



**Tax Exempt &  
Government Entities**

## **Tax-Exempt Bonds for 501(c)(3) Charitable Organizations**

---



---

## Contents

|   |    |
|---|----|
| Introduction .....  | 1  |
| Background .....  | 2  |
| Tax-Exempt Bonds for 501(c)(3) Charitable Organizations.....                                | 2  |
| Post-Issuance Compliance Monitoring.....  | 8  |
| What To Do When You Discover a Violation – TEB Voluntary Closing<br>Agreement Program ..... | 10 |
| More Information .....  | 10 |

---

## Introduction

This publication provides an overview of the special federal tax law rules that apply to municipal financing arrangements commonly known as “qualified 501(c)(3) bonds” under Section 145 of the Internal Revenue Code (IRC). It is intended to help issuers and 501(c)(3) organizations meet federal tax law requirements to ensure that interest earned by bondholders is exempt from taxation under IRC Section 103.

This publication is an overview of the rules; it isn’t official guidance that you may rely on for planning purposes. It refers to various IRC sections, Income Tax Regulations (Treas. Reg.), revenue procedures and other official guidance. Please refer to the official guidance for the rules that apply to qualified 501(c)(3) bonds.

For publications that discuss the general rules that apply to governmental bonds and private activity bonds, see IRS [Publication 4079, Tax-Exempt Governmental Bonds](#), and IRS [Publication 4078, Tax-Exempt Private Activity Bonds](#). For an overview of the responsibilities of an issuer of tax-exempt bonds in a conduit financing arrangement, see IRS [Publication 5005, Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds](#). IRS also provides more detailed information at [www.irs.gov/bonds](http://www.irs.gov/bonds). See also [More Information](#), at the end of this publication.

---

## Background

State and local governments receive direct and indirect tax benefits under the IRC that lower borrowing costs on their valid debt obligations. Because interest paid to bondholders on these obligations is not includable in their gross income for federal income tax purposes, bondholders are willing to accept a lower interest rate than they would accept if the interest was taxable. These benefits apply to many different types of municipal debt financing arrangements including bonds, notes, loans, lease purchase contracts, lines of credit and commercial paper (collectively referred to as “bonds” in this publication).

To receive these benefits, issuers must ensure that the requirements under the IRC are met, generally for as long as the bonds remain outstanding. These requirements include, but are not limited to, information filing and other requirements related to issuance, the proper and timely use of bond proceeds and bond-financed property, and limitations on how bond proceeds may be invested. Special additional rules apply to bonds that are private activity bonds for those bonds to be tax-exempt qualified private activity bonds. This publication describes rules that apply to a particular type of qualified private activity bonds: qualified 501(c)(3) bonds. Information on the requirements that apply to other types of qualified private activity bonds are beyond the scope of this publication. For information about these unique requirements, visit [IRS.gov/bonds](https://www.irs.gov/bonds). For information on the general rules that apply to all types of qualified private activity bonds, see IRS [Publication 4078, Tax-Exempt Private Activity Bonds](#).

This publication also addresses practices and steps an issuer or 501(c)(3) organization can take to protect the tax-exempt status of qualified 501(c)(3) bonds. For example, because requirements and limitations generally apply at the time the bonds are issued and throughout the term of the bonds, this publication encourages issuers and beneficiaries of tax-exempt bonds to create procedures for monitoring compliance throughout the life of the bonds. For more information, see the discussion in [Post-Issuance Compliance Monitoring](#).

---

## Tax-Exempt Bonds for 501(c)(3) Charitable Organizations

Generally interest on a private activity bond is not tax-exempt; however, the interest may be excludable from tax if the issuer meets additional requirements that apply to private activity bonds, making the bonds qualified private activity bonds. A qualified 501(c)(3) bond is a type of qualified private activity bond. In this section, we briefly discuss the tests for determining whether a bond is a private activity bond. This section also describes the rules an issuer must meet for a bond to be a qualified 501(c)(3) bond.

When applicable, these discussions include any special remedial action provision that applies to the particular requirement. If a deliberate action that results in a violation of any of the federal tax requirements cannot be corrected under these special remedial action provisions, issuers may be able to enter into a closing agreement under the Tax-Exempt Bonds (TEB) Voluntary Closing Agreement Program (TEB VCAP) described in [Notice 2008-31, 2008-11 I.R.B. 592](#) (see [What To Do When You Discover a Violation - TEB Voluntary Closing Agreement Program](#)).

## Testing for Private Activity Bonds

A state or local bond will be a private activity bond if as of the issue date of the bonds or at any time while the bonds are outstanding, the bond issue exceeds the limits set forth in either of the private activity bond tests:

- the private business tests of IRC Section 141(b), which consists of the private use test and the private security and payment test, or
- the private loan financing test of IRC Section 141(c).

For a description of the private business test under Section 141(b) and the private loan test under Section 141(c), see [Publication 4079, Tax-Exempt Governmental Bonds](#).

## Qualified 501(c)(3) Bonds are Private Activity Bonds

Private activity bonds are subject to general rules that apply to all tax-exempt bonds, such as the arbitrage rules, rules against hedge bonds or abusive tax transactions and record retention rules, and to special rules that apply to all private activity bonds, such as rules that limit maturities on the bonds and public approval requirements. For a description of these rules, see [Publication 4078, Tax-Exempt Private Activity Bonds](#). This publication addresses only additional special rules that apply to qualified 501(c)(3) bonds under IRC Section 145.

## Qualified Use Tests—Ownership and Modified Private Business Tests

To be qualified 501(c)(3) bonds, the bonds must meet the requirements of IRC Section 145. Section 145(a) contains two tests for determining whether a bond is a qualified 501(c)(3) bond:

- the ownership test, and
- the modified private business tests.

Both tests are applied to determine if the bond is a qualified 501(c)(3) bond, but the requirements work differently. For the bond to be a qualified 501(c)(3) bond, the bond-financed property must meet the ownership test **and** the bond must not exceed the limits set forth in the modified private business tests. Bonds issued for a 501(c)(3) organization that exceed the modified private business test limits or fail to meet the ownership test are private activity bonds that are not tax-exempt.

**Ownership Test.** IRC Section 145(a)(1) provides that all property financed by the net proceeds of a qualified 501(c)(3) bond issue must be owned by either an organization described in Section 501(c)(3) (a 501(c)(3) organization) or a state or local governmental unit. Even if the financed property is owned by a 501(c)(3) organization or a state or local government, the modified private business tests must still be applied to determine if the bond is qualified under Section 145(a).

**Modified Private Business Tests.** Bonds are not qualified 501(c)(3) bonds if they exceed the limits set forth in the modified private business tests. A bond exceeds these limits if both the private business use test limits and the private security or payment test limits of IRC Section 141(b), as modified under Section 145, are exceeded. In other words, the tests that were used to determine if the bond is a private activity bond are modified and reapplied to determine whether a private activity bond is a qualified 501(c)(3) bond. For a description of the private business tests under Section 141(b), see [Publication 4079, Tax-Exempt Governmental Bonds](#).

Under the modified private business tests, the portion of the financed property used by a 501(c)(3) organization in an activity related to its charitable purposes is treated as though it were used by a governmental unit. This portion must be tested to determine how much, if any, is used for a private business use for which there are private payments or security. Any amount of private

business use for which there is a private payment or security must be added to the amount of continued private use of the financed facility arising from any unrelated trade or business use of the financed property. Stated differently, under the modified tests, private business use by someone other than a 501(c)(3) organization of that portion of the bond-financed facility that otherwise would be treated as governmental use with respect to the 501(c)(3) organization that owns the facility must be aggregated with unrelated trade or business use of the financed facility by the 501(c)(3) organization to see if the modified private business use limit is exceeded. Generally, issuance costs financed with bond proceeds are treated as private business use when applying the modified private business test.

Under IRC Section 145(a)(2), the private business tests are modified (1) to apply to the net proceeds of the bonds (the proceeds of a bond issue reduced by amounts allocated to a reasonably required reserve or replacement fund) and (2) so that no more than 5% of private business use and no more than 5% of private security or payments are permitted (in contrast, IRC Section 141(b) generally uses 10% limits). For example, if the aggregate of private business use exceeds 5% of the net proceeds and the aggregate of private payments exceeds the 5% of the net proceeds, the bonds meet the modified private business tests and therefore are not qualified 501(c)(3) bonds. Also, Treas. Reg. Section 1.145-2 limits certain of the general private activity exceptions available under Section 141 so they do not apply to qualified 501(c)(3) bonds.

**Unrelated Trade or Business.** Under IRC Section 145(a)(2), a 501(c)(3) organization is not treated as a governmental unit with respect to its activities that constitute unrelated trade or business activities. Thus, the activities continue to be treated as private business activities. Under IRC Section 513(a), the term “unrelated trade or business” means any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under IRC Section 501. See IRC Section 513(a) for three narrow situations where certain activities are not treated as unrelated trade or business.

### **Qualified 501(c)(3) Organization**

Generally a 501(c)(3) organization must be organized and operated exclusively for educational, religious, or charitable purposes, and no part of the organization’s net earnings may inure to or for the benefit of any private shareholders or individuals. To qualify as a 501(c)(3) organization, the organization must have received a determination letter from the IRS stating that it is an exempt organization described in IRC Section 501(c)(3). For information about filing an application for exemption under Section 501(c)(3), see IRS [Publication 4220, Applying for 501\(c\)\(3\) Tax-Exempt Status](#), and IRS [Publication 557, Tax-Exempt Status for Your Organization](#).

In addition, the 501(c)(3) organization must maintain its 501(c)(3) tax-exempt status throughout the entire term that the bonds are outstanding. Organizations described in IRC Section 501(c)(3) must meet certain requirements to maintain their exempt status. These requirements are generally beyond the scope of this publication, however, the requirement to file a Schedule K to the Form 990, Return of Organization Exempt From Income Tax, is a special filing requirement related to tax-exempt financing for 501(c)(3) organizations.

**Special Filing Requirements to Retain 501(c)(3) Status; Schedule K (Form 990).** Most exempt organizations must file returns and reports at some time during (or following the close of) their accounting period. If an organization fails to meet its annual reporting requirement for three consecutive years, it will automatically lose its tax-exempt status. To regain its exempt status, an organization will have to reapply for recognition as a tax-exempt organization or seek relief under special procedures. If the exempt status is not reinstated retroactive to the date of automatic revocation, there will exist a time during which the organization will not be a 501(c)(3) organization. This could cause bonds benefiting the organization to fail the requirements for tax exemption under IRC Section 145(a).

Section 501(c)(3) organizations benefiting from tax-exempt bond obligations that are required to file Form 990, or choose to do so, must also complete and attach [Schedule K \(Form 990\), Supplemental Information on Tax-Exempt Bonds](#). On Schedule K (Form 990), the 501(c)(3) organization will provide required information for each outstanding tax-exempt bond issue (including refunding bonds) that (1) had an outstanding principal amount of more than \$100,000 as of the last day of the tax year and (2) was issued after December 31, 2002. The required information includes information concerning the use of bond proceeds, any private business use of bond-financed property, arbitrage requirements and post-issuance compliance. For additional information, see [Publication 557, Tax-Exempt Status for Your Organization](#).

### **Application of the Ownership Test and the Modified Private Business Tests**

The ownership test and the modified private business tests are applied at issuance to determine whether any arrangement with respect to the bond-financed facility will cause the bonds to fail to meet the requirements of IRC Section 145(a). Even if the requirements of Section 145(a) are met at issuance, however, a deliberate action taken after issuance may cause the bonds to fail to meet the requirements of Section 145(a). A qualified 501(c)(3) bond issue can lose its tax-exempt status if the issuer or another user of the financed facilities takes a “deliberate action” after the issue date that causes the issue to fail the ownership test of Section 145(a)(1) or satisfy the modified private business tests of Section 145(a)(2). A deliberate action is any action taken by the issuer or 501(c)(3) organization that is within its control. Intent to violate the ownership test, the private business use test or the private security or payment tests is not necessary for an action to be deliberate. A deliberate action occurs on the date the issuer or 501(c)(3) organization enters into a binding contract (that is not subject to any material contingencies) with a nonqualified person for use of the bond-financed property.

Many types of arrangements can result in the modified private business tests under Section 145 being met at issuance or later, including management and service contracts and research agreements.

**Management and Service Contracts.** Contracts for a private entity to manage a bond-financed facility may cause the modified private business tests to be met. For example, a management contract between a 501(c)(3) organization and a for-profit entity under which the for-profit entity receives compensation for services provided with respect to bond-financed property may result in the bonds meeting the modified private business tests. The IRS has provided safe harbors protecting against private use for management and service contracts when the service is provided in connection with bond-financed property. Those safe harbors apply to the modified private business tests. For more information, see [Revenue Procedure 2017-13](#). Contracts that fail the safe harbor do not automatically meet the modified private business tests; all facts and circumstances are considered to determine whether the contract meets the tests.

**Research Agreements.** Research agreements may also cause the modified private business tests under Section 145 to be met. For example, when for-profit entities or the federal government sponsor research at a facility owned by a 501(c)(3) organization that financed the facility with tax-exempt bonds, the research agreements may result in a violation of the modified private business tests. However, the IRS has provided safe harbors that apply to these research agreements. For more information, see [Revenue Procedure 2007-47, 2007-29 I.R.B. 108](#). As with the management contracts, failure to meet the safe harbors does not automatically cause the modified private business tests to be met.

**Remedial Actions for Nonqualified Use.** The regulations provide that an issuer or borrower that engages in a deliberate action causing the ownership requirement to be failed, or the modified private activity bond tests to be met, may, in certain cases, cure that deliberate action using one of the prescribed remedial actions. Treas. Reg. 1.145-2(a) and [Revenue Procedure 2018-26](#) provide that an issuer may take remedial actions to cure a deliberate action that would otherwise cause the 501(c)(3) bonds to lose their tax-exempt status. The remedial actions can include redemption or defeasance of nonqualified bonds, alternative use of disposition proceeds and alternative use of bond-financed property.

**Example:** A 501(c)(3) organization sells a building financed with tax-exempt qualified 501(c)(3) bond proceeds to a for-profit corporation for the fair market value of the building. This change in ownership, and the change in the use of the property from a qualified use to a private business use, is a deliberate action that causes the issue to fail the ownership test and causes the bonds to exceed the limits under the modified private business tests. However, the issuer of the bonds may remediate the deliberate action by redeeming the nonqualified bonds within 90 days of the action.

### **Other Requirements Under Section 145 for Qualified 501(c)(3) Bonds**

IRC Section 145 imposes other requirements on certain qualified 501(c)(3) bonds. These are a volume limit on non-hospital bonds and limits on proceeds used for residential rental housing.

**Volume Limitation on Non-Hospital Bonds.** IRC Section 145(b) limits the amount of qualified 501(c)(3) bonds that may be issued to benefit a 501(c)(3) organization. This rule does not apply to qualified hospital bonds, which is any bond issue for which at least 95% of the proceeds are used for a hospital. This rule also does not apply to bonds issued after August 5, 1997, except those from which less than 95% of the net proceeds will be used to finance capital expenditures.

Generally, if Section 145(b) applies, the aggregate authorized face amount of a qualified 501(c)(3) bond issue allocated to a 501(c)(3) organization, when increased by the amount of outstanding tax-exempt non-hospital bonds allocated to the organization, may not exceed \$150 million.

Certain outstanding qualified 501(c)(3) bonds are not counted in the allocation. The aggregation rules exclude qualified hospital bonds in their entirety, and exclude the portion of other outstanding bonds that financed a hospital. They also exclude any issue not subject to the Tax Reform Act of 1986, if at least 90% of the net proceeds of the issue were used with respect to a hospital. Finally, the rules exclude outstanding bonds that are to be currently refunded by the new issue.

Bonds are allocable to a 501(c)(3) organization under a set of “test period beneficiary” rules that bring in bond issues benefitting certain related entities, and another rule that treats organizations under common management or control as one entity. These rules may result in the Section



145(b) limit being exceeded well after the issue date for a bond issue in the event of a merger or other transaction that brings additional bond issues into the analysis.

**Example:** A 501(c)(3) organization occupied all the educational facilities financed with a prior \$145 million issue of qualified 501(c)(3) bonds during the three-year test period. On the date of issuance of new qualified 501(c)(3) bonds to finance an educational facility for the organization, \$95 million of the prior bonds are still outstanding. If less than 95% of the net proceeds of the new bond issue will be used to finance capital expenditures, the authorized face amount of the new issue would be limited to \$55 million.

**Proceeds Used for Residential Rental Housing for Family Units.** Under IRC Section 145(d), if a 501(c)(3) organization uses proceeds of qualified 501(c)(3) bonds to finance housing units, additional restrictions apply. Generally, under IRC Section 145(d)(2), if any portion of the net proceeds of a qualified 501(c)(3) bond issue are used to finance residential rental housing for family units, that portion must be used to provide one of the following:

- residential rental property for family housing where the first use of the property is pursuant to the bond issue
- qualified residential rental projects satisfying the requirements under IRC Section 142(d), including the minimum occupancy thresholds for low-income tenants
- property that is to be substantially rehabilitated beginning within a two-year period ending one year after the date of the acquisition of the property

For determining whether use is the first use, Section 145(d)(3) provides special rules. First, if the first use of property is pursuant to taxable financing, and there was a reasonable expectation when the taxable financing was provided that it would be replaced with tax-exempt financing, and the taxable financing is replaced within a reasonable period with tax-exempt financing, the first use will be treated as being under the tax-exempt financing. Second, if at the time of the first use there was no operating state or local program for tax-exempt financing of the property, the first use will be treated as under the first tax-exempt financing of the property.

For determining whether a rehabilitation is substantial, Section 145(d)(4) looks to the rules for rehabilitation credits in IRC Section 47 with certain adjustments to that section's definition of "substantially rehabilitated."

### **Election to Apply Other Qualified Private Activity Bond Rules**

IRC Section 145(e) permits an issuer to elect out of applying Section 145 if the bond issue would otherwise qualify as an exempt facility bond or a qualified redevelopment bond to which the volume cap limitations of Section 146 apply.

### **Special Maturity Limitation Rule**

Generally, private activity bonds are subject to limits on the maturity of the bonds. Those rules are described in [Publication 4078, Tax-Exempt Private Activity Bonds](#). A special rule exists for certain qualified 501(c)(3) bonds. IRC Section 147(b)(4) provides that the issuer may elect a special exception to the general maturity limitation rule with respect to pooled financings of 501(c)(3) organizations.

## Refunding of Qualified 501(c)(3) Bonds

Qualified 501(c)(3) bonds may be currently refunded. The Tax Cuts and Jobs Act (2017) repealed the exclusion from gross income for interest on bonds issued to advance refund another bond. The repeal applies to advance refunding bonds issued after December 31, 2017. A bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bonds. For rules describing what is a refunding bond issue, see [Publication 4078, Tax-Exempt Private Activity Bonds](#).

---

## Post-Issuance Compliance Monitoring

This section supplements the information about compliance monitoring procedures for private activity bonds, in [Publication 4078, Tax-Exempt Private Activity Bonds](#). For information on procedures and other options to assist issuers in their tax compliance responsibilities, see [Publication 5005, Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds](#).

