MacArthur Foundation

*Office of the General Counsel*

**Legal and Tax Considerations in the Offering of Bonds by a Private Foundation**
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The COVID-19 pandemic wreaked havoc on the nation and the world and exposed again racial inequities in healthcare and delivery as communities of color were disproportionately affected by the pandemic. In May, the killing of George Floyd and renewed attention on other killings of Black Americans, such as Breonna Taylor, Ahmaud Arbery, and others, laid bare the failure of the country to confront racism and sparked protests and demands for change. As a result of these twin crises, some foundations decided to issue social bonds[1] to increase their grantmaking to meet the needs arising from the crises.

There are a number of legal issues associated with a foundation considering a bond offering and this memorandum briefly describes the issues, by category, based on MacArthur's experience. This is not intended as a comprehensive discussion of the complex legal issues arising from the bond issuance, nor is it intended as legal advice. Many of the legal issues, including securities and tax issues, are quite complex or not fully settled and a foundation should consult experienced and qualified tax counsel early in the process of considering the issuance of bonds. The amount, duration, and use of the bond proceeds could also impact the legal analysis associated with the issuance of bonds. And different foundations may have different risk tolerances or needs that lead them to different conclusion or steps. It is hoped, however, that this will serve as a useful roadmap for other foundations contemplating this strategy in the future.

## Private Foundation-Related Issues
## (Unrelated Business Income, including Debt-Financed Income, and Qualifying Distributions)

Anytime a foundation incurs debt, the rules relating to unrelated business income and, in particular, debt-financed income come into play. These rules can be complicated, particularly when incurring bond debt that may be used for a variety of purposes. Exhibit 1 is a brief overview of the rules.

Similarly, the expenditure of bond proceeds and for what purposes can raise issues around which expenditures constitute qualifying distributions. Exhibit 2 briefly describes the qualifying distribution rules.

With respect to the private foundation-related matters arising from the bond issuance, serious consideration should be given to obtaining an opinion of counsel on specific matters. Depending on the

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[1] Some foundations had issued bonds in the past, principally for capital projects, but MacArthur had never issued bonds before.

qualifications of in-house counsel, it is generally advisable to rely on expert outside counsel, although not legally required.[2]

Opinions can include the following issues:

- Whether the interest paid on the bonds can be counted as a qualifying distribution;
- Whether the use of the bond proceeds for grants will avoid debt-financed income with respect to investment assets purchased while the debt is outstanding;
- Whether the income from the bond proceeds is unrelated business income; and
- Whether in calculating its annual distribution requirement under section 4942 of the Internal Revenue Code ("Code"), the foundation can exclude the value of any securities purchased with bond proceeds.

There are certain steps a foundation should take to meet the legal requirements and helpful to obtaining an opinion. This includes establishing a separate account for the bond proceeds (to ensure the separation from the investment portfolio to avoid debt-financed income and ensuring that there is a wall between expenditure of the bond proceeds and the investment portfolio).

## Avoiding Debt-Financed Income

A further analysis of debt-financed income[3] reflects the complexity of this issue.

Under the definitions of debt-financed income, in each case, there must be indebtedness that would not be incurred but for the acquisition of specific income-producing property, regardless of the timing of the acquisition. And, if the indebtedness is incurred after the acquisition of the property, the incurrence of such debt must have been reasonably foreseeable at the time of acquisition.

Section 514 provides that debt-financed property does not include any property, substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(c)(3).[4] In other words, if the debt is used to acquire property that is used in furtherance of an organization's exempt purposes, that property (even if it is income-producing) will not be considered debt-financed property.

The legislative history of section 514 of the Code indicates that debt is traced to the use of proceeds of the debt and that, if traced to an exempt use (whether an exempt expenditure or the purchase of exempt-use property), the debt will not give rise to debt-financed income. The General Explanation of the Tax Reform Act of 1969 ("General Explanation"), issued by the Joint Committee on Taxation, explained the

[2] See, e.g., 26 CFR ¶1.6664-4(c)(1) and (2).
[3] Special thanks and credit to Caroline W. Waldner and Celia Roady of Morgan Lewis who provided this analysis in connection with an opinion to MacArthur on these issues.
[4] Code § 514(b)(1)(A)(i).

application of the "but for" and "reasonably foreseeable" tests.[5] The General Explanation stated that the general rule that income-producing property will be considered to be debt-financed property (making income from it taxable) only where there is "acquisition indebtedness" attributable to it. It further stated that acquisition indebtedness exists with respect to property whenever the indebtedness was incurred in acquiring or improving the property, or the indebtedness would not have been incurred "but for" the acquisition or improvement of the property.

The General Explanation also addresses the question of whether an exempt organization that has an investment portfolio could borrow funds for exempt purposes without creating an acquisition indebtedness with respect to its investment portfolio. It notes that "where a church has a portfolio of investments with no debt, and subsequently incurs a debt to construct a church related building, such as a seminary, such debt will not be considered an acquisition indebtedness with respect to the investment portfolio." The General Explanation, in effect, follows a tracing rule to determine that the use of the borrowed funds was for the acquisition of exempt-use property rather than for the acquisition of any income-producing property in the investment portfolio that may have been purchased or sold at the time.

The General Explanation further indicates that this tracing concept would apply even if the funds were expended for charitable purposes rather than used to acquire related exempt-use property, stating that, ("[F]or example, where a charitable organization pledges recently acquired property to borrow funds which it immediately uses for its tax-exempt purposes … it will be assumed that the borrowing is for the organization's exempt purposes.") The General Explanation added a caveat, consistent with the statutory language of section 514, that "[T]his could not be used to circumvent [section 514] where investment property is also acquired and the borrowing would not have occurred but for the investment property acquisition."

The General Explanation establishes three important points about the application of section 514. The first is that an exempt organization can make a decision to borrow funds for exempt purposes (either for exempt purpose expenditures or the purchase of exempt-use property) without creating an acquisition indebtedness with respect to its investment portfolio. The second is that a tracing rule may be applied to determine how the proceeds of the borrowing were applied, i.e., whether they were used for exempt purposes or for the acquisition of specific income-producing property. The third is that the "but for" and "reasonably foreseeable" tests function as anti-abuse rules that are intended to prevent an organization from circumventing the purpose of section 514 of the Code.

The concepts set forth in the General Explanation are reflected in the Treasury Regulations under section 514. Treasury Regulation section 1.514(c)-1(a) provides that whether the incurrence of a debt after the acquisition of property is "reasonably foreseeable" depends on the facts and circumstances. The test is an objective test; the fact that an organization did not actually foresee the need to incur debt in the future does not mean the debt was not "reasonably foreseeable."[6]

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[5] General Explanation of the Tax Reform Act of 1969, H.R. 13270, Staff of the Joint Committee on Internal Revenue Taxation, https://www.pgdc.com/files/generalexplanati00jcs1670_bw.pdf, beginning on p. 62.
[6] *Id*.

Section 1.514(c)-1(a)(2) of the Treasury Regulations includes several examples illustrating how the "but for" and "reasonably foreseeable" requirements are applied. One example involves an exempt organization that pledges investment assets as security for a loan, and then subsequently uses the loan proceeds to purchase an office building that is leased for nonexempt purposes.[7] This example concludes that the loan constitutes an acquisition indebtedness with respect to the office building. Even though the loan was incurred prior to the acquisition of the building, the facts show that the loan would not have been incurred but for the need to finance such acquisition. This example traces the use of the loan proceeds to the purchase of the office building, even though such use was made subsequent to the incurrence of the indebtedness.

Another example involves that of an exempt scientific organization that depletes its working capital to remodel an office building rented out for the production of income by leaving the organization without adequate working capital to continue its operations.[8] The organization subsequently mortgages its laboratory to obtain funds to replace the working capital. This example concludes that the mortgage loan is acquisition indebtedness with respect to the office building despite having been incurred after the improvement of the office building because such indebtedness would not have been incurred but for such improvement. This example further notes that the need to incur the indebtedness was reasonably foreseeable since the organization reduced its working capital below the amount necessary to continue current operations. This example also traces the borrowing to the income-producing property that was renovated with the working capital funds that were subsequently replaced by the indebtedness.

Both of the above examples involve situations in which the exempt organization sought to structure and time its indebtedness with respect to the acquisition of specific income-producing property in a manner intended to circumvent the application of section 514. In the first example, instead of taking out a mortgage to purchase the office building, the organization borrowed the money first, pledging investment assets as security, and then used the proceeds to acquire the office building. In that example, the Regulations treat the office building—rather than the investment assets that secured the loan—as the debt-financed property, since the indebtedness would not have been incurred but for the acquisition of the office building.

In the second example, instead of borrowing funds to finance the remodeling of a nonexempt use rental office building, the organization depleted its working capital to an unsustainable level to finance improvements to the building, and then mortgaged its laboratory to obtain funds to replace the working capital. The example concludes that the indebtedness would not have been incurred but for the need to remodel the office building, and the need for such debt was reasonably foreseeable.

Consistent with the General Explanation, these examples indicate that the "but for" and "reasonably foreseeable" tests function as mechanisms to prevent an exempt organization from seeking to structure

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[7] Treas. Reg. § 1.514(c)-1(a)(2), Example 1.
[8] Treas. Reg. § 1.514(c)-1(a)(2), Example 2.

and time its borrowing with respect to its acquisition of unrelated income producing property to escape the application of the debt-financed income rules. The examples also make it clear that the incurrence of debt must be linked to the acquisition of specific income-producing property. Such a link is necessary to calculate the amount of debt-financed income with respect to the income generated from the specific property.

Many of the cases under section 514 of the Code involve organizations that have argued, without success, that buying stock on margin is not subject to section 514.[9] In those cases, the courts have concluded that the margin debt is acquisition indebtedness with respect to the stock acquired with such debt and have had no difficulty identifying the specific property with respect to which the acquisition indebtedness relates because the borrowing is so closely tied to the acquisition. The courts have considered it irrelevant that the investment income generated by those investments will be applied to support the organization's exempt purposes, focusing instead on the fact that the borrowing was intended to be used to acquire specific income-producing property.

In one case, *Southwest Texas Electrical Cooperative v. Commissioner*,[10] the Fifth Circuit (affirming the Tax Court) concluded that a borrowing was acquisition indebtedness where the actual use of the borrowing was to invest in Treasury securities, even though the stated purpose of the borrowing was to finance future operating expenses. In that case, the organization received a $5.148 million loan from the Rural Electrification Administration to finance an expansion and upgrade of its facilities. The organization drew down half the loan funds to finance the expansion and funded the remainder of the construction costs out of its own funds.

Three years after construction was completed and after receiving notice that the remaining loan funds would soon become unavailable, the organization chose to draw down the remaining balance of $2.574 million. The interest rate on the borrowed funds was 5%. After depositing them in an operating account for one day, the organization invested them in Treasury securities bearing a 9% interest rate. The court found that the organization's purpose in drawing down funds was to make arbitrage profits on the rate differential between U.S. Treasury securities earning 9% purchased with the loan funds costing 5% and held, therefore, that the Treasury securities were debt-financed property.

Had the organization drawn down the entire loan amount and used those loan proceeds (rather than working capital) for the expansion project, then the Internal Revenue Service ("IRS") agreed that the loan would not have been an acquisition indebtedness because it would have been used entirely for a related use. Instead, however, the organization delayed the drawdown of the loan proceeds for three years, used working capital to construct the project instead, then drew down the remaining loan proceeds shortly

[9] *See Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States*, 208 F.3d 147, 156 (2d Cir. 2000) ("*Bartels I*"), where the taxpayer tried to argue, without success, that margin debt was not subject to *section 514*; *see also The Henry E. and Nancy Horton Bartels Trust For The Benefit Of Cornell University v. United States, 617 F.3d 1357 (Fed. Cir. 2010*), reaching the same conclusion as *Bartels I*; *see also Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347* (3d Cir. 1980), reaching the same conclusion where an employee profit-sharing plan purchased securities on margin.

[10] 67 F.3d 87 (5th Cir. 1995).

before such funds became unavailable and invested the loan proceeds in Treasury securities that generated arbitrage. As a result, the Court found that the indebtedness would not have been incurred "but for" the desire to invest in the Treasury securities, rejecting the organization's argument that its primary motive for taking the loan was to secure financing for its future exempt operating needs.[11]

In Technical Advice Memorandum 9012001, the IRS held that interest earned on bond proceeds placed in an escrow account was not debt-financed income. The bond proceeds were placed in the account and applied at a later date to pay off a pre-existing debt that was used to construct a building, substantially all of the use of which was related to the organization's exempt purpose. The IRS held that, because there was nexus between the funds set aside in the escrow account and the original debt, the funds were treated as a refinancing of the original debt and, because the original debt was used for exempt purposes, the income earned on the bond proceeds was not debt-financed income. The IRS also noted that the conclusion might have been different if the taxpayer had not taken steps to tie the bond proceeds so closely to the repayment of the prior debt including, for example, by placing the funds in a separate escrow.

## Compliance with Securities Laws

This bond issuance does not require registration under the federal securities law of 1933 under the exemption of rule 3(a) 4 of such Act. It is important to remember, however, that the bonds are securities within the meaning of the anti-fraud rules of the Securities and Exchange Commission ("SEC"), including Rule 10b-5. These rules can be tricky and advice from securities lawyers is recommended when determining what comments may be made regarding the issuance outside of the Offering Memorandum.

Practically, however, these rules warrant caution in making public statements about the bond issuance outside of what is contained in the Offering Memorandum itself. This includes statements made in press releases or on Twitter or other social media, or in conversations with potential purchasers. Counsel should consider drafting appropriate language that can be used as a caveat in public statements.[12]

There may also be additional securities laws that are implicated including SEC Rule 15c2-12 and continuing disclosure requirements under the Bond Purchase Agreement referenced below.

Foundations should also confirm compliance with state securities laws with the advice of counsel with expertise in this area.

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[11] In rejecting the organization's argument, the Court noted that "other circuits have held or assumed that indebtedness incurred for the making of passive investments is attributable to those investments" citing *Kern County Elec. Pension Fund v. Comm'r*, 96 T.C. 845 (1991), aff'd 988 F.2d 120 (9th Cir. 1993); *Mose & Garrison Siskin Memorial Found. v. U.S.*, 790 F.2d 480 (6th Cir. 1986); *Elliot Knitwear Profit Sharing Plan v. Comm'r*, 614 F.2d 347 (3d Cir. 1980).

[12] Typical language includes: nothing herein is intended as a recommendation to buy or sell securities. Any comments relating to the issuance of the bonds is contained in the Offering Memorandum available at [insert link].

## Agreement and Related Legal Obligations

The primary legal documents associated with a bond issuance include the following:

- Offering Memorandum (including Appendix A describing the foundation);
- Bond Indenture;
- Bond Purchase Agreement, including ancillary agreements; and
- Various legal opinions relating to the authority to issue and related opinions.

If a foundation wishes to obtain certification of the bonds as a "social" bond (as MacArthur and a number of other foundations did), there are additional documents described more fully below.

Foundation counsel will also need to coordinate the necessary due diligence requests from bond counsel, including collecting a wide range of documents and other materials necessary for the bond issuance.

Many of the above agreements are standard and are prepared by underwriter's counsel or foundation outside counsel. Appendix A of the Offering Memorandum describes the nature of the foundation, its operations, governance, programs, intended use of proceeds, and finances and can be prepared by inside counsel if available and knowledgeable about the aspects with assistance from other foundation staff (as was the case with the MacArthur).

### Board Resolution

In addition, special care should be given to the resolution of the Board approving the bond issuance as this will be necessary for the issuance of other documents and some legal opinions. It is advisable to consult with experienced outside bond counsel regarding this resolution to help prevent the need to go back to the Board for additional resolutions if critical language is missing.

### Ratings

Bond offerings will require a bond rating to enhance marketability. There are two primary bond rating agencies: Moody's and Standard & Poor's. Obtaining a rating requires a bond presentation to be submitted to the bond rating agency selected, together with relevant documentation. Accuracy and care in the factual representations is critical as this will be relied upon by the ratings agency.

### Social Bond Process

MacArthur and some other foundations also sought designation of the bonds as “social” bonds.[13] This is a designation under the Social Bond Principles issued by the International Capital Market Association and is recommended to be subject to external review, including, in MacArthur’s case, a second-party opinion issued by a qualified firm. The issuer must demonstrate that the proceeds of the bond exclusively support positive social outcomes/social projects, many of which align with one or more of the sustainable development goals of the United Nations. The Social Bond Principles have four key components: use of proceeds; process for project evaluation and selection; management of proceeds; and reporting. Social Bond Principles, Voluntary Process Guidelines for Issuing Social Bonds, June 2020 (International Capital Markets Association).

This process requires counsel to review the proposed contract with the second-party opinion issuer, review of the framework and opinion and ensuring that the foundation has in place the processes to comply with the representations made to the second party opinion provider.

### Discussions with Bond Investors

The issuance of bonds will also require discussion with prospective investors, through a pre-recorded session where staff of the foundation address key issues and/or in conversations with interested purchasers. Here, counsel must be alert to ensuring that the information provided closely hews to the Offering Memorandum or other publicly available information.

## Conclusion

Issuance of bonds by foundations, including social bonds, requires attention to the legal requirements and necessary documentation associated with a process that is subject to a range of regulations. Billions of dollars of bonds are issued through capital markets and, in 2020, foundations contributed almost $2 billion. Done prudently and consistent with law, the issuance of bonds can be a powerful tool in a foundation’s toolbox for impact.

Attachments

[13] Foundations may choose to issue social bonds to attract investors interested in or required by their mandate to purchase social bonds or to ensure the bonds align with their programmatic goals and values.

## EXHIBIT 1

**Overview of UBTI**

Section 511 of the Internal Revenue Code ("IRC" or "Code") imposes a tax on the unrelated business income of tax-exempt organizations described in Code section 501(c)(3). Generally, the term "unrelated business taxable income" ("UBTI") means income derived from any unrelated trade or business regularly carried on by a tax-exempt organization.[1] By statute, dividends, interest, rents, and capital gains are excluded from the computation of UBTI.[2] However, this exclusion does not apply to investment income earned on "debt-financed property."[3] Thus, dividend, interest, and other "passive income" is subject to tax if the underlying property is debt-financed.

Subject to certain exceptions, "debt-financed property" is defined in Code section 514(b)(1) as:

> [A]ny property which is held to produce income and with respect to which there is an acquisition indebtedness ... at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).[4]

However, the term "debt-financed property" does *not* include any property, substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance of an organization's exempt purpose.[5]

With respect to any debt-financed property, "acquisition indebtedness" is defined in Code section 514(c)(1)(A)–(C) as the unpaid amount of:

(A) The indebtedness incurred by the organization in acquiring or improving the property;
(B) The indebtedness incurred before the acquisition or improvement of the property if such indebtedness would not have been incurred but for the acquisition or improvement; and
(C) The indebtedness incurred after the acquisition or improvement of the property if such indebtedness would not have been incurred but for the acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.[6]

[1] IRC § 512(a).
[2] IRC § 512(b)(1), (3), (5).
[3] IRC § 512(b)(4).
[4] IRC § 514(b)(1).
[5] IRC § 514(b)(1)(A)(i).
[6] IRC § 514(c)(1)(A)-(C); Treas. Reg. § 1.514(c)-1(a)(1).

# EXHIBIT 2

## Qualifying Distributions

**Overview of distribution requirements**

Section 4942(a) of the Internal Revenue Code ("Code") imposes on the undistributed income of a private foundation for any taxable year, which has not been distributed by the first day of the second (or any succeeding) taxable year following such taxable year, a tax equal to 15 percent of the amount of the income remaining undistributed at the beginning of such second (or succeeding) taxable year. Code section 4942(c) defines the term "undistributed income" as the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made before such time out of such distributable amount.

Code section 4942(d) provides that the term "distributable amount" means, with respect to any foundation for any taxable year, an amount equal to the sum of the minimum investment return plus the income modifications described in Code section 4942(f)(2)(C), reduced by the sum of the taxes imposed on the private foundation for the taxable year under subtitle A and Code section 4940. The starting point for determining the annual distributable amount is calculating the "minimum investment return" defined in Code section 4942(e). As defined in this section, the minimum investment return for any tax year is 5% of the net aggregate fair market of all investment assets of the foundation.

Code section 4942(e)(1)(A)–(B) provides that the value of the foundation's investment assets is reduced by the "acquisition indebtedness" with respect to such assets, as determined under Code section 514(c)(1) (without regard to the taxable year in which the indebtedness was incurred).[1] As described above, "acquisition indebtedness" includes indebtedness incurred by a foundation in acquiring income-producing property, the use of which is not substantially related (aside from the need for income or funds) to the exercise or performance of an organization's exempt purpose or function. Debt incurred by a foundation to acquire securities or other portfolio assets is "acquisition indebtedness" for these purposes.[2]

Code section 4942(g)(1) defines a "qualifying distribution" as

(a) Any amount paid to accomplish one or more purposes described in Code section 170(c)(2)(B), other than any contribution to an organization controlled by the foundation or one or more of its disqualified persons or to a private foundation which is not an operating foundation, except as otherwise provided, or

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[1] *Accord,* Treas. Reg. § 53.4942(a)-2(c)(4)(i)(c).

[2] *E.g.*, Henry E. & Nancy Horton Bartels Trust v. United States, 209 F.3d 147 (2d Cir. 2000) (securities); Southwest Texas Elec. Coop., Inc. v. Comm'r, 67 F.3d 87 (5th Cir. 1995) (U.S. Treasury notes); Elliot Knitwear Profit Sharing Plan v. Comm'r, 614 F.2d 347 (3d Cir. 1980) (securities); Kern County Elec. Pension Fund v. Comm'r, 96 T.C. 845 (1991) (certificate of deposit); Rev. Rul. 74-197, 1974-1 C.B. 143 (securities); and PLR 199952089 (Dec. 29, 1999) (equity interests).

(b) Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in Code section 170(c)(2)(B).

The applicable Treasury Regulations provide that, if a foundation borrows money in a particular taxable year for a specific charitable purpose, a qualifying distribution is deemed to occur only in the year when the funds are actually distributed for the purpose for which they were borrowed.[3] The Regulations further provide that any payment of interest with respect to such a loan "shall be treated as a deduction" in computing the foundation's adjusted net income.[4]

[3] Treas. Reg. § 53.4942(a)-3(a)(4)(i).
[4] Treas. Reg. § 53.4942(a)-3(a)(4)(iii).