AN EXAMINATION OF 63-20 FINANCING

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ABSTRACT

The IRS revenue ruling 63-20 of 1963 allows governments to create a nonprofit entity to issue tax-exempt bonds to finance tangible public assets. Little to no literature exists on this subject; therefore, this paper explores the definition and structure of this financing tool. In addition, we present examples of current projects using this financing model and their advantages and disadvantages.

1. INTRODUCTION

Governments of all shapes and sizes rely on a variety of mechanisms to finance large capital projects for the public good. And governments traditionally rely on general obligation bonds and revenue bonds to fund these capital projects. As economic crises become more consistent and intense, governments look for new innovative ways to finance public assets without sacrificing the taxes use to cover general fund goods and services. As a result, governments have turned to long-term leases—vendor leases and municipal lease finance securities—where governments lease capital assets. However, under municipal lease finance securities, the government, rather than vendor, floats the debt directly (certificates of
participation) or creates a conduit—a nonprofit corporation—to float the debt (63-20 financing). In both instances, the government leases back the project for the duration of the debt.

Although less known and popular as certificates of participations (COPs), 63-20 financing is becoming a comparable alternative to COPs as governments reach legal debt limits. For example, in 63-20 financing structure has been used to build hospitals, toll roads and bridges, university buildings, city halls, water and sewage facilities, and even hotels and convention centers.

This paper examines what 63-20 financing is and is not by explaining the IRS Revenue Rule (63-20) and Revenue Procedure (82-26), exploring its structure and usage, and evaluating its advantages and disadvantages. However, we begin by providing a short history of tax-exempt financing and the recent emergence of an old financing tool.

2. AN ABBREVIATED HISTORY OF TAX-EXEMPT BONDS

Traditionally, public entities own and operate buildings (like schools, roads, bridges, town halls, libraries, and water and sewage facilities) that are financed through tax-exempt bonds. 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.\(^1\) 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 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.\(^2\)

Beyond the increasing reliance on revenue bonds, governments began establishing statutory authorities, those without the authority to tax but with an authority to float debt, to accomplish purposes beyond the normal purview of general governmental activity. For example, such authorities were created “to circumvent debt or expenditure limitations that restrict general units of government [and] in other instances, the statutory authority would serve as a conduit for financing nongovernmental activities in the tax-exempt market,”\(^3\) such as industrial pollution control, residential home mortgages, nonprofit hospitals, and industrial or commercial enterprises. According to Petersen, “by the mid-eighties, statutory authorities, accounted for over one-half of all long-term tax-exempt borrowing”\(^4\) and “over 50 percent of new long-term issues were used for nontraditional purposes. After the passage of the Tax Reform Act of 1986, this growth of the nontraditional debt was greatly curtailed”\(^5\) although the usage of nonprofit corporations continued to grow.

As a result, governments parted ways with conventional debt instruments in favor of municipal lease finance securities (certificates of participation and 63-20 financing) and vendor leases. Both result in the government leasing a project but the differences appear with the lessor. In the case of a municipal lease finance security, the lessor is typically a nonprofit corporation (in some instances it is a private vendor or another public entity)\(^6\) but in a vendor lease, the lessor is a private company or entity.

Although the 63-20 financing tool appears to gaining more attention, this structure has been around since 1963 when the Internal Revenue Service issued Revenue Ruling 63-20.
Traditionally, governments have financed courthouses, schools, and other government projects via nonprofit corporations, today, governments are using 63-20 financing as a way to partner with the private sector to build hospitals, roads, bridges, and even hotels and convention centers. The next section defines a 63-20 corporation; its structure and process, and provides examples of recent projects using this tool.

3. THE 63-20 FINANCING TOOL

Every year the Internal Revenue Service publishes revenue rulings and revenue procedures. Revenue rulings (Rev. Rul.) provide official IRS interpretations of the Internal Revenue Code, related statutes, tax treaties and regulations. It is the conclusion of the IRS on how the law is applied to a specific set of facts. Revenue procedures (Rev. Proc.) are official IRS statements about procedural and administration matters of the tax laws.7 In January 1963, the IRS issued Rev. Rul. 63-20 (see Appendix I for the full text of the ruling), which interprets section 103—interest on certain governmental obligations—of the revenue code. The result is an alternative form of financing for governments through the creation of a private, nonprofit corporation. The definition, structure, and examples of 63-20 corporations follow.

3.1 Definition

A 63-20 corporation is a private, nonprofit corporation created under a state’s nonprofit law8 that has the right to float debt on behalf of the government agency “for the purpose of stimulating industrial development 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.”9

In 1982, the IRS issued Revenue Procedure 82-26 to establish additional clarifications for each of the five requirements (see Appendix II for the full text of the procedure). This procedure is only a guide to assist issuers and other stakeholders; it does not determine what qualifies as “on behalf of” nor the taxability of bond interest but it helps define public in nature:

- “The governmental unit must have exclusive beneficial possession and use of at least 95 percent of the fair market value of the facilities; or
- 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

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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.”

Overall, the ruling allows for the creation of a nonprofit entity, separate from the jurisdiction of the government, which has the ability to issue tax-exempt bonds for the financing of tangible assets, which “are essentially public in nature,” within the governmental jurisdiction.

3.2 Structure

How does a 63-20 corporation work? Implementation begins with the creation of a nonprofit entity by the governmental authority where the asset will be located. “The nonprofit, which conforms to the state’s nonprofit laws, does not require special legislation or referendum and may be formed for any purpose other than profit. In addition, the entity creating the nonprofit has control over the nonprofit’s purposes and powers.”

The nonprofit is then allowed to issue tax-free bonds for the purpose of financing projects for a public interest. A third party is normally involved at this stage for design, building, maintenance, and securing financing and underwriting.

The nonprofit owns the assets for which it is issuing the bonds. In most of these bond issuances the government will “lease” the asset from the nonprofit, where the lease payment is equal to the principle plus interest. Resources for the lease payment are generally raised through asset based income, such as tolls for highways or operating income from privately used establishments. However, in some instances the bond payment is made only through the government’s lease of the asset without income generated by the project itself (such as the construction of a municipal building).

Once the debt matures, generally at the end of the lease, the title of the asset is transferred to the jurisdictional government. The public entity either sells this to the original contractor or other third party (as in the case of many toll roads, private-use buildings), or it permanently retains ownership (as with municipal buildings). In addition, the nonprofit organization is dissolved. Figure 1 depicts this structure.
3.3 Examples

Historically, nonprofit corporations act as conduits for public agencies to finance hospitals, schools, city halls, and court houses. Alternatively, private companies finance structures through the issuance of private activity bonds. These bonds are less attractive to investors because they have higher interest rates and are not tax exempt. As governments become more cash strapped and lack resources (e.g., they have reached their legal debt limit) to fund public capital assets, they need to find innovative ways to build and maintain these structures. One way to fill this need is through the use of a 63-20 corporation. When partnering with the public sector, the private company takes advantage of the lower interest rate, tax-exempt bonds and the public sector takes advantage of the financial resources its lacks. In recent years, such partnerships have been responsible for financing and constructing buildings and transportation projects. Table 1 lists these projects.
### Table 1

**List of Selected 63-20 Corporations, Their Projects, and Costs**

<table>
<thead>
<tr>
<th>63-20 Corporation</th>
<th>Structure</th>
<th>Cost</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tumwater Office Properties</td>
<td>State Building</td>
<td>$58.8 million</td>
<td>Washington</td>
</tr>
<tr>
<td>Highlands Community Facilities Association</td>
<td>Sewer facility</td>
<td>$4.45 million</td>
<td>Washington</td>
</tr>
<tr>
<td>Redmond Community Properties</td>
<td>City Hall</td>
<td>$39.3 million</td>
<td>Washington</td>
</tr>
<tr>
<td>Broadway Office Properties</td>
<td>Office building &amp; parking garage</td>
<td>$63.5 million</td>
<td>Washington</td>
</tr>
<tr>
<td>Goat Hill Properties</td>
<td>Office building &amp; parking garage</td>
<td>$101.0 million</td>
<td>Washington</td>
</tr>
<tr>
<td>Radford Court Properties</td>
<td>Student housing</td>
<td>$53.1 million</td>
<td>University of Washington</td>
</tr>
<tr>
<td>University of Washington Alumni Association</td>
<td>Refunding of bonds</td>
<td>$19.9 million</td>
<td>University of Washington</td>
</tr>
<tr>
<td>25th Avenue Properties</td>
<td>Student Housing</td>
<td>$34.1 million</td>
<td>University of Washington</td>
</tr>
<tr>
<td>Pocahontas Parkway Association</td>
<td>Transportation</td>
<td>$354 million</td>
<td>Virginia</td>
</tr>
<tr>
<td>Route 3 North Transportation Improvements Association</td>
<td>Transportation</td>
<td>$394.5 million</td>
<td>Massachusetts</td>
</tr>
<tr>
<td>Las Vegas Monorail Company</td>
<td>Transportation</td>
<td>$650 million</td>
<td>Nevada</td>
</tr>
<tr>
<td>Overland Park Development Corporation</td>
<td>Hotel &amp; Convention Center</td>
<td>$88 million</td>
<td>Kansas</td>
</tr>
</tbody>
</table>

#### 3.3.1 “Public in Nature” Buildings

The first rule for creating a 63-20 corporation says the project must be “essentially public in nature.” Buildings that benefit the public at large probably fit this definition. For example, the state of Washington has created eight 63-20 corporations on behalf of five public entities. These projects range from student housing at the University of Washington, to a city hall building in Redmond. All told, these eight nonprofit corporations have financed over $375 million for projects that are “essentially public in nature.”

However, could we argue that parking garages, hotels, and convention centers are these essentially public in nature? In 2008, the Mayor of Spokane, Washington sued to stop the construction of a parking garage for a shopping mall that was financed through a 63-20 corporation.12 And according to Donald Korb, who is the Chief Counsel for the Internal Revenue Service, the federal government believes 63-20 corporations have not been established to finance hotels.

We have checked rulings issued recently and believe that there is no instance where we in the Office of Chief Counsel have ruled favorably that tax-exempt bonds can be issued by a 63-20 corporation for the funding of a hotel. Having said that, we can make no representation regarding the existence or scope of any such transactions that may have been consummated without rulings from us.13
Yet, groups like HVS and the Strategic Advisory Group, LLC, argue 63-20 can be used to finance hotel. For example, the Strategic Advisory Group contends in a 2001 presentation, that 63-20 financing “provides for the issuance of tax-exempt debt for private entity when the private purpose meets IRS regulations.”

They argue since access to conventional capital markets is limited; the best alternative is to partner with cities, where residual benefits flow to the city after the payment of the debt. The group highlights Overland Park (Kansas) Sheraton, which is owned by a nonprofit corporation, Overland Park Development Corporation.

### 3.3.2 Transportation

Some argue that the public sector is increasingly unable to meet its infrastructure needs alone and must enter into public-private partnerships to fund transportation. The Pocahontas Parkway in Virginia, Massachusetts’ Route 3, and the Las Vegas Monorail are three examples where 63-20 corporations were established to create partnerships and finance major transportation projects across the United States. Each is discussed in turn.

After 18 months of negotiations and creation of a 63-20 corporation—the Pocahontas Parkway Association (PPA)—construction began on the $354 million, 8.8-mile tolled Pocahontas Parkway. “Under the terms of the agreements, Transurban, a private Australian toll road operator, acquired the sole rights to enhance, manage, operate, maintain and collect tolls on the Parkway for 99 years. In addition, Transurban has defeased all of PPA’s underlying debt.” The project is paid for by the tolls it generates.

In 1999, the state of Massachusetts created a 63-20 corporation, the Route 3 North Transportation Improvements Association. This nonprofit was responsible for financing an existing 21-mile, $394.5 million highway project and the state of Massachusetts pledged to lease the highway for the cost of the debt service, operations, and maintenance. Lease payments are made through annual appropriations by the state legislature.

A 63-20 corporation, the Las Vegas Monorail Company, was used to finance an upgrade and extension of Las Vegas Monorail. In fact, the state of Nevada created the nonprofit corporation “for the sole purpose of acquiring the existing monorail project from MGM Grand-Bally’s Monorail LLC and then develop, operate, and maintain the new expanded project.” In this example, a public entity issued the debt but passes the proceeds to the nonprofit. “LVMC maintains a collection fund from which it will pay operations and maintenance costs. LVMC transfers net project revenues on a monthly basis to a trustee for loan payments that mirror debt service payments on the Departments bonds and for the maintenance of debt service reserves. LVMC also maintains a separate capital replacement funds. Although LVMC has executed a management contract which includes operations and maintenance agreement, fairbox, advertising, and other project revenues remain the property of LVMC.”

### 6. ADVANTAGES AND DISADVANTAGES

Why would a public agency want to create a conduit to issue debt to build public projects? The overarching reason is political expediency. Although these bonds are tax-exempt, the debt is not subject to the legal debt limits of the public agency nor is it measured as a long-term liability. Rather, because the public agency leases the project from the nonprofit corporation, the lease payments are calculated under current liabilities.
In addition, the debt does not have to be approved by referendum or state legislature. This is particularly attractive to public entities “that have federal or court-mandated capital investment requirements or where voters are reluctant to approve a new bond issue.” Moreover, the completion of projects relying on 63-20 is expedited at a faster rate than those projects using conventional financing. In fact, the Office of Financial Management for the state of Washington argues in their report, Best Management Practices for Capital Projects, that 63-20 is best “for projects when flexibility is desired in choosing a project delivery method, and when projects must be constructed quickly.”

