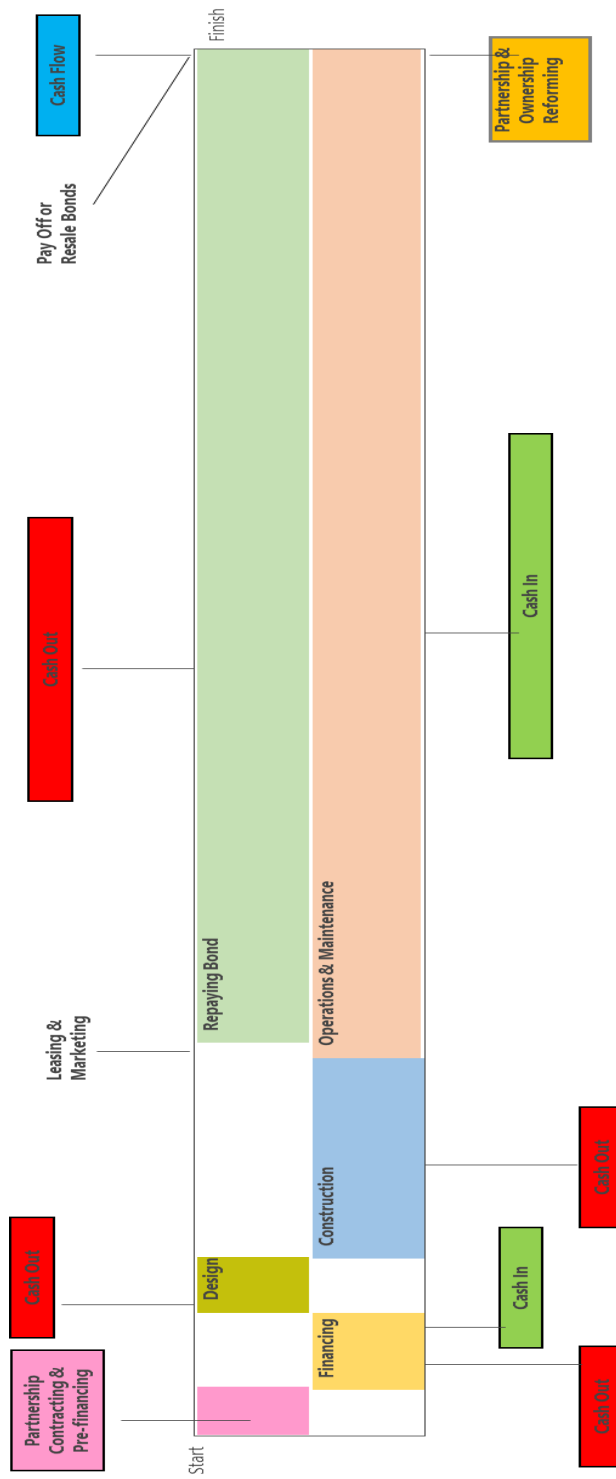


Figure 2: Conceptual Cash Flow Model

Below are two charts representing the financing procedures of 501(c)3 and 63-20 bonds under public-private partnership. A P3 structure is formed with three parties – the university, the non-profit organization and the private entities (including developer, designer, construction contractor, property manager, etc.) for university real estate projects. The 501(c)3 structure (Figure 3) contains a conduit issuer which doesn't exist in 63-20 process, while the 63-20 structure (Figure 4) requires a mandatory ownership reversion at the end of project life cycle.

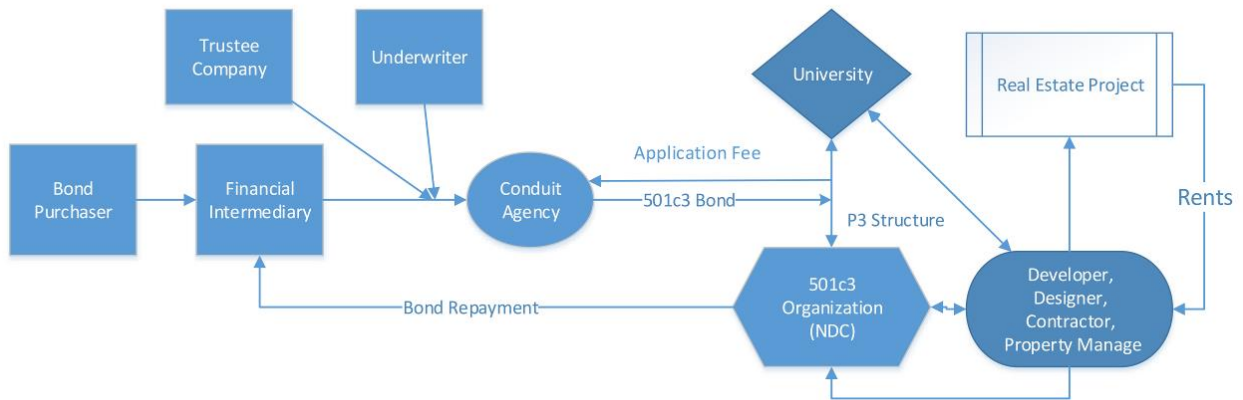


Figure 3: 501(c) 3 Financing Structure

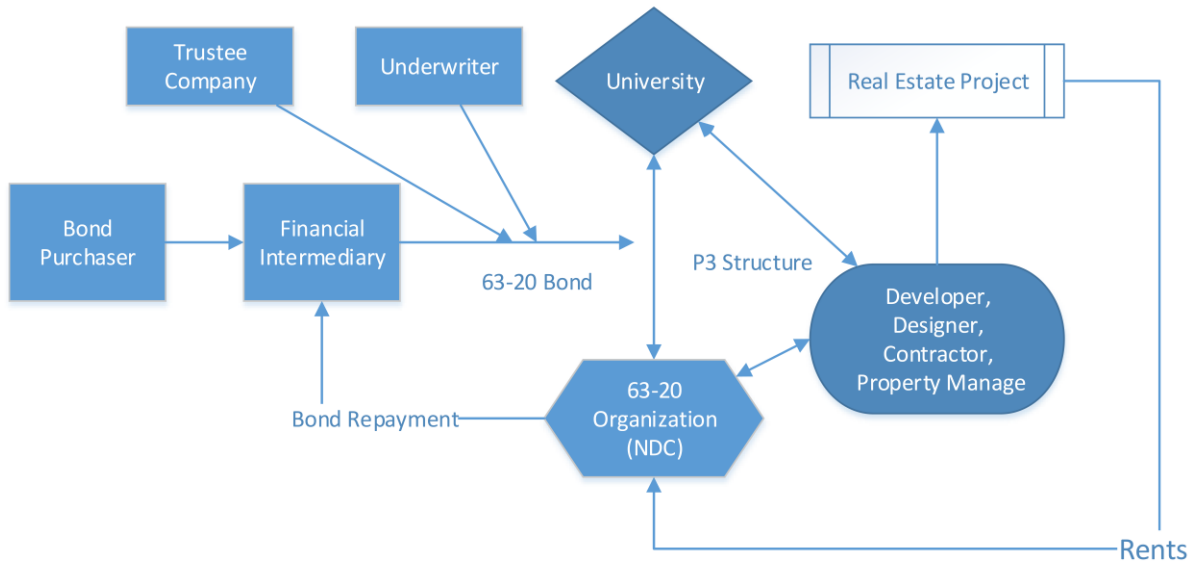


Figure 4: 63-20 Financing Structure

## **4 Case Review and Interview Design**

### **4.1 Bond-financed P3 Projects for University Real Estate**

#### **Projects in Washington State**

501(c)3 financings are commonly used by non-profit organizations (mostly public charity organizations) in Washington State. Application fee and limited annual bond volume are two major constraints in applying and using 501(c)3 bonds.

63-20 financings are being used in Washington State on a limited basis, primarily to free issuers from constraints of public works laws, and gain choice of project delivery methods, flexibility in timing transactions, and a method to contract for ongoing maintenance, even if they ultimately pay higher financing costs.<sup>38</sup>

The cases studied in this thesis are all located in Washington State, under the Public-Private Partnership in which the University of Washington (UW) as the public sector, the National Development Council (NDC) as the non-profit partner. In 501(c)3 processes, NDC serves as the 501(c)3 organization; while in 63-20 processes, NDC is the 63-20 organization who issues the bonds on-behalf-of the university.

In this context, the University of Washington bonds issuance is a good example. In the year of 2006, the university was granted authority to issue General Revenue Bonds (GRBs), the repayment of which is backed by multiple revenue sources of the University. The diversity of revenues in the repayment stream provides investors with some repayment

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<sup>38</sup> State of Washington, Office of the State Treasurer, Reports on 63-20 Capital Projects Financing. Jan. 23, 2006

protection and comes with higher ratings (and lower borrowing costs) than other financing mechanisms. In terms of the above, the University of Washington tries to use general revenue bonds when they can.<sup>39</sup>

There are always exceptions to every rule. The UW has issued both 501c-3 bonds (with WEDFA as the conduit issuer) and 63-20 bonds to fund various projects. Always, both bonds come with same interest costs, as the pledged repayment stream is the same under both borrowing platforms. However, the issuance costs associated with the two types are quite different. In the case of 501c-3 bonds, a significant fee is paid to the issuer, in this case WEDFA.

In Washington State, there are 16 universities and colleges that are eligible to issue 501(c)3 tax-exempt bonds: Antioch University, Seattle University, Seattle Pacific University, Cornish College of the Arts, University of Puget Sound, Pacific Lutheran University, Saint Martin's University, Pacific Northwest University of Health Sciences, Heritage University, Walla Walla University, Whitman College, Gonzaga University, Whitworth University, Northwest Indian College, Bastyr University, and Henry Cogswell College. Meanwhile, there are 6 public universities in Washington State, which are able to issue 63-20 bonds: Central Washington University, Eastern Washington University, Evergreen State College, University of Washington, Washington State University, and Western Washington University.

The table below shows a list of major players in the tax-exempt bond market in Washington State.

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<sup>39</sup> UW Real Estate Department

Table 4: Profiles of Key Players of Tax-exempt Bonds in Washington State

Key Players' Profiles	Introduction	P3 and Tax-exempt Bond Options	P3 and Tax-exempt Bond Activities
National Development Council (NDC)	NDC is a nationwide non-profit organization, which is aimed at helping public and non-profit entities access funds to finance their capital or real estate development projects.	NDC is able to finance both 501(c)3 and 63-20 tax-exempt bonds.	NDC has forged a unique form of public-private partnerships to produce more than \$2.0 billion of projects for local governments and non-profit and public institutions.
Washington Higher Education Facilities Authority (WHEFA) <sup>40</sup>	The purpose of WHEFA is to support the financing needs of Washington's nonprofit, independent colleges and universities through tax-exempt bonds (501(c)3 bonds).	A higher education institution is eligible for financing by WHEFA if: <ul style="list-style-type: none"> <li>- It is private and nonprofit</li> <li>- The main campus is situated in the state</li> <li>- It is open to all residents of the state – no restriction on racial or religious grounds</li> <li>- It provides programs of education beyond high school leading at least to the baccalaureate degree</li> <li>- It is accredited by the Northwest Association of Schools and Colleges or by an accrediting association recognized by the higher education coordinating board or successor agency. (per RCW 28B.07.020)</li> </ul>	WHEFA has financed different types of projects for universities in Washington State, including: <ul style="list-style-type: none"> <li>- Classroom buildings</li> <li>- Science laboratories</li> <li>- Healthcare facilities</li> <li>- Student residential facilities</li> <li>- Technological improvements</li> <li>- Performing Arts buildings</li> <li>- Athletic facilities and fields</li> <li>- Parking facilities</li> </ul> <p>As of October 15, 2012, WHEFA has completed 83 financings (since 1983), as a total of \$1,694,685,958 through 501(c) 3 program (\$686,224,788 outstanding)</p>

<sup>40</sup> <http://www.whefa.org/USCECPresentation.pdf>

Table 4 Continued

Key Players' Profiles	Introduction	P3 and Tax-exempt Bond Options	P3 and Tax-exempt Bond Activities
<p>WEDFA (Washington Economic Development Finance Authority) <sup>41</sup></p>	<p>The Washington Economic Development Finance Authority (WEDFA) is an independent agency within the executive branch of state government. WEDFA was created by the legislature to act as a financial conduit to businesses through the issuance of nonrecourse revenue bonds.</p>	<p>WEDFA has the authority to issue these bonds on both a taxable and tax-exempt basis in support of qualifying projects — primarily manufacturing, processing and waste disposal facilities. WEDFA cannot assist retail projects. WEDFA evaluates such projects in light of their economic contributions, particularly job creation and training in core business areas.</p>	<p>WEDFA has financed hundreds of millions of dollars for 501(c)-3 corporations, including biomedical research facilities, blood processing facilities and job training enterprises.</p>
<p>WSHFC (Washington State Housing Finance Commission)</p>	<p>The Washington State Housing Finance Commission is a publicly accountable, self-supporting team, dedicated to increasing housing access and affordability and to expanding the availability of quality community services for the people of Washington.</p>	<p>The Washington State Housing Finance Commission issues both tax-exempt and taxable bonds to provide below market-rate financing to nonprofit developers and to for-profit developers who set aside a certain percentage of their units for low income individuals, families, and/or educational institutes.</p>	<p>In 2006, the Commission issued nearly \$257 million in nonprofit housing bonds. These bonds are not subject to annual Bond Cap limitations and cannot be combined with the LIHTCs.</p>

<sup>41</sup> <http://www.wshfc.org/facilities/bondslist.pdf>

## 4.2 Interview Design

The research focuses on comparing the difference of two bond financing options for P3 projects. The goal is to determine which bond has fewer restrictions/is easier to issue/more efficient/yields higher.

In this part of the thesis, a series of interviews were conducted based on nine questions listed in Table 5. The purpose of each question is to explore the differences between the two bond programs, from each interviewee's perspective. The three interviewees include a director who is also a financing professional from the National Development Council (NDC), a P3 project advisor who is also a project manager from the NDC, and a financing manager from the Real Estate Office of the University of Washington. The National Development Council is a non-profit entity that can partner with public and non-profit organizations to issue and use 501(c)3 or 63-20 tax-exempt bonds. The University of Washington is the largest public university in Washington State, which has the capability of using 501(c)3 and 63-20 bonds by partnering with a non-profit organization. The interviews from these two parties provided their unique thoughts regarding the university real estate projects under P3 structure and using tax-exempt bond as the financing source.

All interviewees have involved in the public-private partnership of one or several university real estate projects. The reason for selecting these interviewees was not only because of their familiarity of certain projects but also their different roles and experience involved in each process.

Table 5: Interview Questions and Targeted Answers

No.	Questions asked during the interviews	Target answers
1	How much tax savings?	Different effects of two bonds
2	What is the major difference between bond issuers under each bond program?	Issuer
3	What are the differences in types of projects that can be financed between the two bond programs?	Project type
4	Do both type of bond have an annual cap to the amount of bonds that can be issued under a program?	Cap limits
5	Which program will take longer to issue bonds?	Issuing Duration
6	Is your organization playing different roles in 501(c)3 and 63-20 financing processes?	Role of the P3 parties
7	Will financial returns to your organization differ based on which program is used to finance sponsored projects (different operation processes)?	Financial return
8	What's the advantage of using a non-profit partner to issue tax-exempt bonds and finance the real estate projects?	P3 advantages
9	What's your criteria of selecting a qualified project? Have you killed any project before you start?	Decision making

The cases that are referred to in this thesis, which were done between the University of Washington and the National Development Council, are listed in Table 6 below:

Table 6: Cases List

No.	Project Name	Bond Program & Property Type
1	South Lake Union UW medicine building, Phase 1 & 2	501c3 bond, research building
2	South Lake Union UW medicine building, Phase 3	63-20 bond, research building
3	Commodore Duchess-housing	63-20 bond, student housing
4	4245 Roosevelt- UWMC clinic	63-20 bond, research building

### 4.3 Interview Findings

63-20 and 501(c)3 models are created and used broadly in the Northwest. There are two major features of these kinds of models. Firstly, it creates a delivery model that led by private developers; secondly, the construction cost will be much lower under this model than using the traditional financing method, although the financing cost is higher (30 – 40 basis points higher interest rate). Generally 100% of the project cost can be financed by the tax-exempt bonds issued.

In the next section, I provide some background on UW tax-exempt bond financing projects. Although UW has financed some real estate projects with 63-20 bonds in the past, there are only two current outstanding tax-exempt bond projects. For the South Lake Union buildings, Vulcan is the land owner, UW resides the buildings, NDC operates the property for UW, UW pays rents to NDC and NDC pays the debt.

### 4.3.1 Financial Outcome Comparison

(1) Financing costs are different.

Financing costs are different between two bond programs. 501(c)3 is higher than 63-20 bonds because of the fee charged by conduit issuer. In Washington State, the designated government agencies, which serve as conduit issuers of 501(c)3 bonds, include WEDFA (Washington Economic Development Finance Authority), WSHFC (Washington State Housing Finance Commission), Seattle Housing Authority (SHA), etc. The differences among these government agencies as conduit issuers are their varied charges- including application fees, deposits, issuance fees, annual commission fees, etc. In Washington State, WEDFA is charging a lower than HFC, while SHA might be the cheapest.

HFC (Housing Financing Council) is the dominant conduit issuer in Washington State. It charges 15 basis points (0.15%) of the total bond value, and 4 basis points (0.04%) of the outstanding bond value on a yearly base. However, 63-20 bonds don't need a conduit issuer to be involved, as a result, the financing fee of 63-20 bonds is lower than 501(c)3.

(2) Tax savings are the same for both bond programs<sup>42</sup>

Mr. Chuck Depew, NDC, provided an example to illustrate how much tax-savings can be achieved. If the lender's interest rate is 5.75%, and the tax rate is 35% so effective interest rate (after tax) is 3.74% (equals with  $5.75\% * (1-35\%)$ )

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<sup>42</sup> According to Mr. Bill Starley, there's also no tax difference between tax-exempt bond financing and general revenue bond financing for UW, because UW is a governmental agency and is tax-exempted for academic buildings and stadium

If the borrower is eligible for tax-exempt financing, then the lender can lower their rate to 3.74% without impacting their return. Due to tax-exemption the borrower will get a lower rate.

### **4.3.2 Bond Issuer Comparison**

Under Public-private-partnerships, universities are able to issue tax-exempt bonds to finance their real estate projects. From Mr. John Finke's standpoint, there are two purposes of using 501(c)3 and 6-20 tax-exempt bond programs: one is to reduce the construction cost, the other one is to improve the building quality. In UW's case, the issuer of 501(c)3 bonds is WEDFA; while for 63-20 bonds, specifically for SLU Phase 3.1, UW created a sole entity called Washington Biological Research Foundation (WBRF) to issue the bond, and NDC manages WBRF for UW.

According to legal regulations, the issuers of two bonds should be different. Generally speaking, the issuer of 501(c)3 bond is the conduit issuers, while the issuer of 63-20 bonds is the non-profit organizations.

501(c)3 bonds are issued by designated government agencies on behalf of non-profit organizations. For example, Seattle Pacific University (SPU), which is not a government agency, can only use 501(c)3 bond financing rather than 63-20.

63-20 bond issuers are non-profit organizations who can issue bonds on-behalf of the government. This kind of non-profit organization is called "63-20 organizations" or "63-20 entities". Non-profit agencies, such as private schools, cannot issue or use 63-20 bonds.

There are even more limitations regarding bond issuers in the real world.

On the one hand, why does a non-profit organization want to form a P3 structure to use another non-profit, in this case, NDC, to be the bond issuer? The main reason is that tax-exempt bonds always need good credits to issue. However, many non-profits are small, and do not have stable long-term revenue to cover the debt service. NDC has the ability to borrow.

On the other hand, for 63-20 bond, why does the University of Washington need a local non-profit to issue on-behalf-of the local government? Isn't it a public agency? Although 63-20 bonds are designed for public benefits, there are many regulations in practice, including: local government needs to endorse the project, the reversion of the building ownership is mandatory, and the limits on for-profit uses. According to the policy and regulations, UW cannot issue 63-30 bonds by itself. To avoid going through "public procurement" and take advantage of private development, public entities have to let a non-profit manages its development process.

As mentioned at the beginning of this section, there are two advantages of private development. One advantage is that the public entity takes less risk in construction process (timing, funding, and budget). The other advantage is, the actual construction cost of using a private development company is lower than the governmental guaranteed cost (GMT). For example, UW is a tenant in the building which is financed through NDC and operated by NDC as well, so UW pays the rent to NDC, and NDC pays the debt for UW. UW thus has no worry about whether the rent is enough to cover the debt service.

### 4.3.3 Project Type Comparison

Governmental real estate projects are mostly public in nature, so project owners are able to issue 63-20 bonds for those projects. However, not any type of projects owned by the non-profit are qualified to issue 501(c)3 bonds; only the projects which are for public purpose, or the public usage part of the entire projects, can use tax-exempt funds.

Both 501(c)3 and 63-20 bonds can make 5% of the total benefit for private uses, while General Revenue Bonds can use 10% of the total benefits on private use. The “private use” can be paying for the financing cost, using a certain percentage of the building area to run for-profit business. For instance, with a tax-exempt bond financed project, UW can use 3% of the bond benefit to pay for the financing cost, and sub-lease ~7% of the total area to for-profit tenants (e.g. Starbucks) Because 501(c)3 might cost more than 63-20 bonds to pay WEDFA, NDC, attorney, financial advisor, etc., 63-20 projects may include a larger portion of private use than 501(c)3 projects do.

There are some special situations to know about. An example is the Harborview Hospital. Harborview’s project is financed by 63-20 bond with a total value of \$62,540,000, including 156,800 sq. ft. medical office building with 198 underground parking stalls.<sup>43</sup> King County master leases the whole building from NDC. King County only uses 70% of the building by leasing it to UW as a medical center, and leases the rest of the building to some non-profit organizations such as World Health and Gates Global Health Institutes. In this case, although the tax-exempt bond issued by NDC is still 63-20 bond, it is actually called “501(c)3/63-20

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<sup>43</sup> <http://nationaldevelopmentcouncil.org/>

bond” (the general kind is “government/63-20 bond”<sup>44</sup>, as mentioned in the above paragraph). The total benefit of the bond is divided into two parts: 95% are the exempt uses, including state government, public university, and non-profit tenants; 5% can be private uses.

Another scenario of the bond financing for P3 real estate development is to use combined funding source for one project. For example, NDC used 501(c)3 bond and taxable financing to finance the UW Roosevelt Dental Building. The reason is when NDC started the financing process, the tenants at the time in the existing building were not only with UW but also running private business. The private use of the building is not qualified to for “63-20” or 501(c)3 financing.

#### **4.3.4 Cap Limits Comparison**

From Mr. Chuck Depew’s standpoint as a government communication manager, the cap limit is only on 501(c)3 bonds, applied each year and for each state. There are several conduit agencies in Washington State, each of those agencies has a cap limit as well.

Secondly, Mr. John Finke points out that UW has its own debt limit each year, while there’s no cap limit for either 501(c)3 or 63-20 bonds in Washington State. However, different states may have different rules.

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<sup>44</sup> Qualified private activity bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are used for a defined qualified purpose by an entity other than the government issuing the bonds (the “conduit borrower”). For a private activity bond to be tax-exempt, 95% or more of the net bond proceeds must be used for one of the several qualified purposes described in sections 142 through 145, and 1394 of the Code. Governmental bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are generally used to finance activities or facilities owned, operated, or used by that or another government for its own purposes. This can include financing the building, maintenance, or repair of various types of public infrastructure such as highways, schools, fire stations, libraries, or other types of municipal facilities. Ultimately, though, a tax-exempt governmental bond is a state or local bond that is neither a private activity bond, as defined in section 141 of the Code, nor an arbitrage bond within the meaning of section 148 of the Code.

Lastly, Mr. Bill Starley answered this question from UW Real Estate Office's perspective, that this is even not a criteria to select bonds to finance the university's real estate projects.

#### **4.3.5 Issuing Duration Comparison**

All three interviewees thought the two bond programs are taking almost the same time to issue, but 501(c)3 bonds might need longer.

There are two reasons. Firstly, 63-20 bonds issuers can save time on government approvals- the governments are the bond fund end users and at the same time are the approvers. On the other hand, to issue a 501(c)3 bond, a third party- the conduit issuers- must be involved, so the decision making processes will take long. A lot of discussions, talks and negotiations will be taken to achieve a good result.

#### **4.3.6 P3 Parties Involvement Comparison**

Although all the interviewees agree that the roles of their organization plays in two bond programs are the same, they have a different understanding of what role it is.

From the non-profit organization's perspective, NDC in both processes are always the bond beneficiaries and project owners. It is NDC that negotiated with underwriters, issued bonds, financed projects, cooperated with private developers and paid back the debt. In 63-20 processes, NDC will lease the project back to the government agency in order to repay the bond using rent cash flow. Additionally, property management can be done by the local government or directed by the conduit issues – i.e. NDC. NDC uses private property management companies.

From the standpoint of the university, during both bond application processes, UW is the one who does the work: puts together the materials, selects the underwriter, negotiates with stakeholders, hires attorney to draft the initial statements, etc. On the statement of all bonds, UW is stated as the issuer.

#### **4.3.7 Post-construction Financial and Ownership Comparison**

Financial returns in the post-construction period can differ based on which program is used to finance sponsored projects.

##### (1) Interest rate

Using 501(c)3 bonds, UW needs to pay WEDFA 15 basis points (0.15%) of the overall bond value, with 4 basis points (0.04%) escalation each year. In contrast, using 63-20 bonds, UW does not need to pay WEDFA (because there is not a conduit issuer) or WBRF (which was created by UW and was operated by NDC on behalf of UW).<sup>45</sup>

##### (2) Financial returns from operating.

The net benefits of the non-profit organization mostly come from the gap between a percentage of rent collected from the income property operated by the non-profit, and the total cost including debt service and the property management expense. For most University P3 real estate projects that are using 63-20 bonds, it is NDC that always performs the property management. For some 501(c)3 financed projects for private universities, it is the university itself that manages the property. For example, Seattle Pacific University (SPU), as a premier Christian university, has its special requirements on student tenants and property management.

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<sup>45</sup> Author's notes: Compared with general revenue bonds, tax-exempt bonds (both 501(c)3 and 63-20) need to pay 45 more basis points (0.45%) on the interest rate.

In this case, SPU managed their student housing instead of NDC, while most of other partners chose to let NDC help them manage the buildings. In this case, the financial returns for NDC is different from other P3 tax-exempt bond projects.

(3) Building ownership with/without additional cost

Whether there is a mandatory reversion when all bond debt is paid off is another major difference between these two bond programs. For 63-20 bonds, the federal government requires the building ownership to be transferred back to the public entity at no additional cost when all bond debt is paid off. For 501(c)3 bonds, this secure vehicle does not exist - there is no mandatory policy to secure the building for the nonprofit entity. However, NDC always did contractual reversion with the government agencies, such as the public universities, to give back the building at no extra cost at end of the debt service.

With both bonds, UW can get the buildings back with no additional cost at the end of the day, the real concern is whether UW is the land owner and how much the residual value will be. For example, in South Lake Union's case, for the buildings that the University of Washington occupied as tenants, the land owner is Vulcan instead of UW; as a result, UW needs to make sure the ground lease with Vulcan is long enough to zero out the residual value. Generally, the term of 63-20 bonds (15 years) is shorter than 501(c)3 bonds (30 years); it might not be long enough for SLU phase 3.1 (63-20 bond financed).

### **4.3.8 Decision making Comparison**

For the National Development Council, the most important factor is a reasonable cost estimation with enough budget. A solid financial strength and a capability of the entity to repay the bonds are very critical for the future success of the project.

Other criteria include: 1) if it is a government project and will be leased back to the government, the public entity has to be creditably. 2) It is important that the government wants to and can own the project back – or it will involve a big risk to the non-profit.

There is an example for NDC. NDC did not go further with a project in Clark County because the model designed by the private developer is not favorable. 1) The rents will step up every five years. 2) With the 30-year 501(c)3 bond, when the debt is paid off, the private entity will sell the building back to the county – which means the county has to purchase the property twice in order to finally own it, and would pay for the increased rents.

From the university's point, the final decision is always made by the University governing board. Currently, they haven't obtained a decision regarding SLU Phase 3.2 yet.

For the projects financed earlier than 2006, since UW was not able to issue general revenue bonds, we use WEDFA to issue 501(c)3 for the SLU projects (phase1 and 2). For the west campus projects that have been done recently, UW did not use P3 projects because we were able to issue general revenue bonds (after 2006).

## 4.4 Comprehensive Analysis of Two Bond Programs

Based on the interview findings, the thesis provides a comprehensive analysis (see Table 7) of two bond programs: including the similarities and the differences. The category and sequence of the items listed in Table 7 is aligning with the interview questions presented in Table 5.

Table 7: A Comprehensive Comparison of 501(c)3 and 63-20 Bond Programs

Comparison	501(c)3	63-20
Financial Outcome	The two bond programs are similar in how much tax savings can apply. In UW's case, since UW is a public university, it is tax-exempted in natural; as a result, the tax-savings are not changing no matter if a tax-exempt bond or a general revenue bond is used. However, the construction cost can be lower by issuing tax-exempt bonds than general revenue bonds.	
Bond Issuer	<p>Must be a conduit issuer.</p> <p>The non-profit needs to be the project owner, and needs to have high credit ratings.</p> <p>Private (non-profit) universities have to form the P3 structure to issue the bond because its credit is generally not good enough to apply for a tax-exempt bond.</p>	<p>Must be a non-profit organization on-behalf-of the public entity. Public universities need to become a partner of P3 to issue and use the 63-20 bond financing.</p> <p>Public universities can create a non-profit to issue the bond, not necessary to join hands with another non-profit organization. However, a non-profit organization experienced in 63-20 bond financing (like NDC) can be very much helpful in organizing and managing the newly created entity.</p>
Project Type	<p>Must be non-profit.</p> <p>A small percentage of private use can be included - such as paying for financing expense.</p>	<p>Must be public in nature, for governmental use.</p> <p>A small percentage of private use can be included - such as paying for financing expense.</p>

Table 7 Continued

Comparison	501(c)3	63-20
Cap Limits	Cap limit exists, but does not have influences on universities.	No cap limit.
Issuing Duration	Similar but slightly longer than 63-20.	Similar but slightly shorter than 501(c)3.
P3 Parties Involvement	<p>University leads the financing procedure. NDC does not always manage the property.</p> <p>There's no difference in private partner's role (developer, contractor, designer, property manager, etc.)</p>	<p>University leads the financing procedure. NDC always manages the property.</p> <p>There's no difference in private partner's role (developer, contractor, designer, property manager, etc.)</p>
Post-construction Financials	Interest rate: UW need to pay about 15 basis points of the overall bond value with about 4 basis points escalation to the conduit issuer.	No need to pay interests to a conduit issuer.
	<p>Same: Compared with general revenue bonds, tax-exempt bonds (both 501(c)3 and 63-20) need to pay 45 more basis points (0.45%) on the interest rate.</p> <p>Similar in operating income: depends on whether the university wants to operate the property.</p>	
Post-construction Ownership	No mandatory ownership reversion	The property is required by law to return to the university at no extra cost.
	Same: if the land owner is not the university, need to consider about the residual value of the building after 15-30 years' operating.	
Decision making	<p>Similar between two bonds.</p> <p>NDC makes its decision based on (1) the financial strength of the potential partner, and (2) whether the project financing model will be able to maximize the benefit for the public partner.</p> <p>University makes its decision based on the current available capital resource and other uncertain factors.</p>	

## 5 Conclusion

Using 501(c)3 bonds has three primary advantages. Firstly, 501(c)3 bonds are exempt from federal income tax. Secondly, the private partner is able to bring better experience to the public partner in building development and property operations, and to lower the project construction costs. Lastly, by partnering with a large, non-profit organization to issue 501(c)3 bonds, small, non-profit entities, such as small private universities, are able to use tax-exempt debt as a source to develop real estate projects .

63-20 bonds also have advantages. The biggest advantage of using 63-20 tax-exempt bonds to finance a university real estate project under a nicely formed P3 structure is that the title to the improvements is transferred to the public agency at lease maturity when the bonds issued by the nonprofit corporation are retired. This is required by federal law; as a result, 63-20 tax-exempt bonds can provide more secured benefits for the government than 501(c)3 bonds during the course of the financing. As NDC's Director John Finke summarized at the end of the interview:

*“ How well a tax-exempt bond works really depends on how you put the deal together and who (government or private) benefits ”.*

Besides mandatory ownership reversal, 63-20 bonds cost less than 501(c)3 bonds in the financing period. Outside of the aforementioned differences, 63-20 and 501(c)3 bonds offer similar benefits with regard to tax savings, building development and property management expertise.

However, both bond programs have drawbacks with regard to financing P3 structure based university real estate projects.

For 501(c)3 bond, it is not normally used to benefit the government, while 63-20 is. For instance, with 501(c)3 program, the university is not guaranteed to get the building ownership back at no extra cost after the bond is paid off. Another disadvantage of issuing 501(c)3 bonds is the large extra financing cost – mainly charged by conduit issuers- added in addition to the original spend of the whole project.

