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Real Estate Benefits Of Non-Profit Organizations: Taking Full Advantage Of 501(c)(3) Status

Gil Sandler

Real property ownership holds many potential advantages for non-profit organizations.

Large non-profit organizations have long known and utilized their non-profit tax status to full advantage. Most hospitals, colleges, skilled nursing facilities, universities, private schools and large social service agencies need special-purpose facilities on centralized facilities or campuses. Such uses cannot be easily accommodated in rental properties without substantial renovation, nor can new construction or conversion be efficiently financed in the conventional real estate mortgage markets.

There are hundreds of well-capitalized non-profit organizations, including most top-tier hospitals and universities that function as large business enterprises. Almost every world-class hospital, scientific research institute, or university has substantial real-estate facilities built or acquired with tax-exempt bond financing. These organizations maintain investment-grade credit ratings supported by endowment funds fed by massive fund-raising campaigns led by blue-chip boards of trustees. Their financial strength stems, not from positive operating cash flows, which are often neutral or even negative, but from a combination of research and governmental grants, and tax-deductible charitable contributions and bequests. Fortunately, these endowment funds can then be grown through varied investment in stocks, bonds, and even the high-flying private equity or hedge funds, without being taxed on gains or distributions.

By contrast, smaller and medium-size non-profit organizations often struggle to meet their budgetary needs with more limited fund-raising campaigns and are not so well-versed in the application of these tax advantages to reduce what is often their single largest expense—their real estate operating costs.

The purpose of this article is to introduce the advantages of real property ownership for non-profit organizations. It is not intended as an authoritative discourse on all of the tax issues affecting non-profits[1] or as a primer on tax-exempt financing.[2]

Own vs. Rent: The Tax-Exempt Advantage

Whether to own or rent real property is usually a complex decision based on balancing a variety of factors such as cost, suitability of facilities at a particular location, proximity to staff and beneficiary population, anticipated term of utilization and of course, the financial capability of the non-profit to buy or build, in lieu of renting.

Non-profits needing primarily a small quantity of office space would often find it simpler and cost-effective to rent in a convenient office building, and never consider the ownership option. However, once a non-profit outgrows its small office or needs special-purpose facilities[3] not easily financed by a developer or landlord through conventional mortgage loans, the

Gil Sandler, a frequent contributor to the *Real Estate Finance Journal* and other real estate publications, is Managing Director of Realvest Capital Corporation and A.Bridge-Realvest Securities Corporation, a securities broker-dealer, which specializes in capital markets financing for real estate. He can be reached at gsandler@realvestcapital.com.

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ownership alternative becomes much more interesting. The long-term benefits of ownership are universally known: the ability to build equity; custom-design facilities; control one's own destiny without fear of eviction or forced moves or exposure to a landlord's financial problems or preferences. On the other side of the equation, the non-profit will often be uncertain of the long-term suitability of the location or find the costs of construction or conversion to be prohibitive.

Often overlooked, however, are the very substantial advantages of qualified Sec. 501 (c)(3) non-profits to pay less or no local property taxes—like government entities—and to finance their acquisition or construction at lower interest rates through the issuance of tax-exempt bonds. These can tip the balance in favor of ownership.

Real Property Tax

Non-profit organizations operating an enterprise within their permitted tax-exempt non-profit activities can be exempt from real property tax. This exemption is used by churches and temples and private schools—both religious and secular. It is also used—and sometimes abused—by small religious groups running churches or religious schools from mixed-use properties, such as storefronts or basements of residences. Acquisition or construction of new or modified properties must complete a site plan and sometimes, a rezoning, process. Depending on its proximity to primary residences, the project will often be actively opposed by neighboring residents, resulting in the same kind of noisy public meetings as new development projects. Traffic, noise, and less desirable occupants are common irritants that must be assuaged to some degree to locate to a residential area. For these reasons, social service projects like homeless shelters, group homes for the retarded, abused, orphaned, unwed or juvenile delinquents, abortion clinics, and the like, are often relegated to less desirable commercial and industrial sites near railroad lines or major highways. The tie-breaker in community battles is usually left to municipal leaders, whose agenda will most certainly include property taxes.