Another perceived benefit is the reduction in costs and risks. That is, overall costs for those projects financed with 63-20 appear to be lower than they would have been had they been financed with traditional debt mechanisms. In the state of Washington, the use of 63-20 allows public works laws to be by-passed because nonprofits are not subject to these laws. In addition, more risk—construction, operating, building maintenance, and default—is shifted from the public entity to the private nonprofit corporation and bondholders.

Finally, 63-20 financing allows public entities to enter into partnerships with the private sector allowing the public entity to save money as private resources—capital and personnel—are used to finance and manage the project. For example, the University of Washington lacked the resources to build student housing so they partnered with a private company via 62-30 financing to build the project. The private corporation built and managed the housing, lowering the costs and financial risks to the university.

In the end, these benefits are perceived; no empirical evidence exists to substantiate these claims of benefits. However, data do suggest that 63-20 financing is more expensive. For example, legal fees are increased because more man-hours are necessary to tailor the 63-20 financing documents, which lead to higher issuance costs. For example, the Washington State Treasurer’s Office estimates issuance costs ranged from $19.38 to $52.34 per bond whereas traditional methods such as general obligation bonds cost $7.33 and certificates of participation cost $13.65 per bond.

Of course many of these advantages are costly disadvantages. For example, because the debt is not accounted for in long-term liabilities, although eventually—at the end of the lease—the government assumes the project, the government and this financing structure lack accountability.

In addition, unlike general obligation bonds, these tax-exempt bonds are riskier because they are not backed by the full faith and credit of the government. In fact, “the government nor the private developer have direct control over the project and will not bear final responsibility.”

The interest rates are higher because the bond sale is a result of a negotiated sale rather than a competitive bid. This in turn results in higher costs—for the project, for lease payments, and citizen-consumer overall. Moreover, the citizens, who are the ones who pay for the debt via higher taxes, fees, and charges, have no say, unlike general obligations that are approved by referendum. Table 2 provides a summary of the advantages and disadvantages of 63-20 financing.
### Table 2

*Selected Debt Principals As They Relate to 63-20 Financing Structures*

<table>
<thead>
<tr>
<th>Principals</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subject to debt limit</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Referendum</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Control</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Transparency</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Accountability</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Tax-exempt</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Government full faith and credit</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Competitive bid</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Higher Fees and costs</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

### 7. DISCUSSION

The 63-20 financing structure is unique in its operation from traditional financing in numerous ways; however, several of these factors are a cause for some debate as to whether such financing is appropriate.

First, 63-20 financing frees governments of their debt limits, after all it is the non-profit issuing the bonds and taking on the liability and risk of making the payments. Although most governments report this activity in annual financial reports, it is not required. Essentially it allows governments to undertake projects without adhering to debt limitations or other traditional public overview. In addition, governmental jurisdictions may feel obligated, certainly depending on the input of those purchasing bonds, to offer some collateral on the asset as the sponsoring jurisdiction. This could be the case with building a private-use facility, such as a hotel, where the unpredictable market plays a significant role in its success. This would mean that although governments are not affecting their debt limitations and shielding themselves from nearly all risk, it does not mean there is no risk involved.

Second, because the non-profit is issuing the bonds, laws regulating bid requirements, fair-wage standards, and other public works laws may be subverted. This, depending on one’s view, gives more power to the government in structuring bids and may reduce total project completion times and costs. This point is argued by both sides as either a public benefit or subversion of laws regulating interest government activities.

Third, the ownership of the asset is in the hands of a separate entity (the non-profit), and although governments typically require a certain number of the board of directors to be affiliated with the government jurisdiction, ultimate control still rests in the hands of the non-profit organization. This also means project transparency and accountability are not regulated by typical government standards, but that of the private sector. For example, Karen Heldung, an attorney with expertise in 63-20 financing, finds the 63-20 form “troubling because of its artfully contrived lack of responsibility.” She argued:

The responsible government agency must first recognize that although the 63-20 corporation is issuing debt on its “behalf” the non-profit entity may not be under its direct control. Once the government unit approves the corporation and its debt it generally has
no formal role in determining how the corporation carries out the project. Indeed it may not even have the power to remove and reappoint board members. And its inability to replace board members means that this entity is not really politically responsible. Furthermore and perhaps even more troubling, it lacks any independent financial commitment to the project since it is a nonprofit corporation and cannot earn an equity return on any investment. What it constitutes is a group of [hopefully] public-spirited citizens with a sincere interest in the success of the project, but not directly answerable to any elected official, and with no financial stake of their own in the project. How then can this entity be relied upon to act in the long term interest of the private parties, including the developer/sponsor, contractors and bondholders) as well as the government unit?23

Fourth, there is little empirical evidence to support that the benefits outweigh the risks and where evidence does exist, it is often anecdotal and hyperbole. That is, governments do not always properly analyze the relationship between cost of the improvement and the benefit to the public.

Overall, what we do know is that public servants, officers, financiers, and so forth advocate for improved equity, effectiveness, efficiency, accountability, transparency, and public involvement (i.e., citizen participation) particularly in the area of finance and budget yet these same public officials create “innovative” strategies to circumvent legal debt limits and citizen participation and violate financial management principles.
Appendix I Revenue Ruling 63-20

Rev. Rul. 63-20; 1963-1 C.B. 24, January 1963
[*1]

SUBJECT MATTER: SECTION 103.-INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS

APPLICABLE SECTIONS: 26 CRF 1.103-1: Interest upon obligations of a State, Territory, etc. (Also Section 61; 1.61-7.)

TEXT:

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 [*2] 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.


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 [*3] 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 2x 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 [*4] 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 [*5] 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 [*6] 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. [*7] 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 [*8] 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.
Appendix II Revenue Procedure 82-36

Rev. Proc. 82-26; 1982-1 C.B. 476; January 1982

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth the circumstances under which the Service will ordinarily issue an advance ruling that obligations issued by a corporation organized under the general nonprofit corporation law of a state ("nonprofit corporation" or "corporation") will be considered obligations of a state or a political subdivision of a state under section 103 (a) (1) of the Internal Revenue Code.

SEC. 2. BACKGROUND

Section 103 of the Code provides that, subject to the exceptions set forth in sections 103 (b), 103 (c), 103 (f) and 103A, interest on the obligations of a state, a territory, or a possession of the United States, or any of their political subdivisions, or of the District of Columbia ("governmental units") are not includible in gross income. Section 1.103-1 (b) of the Income Tax Regulations provides that obligations issued on behalf of any governmental unit by constituted authorities empowered to issue such obligations are the obligations of the unit.

The Service has issued three revenue rulings that hold that obligations issued by a nonprofit corporation [*2] will be considered obligations of a governmental unit under section 1.103-1 (b) of the regulations if certain conditions are met.

Rev. Rul. 54-296, 1954-2 C.B. 59, holds that notes issued by a nonprofit corporation organized by a group of public-spirited citizens to make improvements to a city-owned building are considered obligations of the city if (1) the city owns all of the stock in the corporation, (2) the city will become absolute owner of the improvements upon retirement of the notes by the corporation at or prior to maturity or upon assumption or discharge of the notes by the city, whichever occurs first, and (3) all of the income earned from the rental of the building inures to the city.

Rev. Rul. 59-41, 1959-1 C.B. 13, holds that obligations issued by a nonprofit corporation organized at the request of a city to finance the acquisition of a system for the supply and distribution of water in and near the city are the obligations of the city if (1) none of the net earnings or assets of the corporation inures to any private person, (2) the city has the right to purchase the system at any time for the outstanding indebtedness of the corporation plus interest, (3) the city will [*3] receive, without demand or further action, fee ownership and immediate exclusive possession of the system when the corporation's debt is paid, (4) the city has stated its intention to take title at that time, and (5) the city has approved the issuance of the obligations and has the right to make recommendations to the corporation regarding operation of the system.

Rev. Rul. 63-20, 1963-1 C.B. 24, holds that obligations of a nonprofit corporation will be considered issued on behalf of a governmental unit if (1) the corporation engages in activities that are essentially public in nature, (2) the corporation is not organized for profit, except to the extent of retiring indebtedness, (3) the corporate income does not inure to any private person, (4) the governmental unit has a beneficial interest in the corporation while the indebtedness is outstanding, and it obtains full legal title to the property of the corporation with respect to which the indebtedness was incurred upon retirement of the indebtedness, and (5) the corporation and the specific obligations to be issued by the corporation have been approved by the governmental unit on whose behalf the obligations are issued.

The requirements [*4] enumerated in Rev. Rul. 63-20 apply to obligations issued by the nonprofit corporations described in Rev. Ruls. 54-296 and 59-41. Under this revenue procedure, the Service will ordinarily issue an advance ruling that obligations issued by a nonprofit corporation meet the requirements in Rev. Rul. 63-20, if the operating rules of sections 3 and 4 below are met.

Historically, the Service has required that certain conditions be met before it issued an advance ruling that obligations issued by a nonprofit corporation met the requirements of Rev. Rul. 63-20. This revenue procedure is intended only to state in one document the conditions that the Service has required to be met in prior years before such an advance ruling was issued. This revenue procedure is not intended to change or add to the conditions that the Service required to be met before it would issue such an advance ruling.

This revenue procedure is not intended to address the question of whether an entity is a political subdivision of a state within the meaning of section 103 of the Code. Further, this revenue procedure is not intended to address the...
issue of whether obligations issued by a corporation that is organized either [*5] under a special state statute or a statute providing that only governmental units may organize the corporation meet the requirements of Rev. Rul. 57-187, 1957-1 C.B. 65, or Rev. Rul. 60-248, 1960-2 C.B. 35. In addition, this revenue procedure is not intended to address the issue of whether trusts created under state laws to further certain public functions meet the requirements of Rev. Rul. 57-151, 1957-1 C.B. 64. Moreover, this revenue procedure does not apply to issues of qualified scholarship funding bonds defined in section 103 (e), which are exempt from federal income tax under section 103 (a) (2).

The operating rules of this revenue procedure are intended only to assist issuers of governmental obligations, and other parties with a material financial interest, in preparing ruling requests. The operating rules do not define, as a matter of law, the circumstances under which obligations to be issued by a nonprofit corporation will be considered issued on behalf of a governmental unit within the meaning of section 1.103-1 (b) of the regulations. Thus, the operating rules are not to be used as tests for determining the taxability of bond interest.


**SEC. 3. GENERAL OPERATING RULES**

The Service will ordinarily rule that obligations issued by a nonprofit corporation are issued on behalf of a governmental unit within the meaning of section 1.103-1 (b) of the regulations if the following requirements are met:

.01 The nonprofit corporation must engage in activities that are essentially public in nature. This requirement will be met if:

1. The activities and purposes of the corporation are those permitted under the general nonprofit corporation law of the state; and

2. The property to be provided [*7] by the corporation's obligations is located within the geographical boundaries of or has a substantial connection with the governmental unit on whose behalf the obligations are issued.

.02 The corporation must not be organized for profit except to the extent of retiring indebtedness. This requirement will be met if:

1. The corporation is organized under the general nonprofit corporation law of the state in which is located the governmental unit on whose behalf the corporation will issue its obligations; and

2. The articles of incorporation of the corporation provide that the corporation is one that is not organized for profit.

.03 The corporate income may not inure to any private person. This requirement will be met if the articles of incorporation provide that the corporate income will not inure to any private person, and in fact, the corporate income does not inure to any private person.

.04 The governmental unit must have a beneficial interest in the corporation while the indebtedness remains outstanding. This requirement will be met if:

1 (a) The governmental unit has exclusive beneficial possession and use of a portion of the property financed by the obligations and additions to that property [*8] equivalent to 95 percent or more of its fair rental value for the life of the obligations.
(including any other obligations, such as those described in section 3.055 of this revenue procedure, issued by the nonprofit corporation either to make improvements to the property or to refund a prior issue of the corporation's obligations). For purposes of determining whether an obligation is an industrial development bond under section 103 (b) of the Code, a nonprofit corporation in the circumstances described in this subparagraph will be considered an exempt person within the meaning of section 103 (b) (3) even if the corporation is not an organization described in section 501 (c) (3) that is exempt from federal taxation under section 501 (a). Use by an instrumentality of a governmental unit will be considered use by the unit if the instrumentality is an instrumentality of only the governmental unit on whose behalf the obligations are issued and the requirements of Rev. Rul. 57-128, 1957-1 C.B. 311, are otherwise met; or

(b) (1) The nonprofit corporation has exclusive beneficial possession and use of a portion of the property financed by the obligations, and any additions to that property, [*9] equivalent to 95 percent or more of its fair rental value for the life of the obligations; and (2) The governmental unit on whose behalf the nonprofit corporation is issuing the obligations (A) appoints or approves the appointment of at least 80 percent of the members of the governing board of the corporation, and (B) has the power to remove, for cause, either directly or through judicial proceedings, any member of the governing board and appoint a successor. If the articles of incorporation of the nonprofit corporation provide that ex-officio representatives of the governmental unit constitute all or a part of the membership of the governing board of the corporation, then the requirements of (A) and (B) shall not apply to the ex-officio members; or

(c) The governmental unit has the right at any time to obtain unencumbered fee title and exclusive possession of the property financed by the obligations, and any additions to that property, by (1) placing into escrow an amount that will be sufficient to defease the obligations, and (2) paying reasonable costs incident to the defeasance. However, the governmental unit, at any time before it defeases the obligations, may not agree or otherwise [*10] be obligated to convey any interest in the property to any person (including the United States of America or its agencies or instrumentalities) for any period extending beyond or beginning after the unit defeases the obligations. In addition, generally the unit may not agree or otherwise be obligated to convey a fee interest in the property to any person who was a user of the property, or a related person under section 103 (b) (6) (C) of the Code, before the defeasance within 90 days after the unit defeases the obligations. If the governmental unit exercises its right under this subparagraph, the corporation must immediately cancel all encumbrances on the property, including leases and management contracts. Any lease, management contract, or other similar encumbrance on the property will be considered immediately cancelled if the lessee, management company, or other user vacates the property within a reasonable time, generally not to exceed 90 days, after the date the governmental unit exercises its right under this subparagraph. Encumbrances that do not significantly interfere with the enjoyment of the property, such as most easements granted to utility companies, are not considered [*11] encumbrances for purposes of this subparagraph; and

2 In the event the nonprofit corporation defaults in its payments under the obligations, the governmental unit has an exclusive option to purchase the property financed by the obligations and additions to that property for the amount of the outstanding indebtedness and accrued interest to the date of default. The governmental unit shall have (a) not less than 90 days from the date it is notified by the nonprofit corporation of the default in which to exercise the option, and (b) not less than 90 days from the date it exercises the option to purchase the property. This requirement does not apply if the governmental unit has the use of the property described in paragraph 1 (a) above.
The governmental unit must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon retirement of the indebtedness. This requirement will be met if:

1. The obligations of the nonprofit corporation are issued on behalf of no more than one governmental unit and unencumbered fee title to the property will vest solely in that governmental unit when the obligations are discharged. For purposes of this revenue procedure obligations are discharged when (a) cash is available at the place of payment on the date that the obligations are due (whether at maturity or upon prior call for redemption) and (b) interest ceases to accrue on the obligations; and

2. All of the original proceeds and investment proceeds of the obligations are used to provide tangible real or tangible personal property. Proceeds are considered to provide tangible property only if the proceeds are (a) used to finance costs that a taxpayer must charge to the property's capital account, may elect to charge to the property's capital account instead of deducting, or may elect to deduct instead and (b) used to fund a reasonably required reserve fund within the meaning of section 103(c)(4) of the Code. The previous sentence does not apply to a de minimis amount, less than $5,000, that is included in the bond issue solely for the purpose of rounding the dollar amount of the issue. If excess proceeds remain on hand after the acquisition or completion of construction or reconstruction of the property, the requirements of this subsection will be considered met if (a) the face amount of the obligations (taking into account estimated investment proceeds) was based on reasonable estimates of the cost of the property at the time the obligations were issued, and (b) the excess proceeds are used and invested in the manner described in sections 3.04, 3.05, and 3.06 of Rev. Proc. 79-5, 1979-1 C.B. 485, as amplified by Rev. Proc. 81-22, 1981-1 C.B. 692. Amounts used to provide a borrower with working capital are not used to provide tangible property. For example, if the proceeds of obligations issued by a nonprofit corporation are used to acquire property from a charitable organization and the corporation subsequently leases the property back to the charitable organization, the proceeds are not used to provide tangible property. Similarly, if the proceeds of obligations issued by a nonprofit corporation are used to acquire a portfolio of outstanding mortgages on tangible property, the proceeds are not used to provide tangible property. For purposes of this revenue procedure, original proceeds are amounts (after payment of all expenses of issuing the obligations) received at any time as a result of the sale of an issue of obligations. For purposes of this revenue procedure investment proceeds are amounts (net of administrative costs) that result from the investment of any proceeds of an issue of obligations. However, for purposes of this subsection investment proceeds do not include amounts earned after the date that (1) the construction, reconstruction, or acquisition of the property is completed, or (2) all of the proceeds (less amounts used to fund a reasonably required reserve fund) have been spent on the construction, reconstruction, or acquisition of the property, whichever occurs later (for rules concerning refunding issues see section 4.01 of this revenue procedure); and

3. Before the obligations are issued, the governmental unit adopts a resolution stating that it will
accept title to the property financed by the obligations, including any additions to that property, when the obligations are discharged; and

5 The indenture or other documents under which the obligations used to originally provide the property provide that any other obligations issued by the nonprofit corporation either to make improvements to the property or to refund a prior issue of the nonprofit corporation's obligations will be discharged no later than the latest maturity date of the original obligations, regardless of whether the original obligations are callable at an earlier [*16] date. In addition, the maturity date of the original obligations or any other obligations issued by the nonprofit corporation with respect to the property may not be extended beyond the latest maturity date of the original obligations, regardless of whether the original obligations are callable at an earlier date. If the governmental unit has the beneficial interest described in section 3.041 (a) of this revenue procedure, the obligations need not meet the requirements of this paragraph (for additional rules concerning refunding issues, see section 4.01 of this revenue procedure); and