For 63-20 bond, private universities and colleges are not eligible to issue such bonds. Additionally, if the university does not own the land outright, a 63-20 term period (15 years , typically) may not be long enough for the university to minimize the residual value since this type of bond is generally held for a shorter period of time than 501(c)3 bonds (30 years, typically).

Based on the above findings, this paper presents several suggestions to P3 practitioners regarding future 501(c)3 and 63-20 tax-exempt bond financing for university real estate projects.

1) Small private universities can only use 501(c)3 bonds, while large public universities can use both 501c3 and 63-20 bonds. Both bond programs can help universities access better development and operation expertise, largely reduce the development timeline, and significantly lower the construction cost.

2) Based on an appropriate organization type and a qualified project type, project financing for 63-20 bonds will cost less than 501(c)3 bonds. Therefore, given both options, large public universities will benefit more from 63-20 bonds.

3) A preferable financing model will include a zero-cost-reversal of building ownership to the university, no matter which type of tax-exempt bond is used.

## 6 Appendix

1. “Public-Private Partnerships: Terms Related to Building and Facility Partnerships”, Government Accounting Office, April 1999. The National Council for Public-Private Partnerships was a resource used in developing the GAO report.  
<http://www.ncP3.org/P3-basics/glossary-of-terms/>
2. John Rappa, 501 (c) (3) BONDS, OLR Research Report, April 19. 2012, visit at:  
<http://www.cga.ct.gov/2012/rpt/2012-R-0146.htm>
3. State of Washington, Office of the State Treasurer, Reports on 63-20 Capital Projects Financing. Jan. 23, 2006
4. A type of financing where an investor purchases a share of the lease revenues of a program rather than the bond being secured by those revenues. The authority usually uses the proceeds to construct a facility that is leased to the municipality, releasing the municipality from restrictions on the amount of debt that they can incur.
5. State of Washington, Office of the State Treasurer, Reports on 63-20 Capital Projects Financing. Jan. 23, 2006
6. Donijo Robbins and Joseph Vander Meulen, An Examination of 63-20 financing, School of Public & Nonprofit Administration, Grand Valley State University, Grand Rapids, Michigan. September 2009.
7. Debra Kaweck and Marvin Friedlander, 501(c)3 BONDS – A Mini-Text
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10. Petersen, J.E. (1991). Debt markets and instruments. In Petersen, J.E. & Strachota, R. Local Government Finance: Concepts and Practices, pp.293-320. Chicago, IL: Government Finance Officers Association, p.296.
11. National Association of Counties. Certificates of Participation: An Innovative Financing
12. Petersen, J.E. (1991), p.296.
13. Municipal Bonds, 2010, statistics of Income Bulletin | Spring 2013
14. For Calendar Year 2009 data, see Barnes, Aaron, "Municipal Bonds, 2009," Statistics of Income Bulletin, Fall 2011, Volume 31, Number 2.
15. (1) In addition, for State income tax purposes, most States allow for the exclusion of interest on bonds issued by government agencies within their own States, thus increasing the benefit to the bondholder.
16. (2) The extent of exclusion of interest income can vary with taxpayer characteristics. For example, banks and insurance companies may be limited as to how much tax-exempt interest they can exclude.
17. Applying for 501(c)3 Tax-Exempt Status, <http://www.irs.gov/pub/irs-pdf/p4220.pdf>
18. Rev. Proc. 82-26, 1982-1 C.B. 114
19. Form 8038-T
20. [http://www.tre.wa.gov/documents/sfc\\_GuidelinesUse63-20FinancingContracts.pdf](http://www.tre.wa.gov/documents/sfc_GuidelinesUse63-20FinancingContracts.pdf)
21. TITLE 26 - INTERNAL REVENUE CODE
22. Subtitle A - Income Taxes
23. CHAPTER 1 - NORMAL TAXES AND SURTAXES

24. Subchapter B - Computation of Taxable Income
25. PART IV - TAX EXEMPTION REQUIREMENTS FOR STATE AND LOCAL BONDS
26. Subpart A - Private Activity Bonds
27. Sec. 145. Qualified 501(c)3 bond
28. Fifty Years of 63-20 Financing: Revisiting an Alternative Development Tool - for Washington State Agencies and Municipalities; [http://www.mrsc.org/artdocmisc/m58-63\\_20.pdf](http://www.mrsc.org/artdocmisc/m58-63_20.pdf)
29. [http://www.tre.wa.gov/documents/sfc\\_GuidelinesUse63-20FinancingContracts.pdf](http://www.tre.wa.gov/documents/sfc_GuidelinesUse63-20FinancingContracts.pdf)
30. [http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Exempt-Purposes-Internal-Revenue-Code-Section-501\(c\)3](http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Exempt-Purposes-Internal-Revenue-Code-Section-501(c)3), Page Last Reviewed or Updated: 2013-01-14
31. Rev. Proc. 82-26, 1982-1 C.B. 114
32. Internal Revenue Service, Revenue Ruling (Rev. Rul. 63-20) 1963-1 C.B. 24; Module B- Introduction to Federal Taxation of Municipal Bonds, [http://www.irs.gov/pub/irs-tege/teb\\_phase\\_1\\_course\\_11204\\_-3module\\_b.pdf](http://www.irs.gov/pub/irs-tege/teb_phase_1_course_11204_-3module_b.pdf)
33. [http://www.tre.wa.gov/documents/sfc\\_GuidelinesUse63-20FinancingContracts.pdf](http://www.tre.wa.gov/documents/sfc_GuidelinesUse63-20FinancingContracts.pdf)
34. State of Washington, Office of the State Treasurer, Reports on 63-20 Capital Projects Financing. Jan. 23, 2006
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36. [http://www.fhwa.dot.gov/ipd/p3/defined/dbfo\\_shadowtoll.htm](http://www.fhwa.dot.gov/ipd/p3/defined/dbfo_shadowtoll.htm)
37. Applying for 501(c)3 Tax-Exempt Status, <http://www.irs.gov/pub/irs-pdf/p4220.pdf>

38. [http://www.tre.wa.gov/documents/sfc\\_GuidelinesUse63-20FinancingContracts.pdf](http://www.tre.wa.gov/documents/sfc_GuidelinesUse63-20FinancingContracts.pdf)
39. State of Washington, Office of the State Treasurer, Reports on 63-20 Capital Projects Financing. Jan. 23, 2006
40. UW Real Estate Department
41. <http://www.whefa.org/USCECPresentation.pdf>
42. <http://nationaldevelopmentcouncil.org/>
43. Qualified private activity bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are used for a defined qualified purpose by an entity other than the government issuing the bonds (the “conduit borrower”). For a private activity bond to be tax-exempt, 95% or more of the net bond proceeds must be used for one of the several qualified purposes described in sections 142 through 145, and 1394 of the Code.
44. Governmental bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are generally used to finance activities or facilities owned, operated, or used by that or another government for its own purposes. This can include financing the building, maintenance, or repair of various types of public infrastructure such as highways, schools, fire stations, libraries, or other types of municipal facilities. Ultimately, though, a tax-exempt governmental bond is a state or local bond that is neither a private activity bond, as defined in section 141 of the Code, nor an arbitrage bond within the meaning of section 148 of the Code.

45. Internal Revenue Code: Sec. 103. Interest on State and local bonds

Sec. 103. Interest on State and local bonds

(a) Exclusion

Except as provided in subsection (b), gross income does not include interest on any State or local bond.

(b) Exceptions

Subsection (a) shall not apply to -

(1) Private activity bond which is not a qualified bond

Any private activity bond which is not a qualified bond (within the meaning of section 141).

(2) Arbitrage bond

Any arbitrage bond (within the meaning of section 148).

(3) Bond not in registered form, etc.

Any bond unless such bond meets the applicable requirements of section 149.

(c) Definitions

For purposes of this section and part IV -

(1) State or local bond

The term "State or local bond" means an obligation of a State or political subdivision thereof.

(2) State

The term "State" includes the District of Columbia and any possession of the United States.

## 46. Rev. Rul. 1963-20 Revenue Ruling

Internal Revenue Service, Revenue Ruling (Rev. Rul. 63-20) 1963-1 C.B. 24

(SECTION 103. — INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS U. S. GOVERNMENT PRINTING OFFICE& WASHINGTON: 1968 Internal

Revenue Bulletin, Cumulative Bulletin 1963 – 1, January - June 1963, page 24 – 29; also released as Technical Information Release 442, dated Jan. 11, 1963.)

Obligations issued by a nonprofit corporation formed under the general nonprofit corporation law of a state for the purpose of stimulating industrial development within a political subdivision of the state will be considered issued `on behalf of' the political subdivision, for the purposes of section 1.103-1 of the Income Tax Regulations, provided each of the following requirements is met: (1) the corporation must engage in activities which are essentially public in nature; (2) the corporation must be one which is not organized for profit (except to the extent of retiring indebtedness); (3) the corporate income must not inure to any private person; (4) the state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon retirement of such indebtedness; and (5) the corporation must have been approved by the state or a political subdivision thereof, either of which must also have approved the specific obligations issued by the corporation. Interest received from such obligations is excludable from gross income under the provisions of section 103(a)(1) of the Internal Revenue Code of 1954.

Revenue Ruling 54-296, C.B. 1954-2, 59; Revenue Ruling 57-187, C.B. 1957-1, 65; Revenue Ruling 59-41, C.B. 1959-1, 13; and Revenue Ruling 60-248, C.B. 1960-2, 35, distinguished.

Full Text

Rev. Rul. 63-20

Advice has been requested whether interest received on bonds issued by a nonprofit industrial development corporation organized under the general nonprofit corporation law of a state is excludable from gross income under section 103(a)(1) of the Internal Revenue Code of 1954.

The S corporation was incorporated as a membership corporation under the general nonprofit corporation law of a state. The corporation was organized for the general purpose of stimulating industrial development within P county. The articles of incorporation authorize the S corporation to purchase, lease and sell industrial sites and buildings and to build industrial facilities for lease or sale to new or expanding businesses within P county. The S corporation does not contemplate pecuniary gain to its members, who consist of representatives of the local chambers of commerce and other private business groups in P county, the county commissioners and officials of participating municipalities. The S corporation will have perpetual existence. The articles of

incorporation further provide that upon retirement of any outstanding corporate indebtedness, or upon dissolution of the corporation, the beneficial interest of any property owned by the S corporation will be solely in P county.

Funds for the operating expenses of the corporation are provided by P county, local chambers of commerce and manufacturing associations and the department of commerce of the state involved.

The S corporation purchased land in P county and erected and equipped a factory thereon which it leased to an industrial firm for a period of 2 x years under a lease agreement. The S corporation financed this project through the issuance of its interest bearing revenue bonds. The total rental to be paid by the industrial firm under the lease agreement is an amount sufficient to pay the principal of and interest on the bonds.

The indenture of trust, under which the bonds were issued, provides that the S corporation will deliver to the indenture trustee a deed of title to the land and factory, which the trustee will hold until the bonds are fully retired. In the event of a default by the S corporation in the payment of the principal and interest on the bonds, the trustee has the power to sell the property and use the proceeds to pay the bondholders.

The Internal Revenue Service holds that obligations of a nonprofit corporation organized pursuant to the general nonprofit corporation law of a state will be considered issued `on behalf of' the state or a political subdivision thereof for the purposes of section 1.103-1 of the Income Tax Regulations, provided each of the following requirements is met: (1) the

corporation must engage in activities which are essentially public in nature; (2) the corporation must be one which is not organized for profit (except to the extent of retiring indebtedness); (3) the corporate income must not inure to any private person; (4) the state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; and (5) the corporation must have been approved by the state or a political subdivision thereof, either of which must also have approved the specific obligations issued by the corporation.

In the instant case, P county does not have a beneficial interest in the S corporation during the period the revenue bonds will be outstanding; nor will the county necessarily acquire full legal title to the land and factory upon retirement of the bonds. The articles of incorporation provide only that, upon retirement of any corporate indebtedness, or upon dissolution of the corporation, P county will have a beneficial interest in the assets of the S corporation. Therefore, there will not necessarily be a vesting of full legal title to the land and factory in P county. Furthermore, while the fact that P county and its participating municipalities are represented among the membership of the S corporation and contribute money to its operations indicates governmental authorization of the corporation and approval of its general objectives, such activities alone are not deemed to constitute approval of the specific bonds issued by the S corporation.

Under the circumstances in the instant case, it is held that the revenue bonds issued by the S corporation are not issued `on behalf of' a political subdivision within the meaning of section 1.103-1 of the regulations. Therefore, the interest received on the bonds will be includible in the gross income of the bondholders under the provisions of section 61(a)(4) of the Code.

Revenue Ruling 54-296, C.B. 1954-2, 59, and Revenue Ruling 59-41, C.B. 1959-1, 13, are distinguishable from the instant case. In both of those rulings, the political subdivision involved had a beneficial interest in the nonprofit corporation prior to the retirement of the indebtedness.

In Revenue Ruling 54-296, a municipality leased to a nonprofit corporation a municipally-owned building in exchange for all its stock. The corporation proposed to issue bonds to finance improvements to the building and it was held that interest on the bonds would be excludable from gross income under section 103 of the Code. The beneficial interest of the municipality consisted in its ownership of all the stock of the corporation and its right under the lease at any time to acquire the improvements by discharging the corporation's indebtedness. Moreover, the municipality retained title to the building which it leased to the corporation.

In Revenue Ruling 59-41, it was held that the bonds of a nonprofit corporation organized under general state law at the request of a municipality to operate the local water system would be issued on behalf of the municipality for purposes of section 103. The

municipality which had the right pursuant to law to purchase the water system, waived such right and entered into a contract with the corporation ratifying and approving the purchase of the system by the corporation. The beneficial interest of the municipality consisted in its right under the contract at any time to purchase the water system for an amount equal to the indebtedness then outstanding with interest.

Also, in each of those rulings the political subdivision involved was to become absolute owner of the property in question upon retirement of the corporate indebtedness.

Revenue Ruling 57-187, C.B. 1957-1, 65, and Revenue Ruling 60-248, C.B. 1960-2, 35, are also distinguishable from the instant case. They hold that interest on bonds issued by a public corporation or corporate governmental agency organized pursuant to a special state statute providing for the creation of such corporations for the particular purpose specified therein and authorizing such corporations to issue bonds to enable them to carry out the specified purpose, is excludable from gross income under section 103 of the Code. In the instant case the corporation in question is not a public corporation or corporate governmental agency organized under such a special state statute; it is a private corporation organized under the general nonprofit law of the state.

The conclusion reached in the instant case is not inconsistent with Revenue Ruling 54-106, C.B. 1954-1, 28, which states that bonds issued by or on behalf of a municipality for the purpose of financing the acquisition or construction of municipally-owned industrial plants for lease to private industry constitute obligations of a political subdivision of a

state within the meaning of section 22(b)(4) of the 1939 Code (section 103 of the 1954 Code). That Revenue Ruling did not consider the question what constitutes issuance of bonds `on behalf of' a political subdivision, which is the issue in the instant case.

#### 47. Sec. 145. Qualified 501(c)3 bond

##### **(a) In general**

For purposes of this part, except as otherwise provided in this section, the term "qualified 501(c)3 bond" means any private activity bond issued as part of an issue if –

(1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)3 organization or a governmental unit, and

(2) such bond would not be a private activity bond if –

(A) 501(c)3 organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and

(B) paragraphs (1) and (2) of section 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

##### **(b) \$150,000,000 limitation on bonds other than hospital bonds**

(1) In general

A bond (other than a qualified hospital bond) shall not be treated as a qualified 501(c)3 bond if the aggregate authorized face amount of the issue (of which such bond is a part) allocated to any 501(c)3 organization which is a test-period beneficiary (when increased by the outstanding tax-exempt nonhospital bonds of such organization) exceeds \$150,000,000.

(2) Outstanding tax-exempt nonhospital bonds

(A) In general

For purposes of applying paragraph (1) with respect to any issue, the outstanding tax-exempt nonhospital bonds of any organization which is a test-period beneficiary with respect to such issue is the aggregate amount of tax-exempt bonds referred to in subparagraph (B) - (i) Which are allocated to such organization, and (ii) Which are outstanding at the time of such later issue (not including as outstanding any bond which is to be redeemed (other than in an advance refunding) from the net proceeds of the later issue).

(B) Bonds taken into account

For purposes of subparagraph (A), the bonds referred to in this subparagraph are - (i) Any qualified 501(c)3 bond other than a qualified hospital bond, and (ii) Any bond to which section 141(a) does not apply if -

(I) such bond would have been an industrial development bond (as defined in section 103(b)(2), as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) if 501(c)3 organizations were not exempt persons, and (II) Such bond was not described in paragraph (4), (5), or (6) of such section 103(b) (as in effect on the date such bond was issued).

(C) Only nonhospital portion of bonds taken into account

(i) In general,

(A) Bond shall be taken into account under subparagraph (B) only to the extent that the proceeds of the issue of which such bond is a part are not used with respect to a hospital.

(ii) Special rule

If 90 percent or more of the net proceeds of an issue are used with respect to a hospital, no bond which is part of such issue shall be taken into account under subparagraph (B)(ii).

(3) Aggregation rule

For purposes of this subsection, 2 or more organizations under common management or control shall be treated as 1 organization.

(4) Allocation of face amount of issue; test-period beneficiary Rules similar to the rules of subparagraphs (C), (D), and (E) of section 144(a)(10) shall apply for purposes of this subsection.

(5) Termination of limitation

This subsection shall not apply with respect to bonds issued after the date of the enactment of this paragraph as part of an issue 95 percent or more of the net proceeds of which are to be used to finance capital expenditures incurred after such date.

**(c) Qualified hospital bond**

For purposes of this section, the term "qualified hospital bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used with respect to a hospital.

**(d) Restrictions on bonds used to provide residential rental housing for family units**

(1) In general

Except as otherwise provided in this subsection, a bond which is part of an issue shall not be a qualified 501(c)3 bond if any portion of the net proceeds of the issue are to be used directly or indirectly to provide residential rental property for family units.

(2) Exception for bonds used to provide qualified residential rental projects Paragraph (1) shall not apply to any bond issued as part of an issue if the portion of such issue which is to be used as described in paragraph (1) is to be used to provide

(A) a residential rental property for family units if the first use of such property is pursuant to such issue,

(B) qualified residential rental projects (as defined in section 142(d)), or

(C) property which is to be substantially rehabilitated in a rehabilitation beginning within the 2-year period ending 1 year after the date of the acquisition of such property.

(3) Certain property treated as new property Solely for purposes of determining under paragraph (2)(A) whether the 1st use of property is pursuant to tax-exempt financing -

(A) In general If -

(i) the 1st use of property is pursuant to taxable financing,

(ii) there was a reasonable expectation (at the time such taxable financing was provided) that such financing would be replaced by tax-exempt financing, and

(iii) the taxable financing is in fact so replaced within a reasonable period after the taxable financing was provided, then the 1st use of such property shall be treated as being pursuant to the tax-exempt financing.

(B) Special rule where no operating State or local program for tax-exempt financing

If, at the time of the 1st use of property, there was no operating State or local program for tax-exempt financing of the property, the 1st use of the property shall be treated as pursuant to the 1st tax-exempt financing of the property.

(C) Definitions

For purposes of this paragraph -

(i) Tax-exempt financing

The term "tax-exempt financing" means financing provided by tax-exempt bonds.

(ii) Taxable financing

The term "taxable financing" means financing which is not tax-exempt financing.

(4) Substantial rehabilitation

(A) In general

Except as provided in subparagraph (B), rules similar to the rules of section 47(c)(1)(C) shall apply in determining for purposes of paragraph (2)(C) whether property is substantially rehabilitated.

(B) Exception

For purposes of subparagraph (A), clause (ii) of section 47 (c)(1)(C) shall not apply, but the Secretary may extend the 24-month period in section 47(c)(1)(C)(i) where appropriate due to circumstances not within the control of the owner.

(e) Election out

This section shall not apply to an issue if -

(1) the issuer elects not to have this section apply to such issue, and

(2) such issue is an issue of exempt facility bonds, or qualified redevelopment bonds, to which section 146 applies.