Since municipalities support their operating budgets with local property tax, they are not thrilled with plans to convert a tax-paying commercial property to tax-exempt use. Conforming site plans not requiring zoning or use variances give the buyer leverage to negotiate minimal tax concessions in the form of a Payment In Lieu of Taxes (''PILOT''). Limited parking or entrances or renovations and additions requiring variances shift the leverage to the municipality to demand both site plan concessions and PILOT payments approaching full commercial ratable levels. Well-established institutions like hospitals or universities that employ many local residents and support local programs can often negotiate PILOTs well below commercial tax levels due to their active involvement in local politics and affairs.

Outside high-rent, central business districts, major urban areas, the most economical property for a small or medium-size non-profit is usually a vacant or commercially unsuccessful site that is paying little or no taxes, or a parcel that is unlikely to be commercially or residentially developed. This can be due to limited frontage, poor visibility, difficult access or location on or near a major highway, or simply, the age of the infrastructure that discourages prospective investors or tenants. Owners in default of taxes or lenders who have foreclosed, or accepted a deed in lieu of foreclosure, may be motivated to make a deal, and the city or town may have little or nothing to lose by accepting a low PILOT payment and expediting approvals. Lenders in possession may even offer to finance redevelopment. In industrial areas being converted to commercial use, brownfield sites awaiting non-residential redevelopment may offer expedited approvals by municipalities, but these are likely to be too costly or large for a smaller non-profit, unless they are part of a larger redevelopment zone.

Non-Profit Ownership: Commercial Condominiums And Stand-Alone Buildings

Commercial Condominiums

The recent popularity of commercial condominium dev elopement has been fueled in part by this property tax advantage. For example, a non-profit seeking 5,000-25,000 Sq. Ft. in New York might rent a floor in Manhattan for $25-$60/SF gross, with escalation for common area maintenance and property tax, the gross rent would include as much as $5-$8/SF for property tax. If the non-profit bought that same floor in a commercial condo building, and became the tax owner, the condo floor would be exempt from property tax and it could save that 10 percent-20 percent portion of the rent allocable to property tax. It would also save the rent components attributable to the owner's return on equity and depreciation or mortgage amortization.

Let's do the math: A hypothetical private, non-profit agency, which might be called NYC Community Service Corp. (''CSC''), administers social welfare programs for lower income residents within the five boroughs of New York City. CSC provides vocational training, counseling and housing and job relocation services to income-eligible residents. CSC has been renting 15,000 SF in an older 14-story class B- building at 28th Street and 10th Avenue in an area undergoing redevelopment for $28 SF (plus $5.00 CAM[4] and tax escalation of $3.00/SF over the $3.00 base). This office houses CSC's core activities, as well as its central administration for all five boroughs of New York. CSC needs at least 20,000 SF for its administrative offices and to house 3,000 SF of satellite agency activities currently rented at another location at $32/SF. The landlord, Ronald Trump, has offered to renew the expiring lease for five years at $35 (plus $6.00

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CAM), but now wants to add the entire $6.00 property tax, provided that the landlord can terminate the lease on six months notice in the event of a sale or conversion of the building. Excluding CAM, the effective rent will rise from $31 to $41/SF or $615,000 annually, which is in the range of market rents in the area. The landlord also advises that he is holding off on new leases requiring fit-out, and has no expansion space available.

CSC needs to update its 15-year-old offices, but would be reluctant to make that investment on a short-term basis. Buildings across the street and on all four corners of CSC's current headquarters are under reconstruction as high-end condominium residences, so it is only a matter of time—maybe only a year or two—before CSC receives a lease termination notice and has to scramble for space what could easily be in a higher-rent, higher-rate environment.

Seeking alternatives, CSC's Executive Director, Dr. John E. B. