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Financing Higher Education Facilities: Developing Procedures to Comply with Requirements of Tax, State and Securities Laws

Many public and private colleges and universities use bonds and other debt to finance capital facilities such as student housing and dining facilities, research labs and clinics, software and other information technology, academic buildings, and athletic facilities. Bonds may be issued on a tax-exempt basis to lower the cost of financing these facilities, and may be sold via the public bond market or placed directly with a bank or other lender. Public universities generally issue tax-exempt "governmental" bonds and also may issue qualified private activity 501(c)(3) bonds ("qualified 501(c)(3) bonds") for flexibility in partnering with 501(c)(3) nonprofit entities. Private colleges and universities access tax-exempt borrowing rates through state conduit issuers of qualified 501(c)(3) bonds. Applicable tax requirements under the Internal Revenue Code of 1986, as amended (the "Code"), limit the types of expenditures that can be funded with bond proceeds, limit private use of tax-exempt bond funded facilities, and impose other ongoing obligations. State and securities laws may impose additional requirements both during the process of selling the bonds and during the life of the bonds.

Written procedures to help identify and address the legal requirements that arise before, during and after a bond issue are an important compliance tool. Procedures identify responsible persons, assign monitoring and other compliance tasks, provide for periodic training, and create a record of compliance.

The following provides a high-level overview of some of the applicable tax, state law and securities law requirements. Depending on the particular bond issue, additional requirements may apply at the time of issuance and throughout the life of the bonds. Each of the following topics should be considered in developing effective compliance procedures.

Tax Law Considerations

Eligible Expenditures for Tax-Exempt Bonds

With some limited exceptions, proceeds of tax-exempt bonds must be used to finance or refinance "capital expenditures." A capital expenditure is any cost of a type that is properly chargeable to a capital account (or would be so chargeable with a proper election) under general federal income tax principles. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. Whether an expenditure is a capital expenditure is determined at the time the expenditure is paid with respect to the property, and future changes in law do not affect whether an expenditure is a capital expenditure.

Capital expenditures can include furniture, fixtures and equipment ("FFE"). FFE includes shelving, office or modular partitions (including internal wiring and devices), appliances, movable furniture, desks, chairs, computers, electronic equipment, data and phone equipment, tables, bookcases and partitions.

Office supplies and janitorial supplies or items with a limited useful life should generally be treated as operating expenses.

Bond proceeds also may be expended on certain costs relating to the bond issuance (such as costs of issuance, although transactions involving qualified 501(c)(3) bonds are limited to using 2% of the bond proceeds for these costs), working capital directly related to the capital project (such as start-up costs) that does not exceed 5% of the bond proceeds, and capitalized interest. In some cases, proceeds also may be used to fund a debt service reserve for the bonds.

Reimbursement Rules for Tax-Exempt Bonds

Issuers of tax-exempt bonds may allocate all or a portion of the proceeds of such bonds to the reimbursement of expenditures made prior to the date of issuance if certain rules are followed. These "reimbursement bonds" may be issued to reimburse capital expenditures that (A) were paid no earlier than 60 days before the date the issuer (or, in the case of a 501(c)(3) bond, the issuer or the borrower) adopted a declaration of intent to reimburse such expenditures from the proceeds of obligations, and (B) are reimbursed no later than 18 months after the later of the date the expenditure was paid or the date the project is placed in service (but no later than three years after the expenditure is paid). Reimbursement bonds may also be issued to reimburse certain costs of issuance, certain preliminary capital expenditures (like architect or engineering fees) or certain *de minimis* costs (not exceeding the lesser of $100,000 or 5% of the proceeds of the bonds).

Arbitrage Bonds

Under Section 148 of the Code, in order for the interest on the bonds to be exempt from federal income taxes, the bonds must not be "arbitrage bonds." Bonds will be arbitrage bonds if either (A) any proceeds of the bonds are reasonably expected to be used, or are intentionally used, directly or indirectly, to acquire investments that have a materially higher yield than the yield on the bonds ("higher yielding investments"), or to replace funds that are used to acquire higher yielding investments, or (B) any applicable arbitrage rebate amounts are not paid when due to the United States, all except as permitted by the Code and related Treasury Regulations.

For more information on arbitrage and rebate, see "Tax-Exempt Bonds: A Quick Guide to Yield Restriction and Rebate Exceptions," available here.

Private Activity Bonds

When tax-exempt bonds are issued to finance a project, there are a variety of rules that apply to use of the project throughout the life of the bonds. One of those rules is that, unless issued as a "qualified private activity bond" (such as a qualified 501(c)(3) bond, the additional requirements of which are described in more detail below), a tax-exempt bond cannot be a "private activity bond." A bond is a private activity bond if the issuer of the bond reasonably expects on the issue date that the bond issue will meet either (A) the two "Private Business Tests" or (B) the "Private Loan Test." The Private Business Tests are met if there is more than the lesser of 10% or $15 million (A) of private business use of the proceeds of an issue and (B) of private payments or private security interest with respect to the issue.