6 The proceeds of fire or other casualty insurance policies received in connection with damage to or destruction of the property financed by the obligations, including any additions to the property, will, subject to the claims of the holders of the obligations, (a) be used to reconstruct the property, regardless of whether the insurance proceeds are sufficient to pay for the reconstruction, or (b) be remitted to the governmental unit; and

7 (a) A reasonable estimate of the fair market value of the property on the latest maturity date of the obligations, regardless of whether the obligations are callable [*17] at an earlier date, is equal to at least 20 percent of the original cost of the property financed by the obligations. The estimated fair market value of property shall be determined without including in the value any addition to the property or any increase or decrease for inflation or deflation during the term of the obligations; and (b) A reasonable estimate of the remaining useful life of the property on the latest maturity date of the obligations, regardless of whether the obligations are callable at an earlier date, is the longer of one year or 20 percent of the originally estimated useful life of the property financed by the obligations. If the property financed by the obligations does not itself meet the requirements of (a) and (b) of this paragraph, these requirements will be considered met if the nonprofit corporation is required to replace the property and the replacement property meets the requirements of (a) and (b) of this paragraph. If the governmental unit has the beneficial interest described in section 3.041 (a) of this revenue procedure, the obligations need not meet the requirements of this paragraph.

.06 The governmental unit must approve both the nonprofit corporation [*18] and the specific obligations to be issued by the corporation. This requirement will be met if, within one year prior to the issuance of the obligations, the governmental unit adopts a resolution approving the purposes and activities of the corporation and the specific obligations to be issued by the corporation. If the corporation intends to issue obligations for a single project through a series of obligations to be issued over a period not to exceed five years, the governmental unit may meet the requirements of this subsection by adopting a single resolution, approving the purposes and activities of the corporation and all obligations to be issued in the series, within one year prior to the issuance of the first issue in the series.

SEC. 4. OPERATING RULES FOR REFUNDING ISSUES

.01 The Service will ordinarily issue an advance ruling that refunding obligations issued by a nonprofit corporation are issued on behalf of a governmental unit if:

1 All of the original and investment proceeds of the refunding issue are used (a) to pay principal, qualified interest, and any premium, on another issue ("the prior issue") of obligations issued on behalf of the governmental unit, and (b) to fund a [*19] reasonably required reserve fund for the refunding issue within the meaning of section 103 (c) (4) of the Code. For purposes of this
subsection, investment proceeds do not include amounts earned after the last obligation of the prior issue is discharged. Qualified interest means unpaid interest on the prior issue reduced by the amount of original proceeds and investment proceeds of the prior issue allocated to pay interest on the prior issue but unexpended therefor. However, unpaid interest on a prior issue shall not be treated as qualified interest if interest on the prior issue is payable less frequently than is reasonable and customary for issues of its type; and

2 The obligations are not advance refunding obligations. For purposes of this subsection advance refunding obligations are refunding obligations that are issued more than 180 days before the date on which the prior obligations are discharged. However, the Service will ordinarily issue an advance ruling that advance refunding obligations issued by a nonprofit corporation are issued on behalf of a governmental unit if the obligations used to provide the tangible property meet the beneficial interest requirement of section 3.04 (*20) of this revenue procedure because the governmental unit has the interest described in section 3.041 (a); and

3 The refunding obligations will be discharged no later than the latest maturity date of the obligations that were issued by the nonprofit corporation to originally provide the property, regardless of whether the original obligations are callable at an earlier date. If the governmental unit has the beneficial interest described in section 3.041 (a) of this revenue procedure, the obligations need not meet the requirements of this paragraph.

4 The requirements set forth in section 3 of this revenue procedure are met, except that section 4.011 instead of section 3.052 shall apply to refunding issues.

SEC. 5. INQUIRIES

Inquiries about this revenue procedure should refer to its number and should be addressed to the Associate Chief Counsel (Technical), Attention: CC:IND:I, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224.
ENDNOTES


7 From http://www.taxalmanac.org/index.php/Revenue_Rulings

8 According to IRS on page B-16 of Module B: Introduction to federal taxation of municipal bonds, The corporation is not a public corporation or a corporate governmental agency organized under such a special state statute; it is a private corporation organized under the general nonprofit laws of the state.


11 Hedlund, K.J. The use of 63-20 nonprofit corporations in infrastructure facility development. Available at www.nossaman.com


14 http://www.destinationmarketing.org/web_images/presentations/developing_convention_center.pdf


20 Office of the State Treasurer, p. 35.

21 Office of the State Treasurer, p. 36