**Steps to Better Monitoring of Qualified 501(c)(3) Bonds.** In formulating procedures, issuers and 501(c)(3) organizations may consider:

- designating one or more officials to assist in post-issuance compliance, including completion of Schedule K (Form 990);
- providing training or other technical support to designated officials;
- designating time intervals within which compliance monitoring activities will be completed; and
- timely completing remedial actions (including requests under TEB VCAP) to correct or otherwise resolve identified noncompliance.

The chart below identifies particular areas for compliance monitoring procedures that are relevant to qualified 501(c)(3) bonds. [Publication 4078, Tax-Exempt Private Activity Bonds](#), contains additional information on other compliance monitoring areas that apply to all private activity bonds, including some of the items in this chart.

## Compliance Procedures

| Type of Procedures                                    | Description of Procedures for Post Closing Matters  | Where Responsibility is Discussed in this Publication   |
|---|---|---|
| 501(c)(3) Status                                      | Procedures to ensure exemption  | Tax-Exempt Bonds for 501(c)(3) Charitable Organizations – Qualified 501(c)(3) Organization  |
| Proprietary Use of Proceeds or Bond-Financed Property | Procedures to timely identify and remediate deliberate actions  | Tax-Exempt Bonds for 501(c)(3) Charitable Organizations – Application of the Ownership Test and the Modified Private Business Tests   |
| \$150 Million Limit                                   | Procedures during mergers and acquisitions to ensure that a limit is not exceeded   | Tax-Exempt Bonds for 501(c)(3) Charitable Organizations – Other Requirements Under Section 145 for Qualified 501(c)(3) Bonds – Volume Limitation on Non-Hospital Bonds  |
| Schedule K (Form 990)                                 | Procedures for the timely completion and filing of Form 990, including Schedule K   | Tax-Exempt Bonds for 501(c)(3) Charitable Organizations – Qualified 501(c)(3) Organization – Special Filing Requirements to Retain 501(c)(3) Status; Schedule K (Form 990)  |
| Reissuance  | Procedures to satisfy tax requirements when a modification in terms results in a reissuance for federal income tax purposes | <a href="#">Publication 4078, Tax-Exempt Private Activity Bonds</a> : Tax-Exempt Private Activity Bonds – What Happens When the Terms of a Private Activity Bond are Modified?  |
| Arbitrage Compliance                                  | Procedures for the timely computation and payment of arbitrage rebate and yield reduction payments                          | <a href="#">Publication 4078, Tax-Exempt Private Activity Bonds</a> : Tax-Exempt Private Activity Bonds – Requirements That Apply at Issuance and Throughout the Life of the Bonds – Proceeds are Subject to Investment Restrictions: the Arbitrage Yield Restriction and Arbitrage Rebate Requirements |
| Record Retention                                      | Procedures for the maintenance of records   | <a href="#">Publication 4078, Tax-Exempt Private Activity Bonds</a> : Tax-Exempt Private Activity Bonds – Issuers Must Retain Records to Show that Requirements are Satisfied   |
| IRS Contacts  | Procedures concerning contacts from the IRS   | <a href="#">Publication 4078, Tax-Exempt Private Activity Bonds</a> : Post-Issuance Compliance Monitoring – Steps to Better Monitoring  |

See [Post-Issuance Compliance](#) for more information.

---

## **What To Do When You Discover a Violation – TEB Voluntary Closing Agreement Program**

IRS is committed to resolving federal tax violations with the issuer. The TEB Voluntary Closing Agreement Program provides remedies for issuers of tax-exempt bonds, tax credit bonds and direct pay bonds that voluntarily come forward to resolve a violation that cannot be corrected under self-correction programs described in the Regulations or other published guidance.

[Publication 4078, Tax-Exempt Private Activity Bonds](#) describes TEB VCAP in more detail.

---

## **More Information**

You can find information about the tax laws that apply to municipal finance arrangements, including tax forms and instructions, revenue procedures and notices, and TEB publications at [IRS.gov/bonds](https://www.irs.gov/bonds).

If you have account specific questions, call 877-829-5500.