The Private Loan Test is met if more than 5% (or $5 million, if less) of the proceeds is treated as being loaned to nongovernmental entities. A bond can also become a private activity bond after issuance if the use of the project changes and, as a result of the change, the bond meets either the Private Business Tests or the Private Loan Test.

Private Business Use. Speaking generally, private business use is the use of tax-exempt bond-financed property in a trade or business carried on by a person other than a "qualified user" (a state or local government entity using the property for governmental purposes). Private business use can arise from a lease, management contract, sponsored research agreement or any other arrangement that gives any private entity, other than a qualified user, special legal entitlements to use the project. Note that the federal government is not a qualified user and use by the federal government generally constitutes private business use.

For more information on private use, see "Tax-Exempt Bonds: A Quick Guide to Private Business Use," available here.

Private Payments or Security. The private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue of tax-exempt bonds. The private payment portion of the test takes into account the payment of the debt service on the bonds that is directly or indirectly to be derived from payments in respect of property used or to be used for a private business use. The private security portion of the test takes into account the payment of the debt service on the bonds that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use.

Qualified Equity. To the extent that facilities are financed with bonds and "qualified equity" (as defined below), the qualified equity can reduce the total amount of private business use allocable to the bonds and allow for additional flexibility for use of the financed facility. Final private activity bond regulations issued on October 26, 2015 (the "Final Mixed Use Regulations"), provide rules for allocating bond proceeds and other sources to eligible mixed-use projects of governmental and 501(c)(3) issuers. Under the Final Mixed Use Regulations, a "project" is defined as one or more facilities or capital projects, including land, buildings, equipment or other property, financed in whole or in part with proceeds of the bonds. An "eligible mixed-use project" is a project financed with governmental bonds and with qualified equity pursuant to the same plan of financing. Generally, an eligible mixed-use project must be wholly owned by one or more governmental persons or by a partnership in which at least one governmental person is a partner.

"Qualified equity" includes proceeds of bonds that are not tax-advantaged (i.e., standard taxable obligations) and funds that are not derived from proceeds of a borrowing (e.g., grants, revenues, etc.) that finance a project under the same plan of financing as the bonds. To constitute the same plan of financing, the equity generally must have been expended for costs no earlier than the start of the reimbursement period for the bonds and no later than the date the project is placed in service. Qualified equity is first allocated to all private business use, with any remaining qualified equity then allocated to governmental use on an annual basis. As a result, if the percentage of the project financed with qualified

equity is greater than the percentage of private business use of the project, all of the qualified equity is allocated to private business use, resulting in 0% private business use allocated to the bonds for that year. For example, if a project that costs $50 million is financed with $10 million in issuer revenues constituting qualified equity and $40 million in tax-exempt bond proceeds, then up to 20% private business use of the project will be allocated to the qualified equity before any private business use is allocated to the bonds. For most facilities, this allocation of private business use will be done on an annual basis.

Qualified 501(c)(3) Bonds

As noted above, a tax-exempt bond cannot be a "private activity bond" unless it is specially qualified. Under Section 145 of the Code, qualified private activity bonds may include bonds issued for the benefit of a 501(c)(3) organization including a private college or university. Acting through a conduit issuer, a 501(c)(3) organization may borrow proceeds of tax-exempt bonds for capital projects. In addition, a public university may find it beneficial to issue qualified 501(c)(3) bonds for a facility that will be leased or otherwise used in whole or in part by 501(c)(3) organizations. Bonds issued as qualified 501(c)(3) bonds are subject to a modified version of the Private Business Tests described above. For purposes of the Private Business Tests, the 501(c)(3) organization is treated as a governmental unit with respect to its activities that do not constitute unrelated trades or businesses under Section 513(a) of the Code. The amount of private business use allowed is reduced to 5%, and bond proceeds spent on costs of issuance are treated as expended for private business use. In addition, qualified 501(c)(3) bonds are subject to public hearing and approval ("TEFRA") requirements, as well as additional restrictions on the use of proceeds.

State Law Considerations

State law varies regarding the status of public universities and their authority to issue bonds. Depending on state law, public universities may issue general revenue, auxiliary revenue or other bonds directly and, again depending on state law, may be required to provide notice to or receive the approval of the state treasurer or other state body.

For example, in Washington state, the "research universities" (the University of Washington and Washington State University) are authorized pursuant to Chapter 28B.142 Revised Code of Washington ("RCW") to issue general revenue bonds for any university purpose, and may obligate any local non-appropriated funds to pay the bonds. The research universities are further authorized to enter into financing leases and incur debt specifically for research purposes under Chapter 28B.140 RCW. The research universities must report annually to the legislature and state treasurer regarding debt issuance activity under these statutes. Washington state universities (the University of Washington and Washington State University), regional universities (Western Washington University, Central Washington University, and Eastern Washington University) and The Evergreen State College have authority to issue auxiliary revenue bonds pursuant to RCW 28B.10.300 *et seq.* to finance student, faculty and employee housing; dining facilities; hospitals and infirmaries; student activities and services; and parking facilities, and to pay the indebtedness from fees, charges, and other auxiliary revenue.

Oregon public universities are authorized to borrow, including through the issuance of revenue bonds, for university purposes. Revenue bonds may be secured by a pledge of all or part of the revenue of the university, and may be made payable from legally available funds on a *pari passu* basis with state-issued bonds issued for university purposes. If the university elects to remain eligible to receive proceeds of state-issued bonds, the university must receive state treasurer approval prior to the issuance of revenue bonds.

A number of public universities, including in Washington and Oregon, have established "internal banks" to provide funding for campus projects. These internal borrowing programs may be funded by external bond proceeds (reloaned internally from the university to a campus borrower on the same or different terms), cash balances, or recycled loan payments from prior internal loans. From a campus borrower's perspective, the internal bank offers access to capital financing at predictable and consistent rates with a reduced institutional borrowing cost. From a bondholder's perspective, any bonds issued to make internal loans are payable from the university revenue obligated to payment of the bonds. If the external debt is issued on a tax-exempt basis, the federal tax requirements discussed above apply.

Public universities and colleges may also finance facilities, including student housing and other fee-producing facilities, through public-private transactions. State law may dictate the structure of any public-private transaction. For example, in Washington, financing contracts for real property require legislative approval, except for financing contracts for research purposes entered into by the research universities. Financing leases for the purchase of equipment require prior notice to the state finance committee. These state law requirements should be taken into consideration in structuring any contract between the public and private partners to the transactions.

State law also identifies the conduit issuer of tax-exempt bonds for the benefit of private universities and colleges. Private colleges and universities may access tax-exempt borrowing rates through state conduit issuers of qualified private activity 501(c)(3) bonds. In Oregon, for example, the Oregon Facilities Authority issues tax-exempt bonds on behalf of private colleges and universities. In Washington, the state issuer of conduit bonds for higher education purposes is the Washington Higher Education Facilities Authority.

Securities Law Considerations

Antifraud Requirements

The federal securities laws prohibit fraud in connection with the sale of securities including state and municipal bonds. Specifically, it is unlawful to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, in connection with the sale of bonds. The antifraud provisions apply any time an issuer "speaks to the market," including when providing disclosure in connection with the issuance of bonds and when providing updates to bond investors. In a 2020 Staff Legal Bulletin, the Securities and Exchange Commission ("SEC") Office of Municipal Securities noted, very broadly, that any public statement (at least by officials who may be viewed as having knowledge regarding the financial condition and operation of an issuer) may be reasonably expected to reach

investors and therefore be subject to the antifraud requirements. Whether a particular statement or omission can give rise to a securities law violation depends on whether the statement or omission is "material." The definition of "material" has been established by case law, and depends on whether there is a substantial likelihood that a reasonable bond investor would consider the information important in making an investment decision or as having significantly altered the total mix of information made available.

Universities, colleges and other bond issuers must take care to confirm the accuracy and completeness of disclosure documents prepared in connection with the sale of bonds, ongoing bond disclosures and other public statements that may reach bond investors. Universities and colleges may choose to provide voluntary disclosure in addition to required disclosures, to provide a robust total mix of information, and as part of an investor communications program. Some universities and colleges include a "bond investor information" page on their website, or provide other voluntary disclosures. Any disclosure program should be designed to ensure the accuracy and completeness of the information.

Continuing Disclosure Requirements

In addition to being attentive to the antifraud requirements, state and municipal bond issuers must comply with Continuing Disclosure Undertakings ("CDUs") to provide annual financial information as well as notice of certain events to bondholders. Bond underwriters are required under SEC Rule 15c2-12 to reasonably determine that an issuer of municipal securities has undertaken to provide this required continuing disclosure via EMMA, a website designed for this purpose.[1] CDUs specify the annual financial information to be provided, including audited financial statements, and a list of events (there are currently 16) that require a notice to be filed within 10 business days of the occurrence of the event. Among others, the required events include material covenant defaults, unscheduled draws on debt service reserves or credit enhancement reflecting financial difficulties, and ratings changes. The newest two events, added in 2019, require notices of certain events relating to financial obligations, including notice of the incurrence of material financial obligations such as liquidity lines of credit, and defaults or other events reflecting financial difficulties.

Disclosure procedures are helpful to universities, colleges and other bond issuers and borrowers in complying with both the antifraud requirements and CDU notice obligations. Procedures identify responsible persons for reviewing and approving bond disclosures, preparing annual filings, monitoring for required notice events, and completing notice filings within 10 business days of the event. Procedures also may address the tax and state law requirements applicable to the university's or college's bonds.

[1] *See* emma.msrb.org.

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Next Steps

If you have any questions regarding higher education financing, including compliance procedures or periodic trainings on the tax, state law and securities law requirements that apply to bond financings, please contact any of our public finance attorneys.

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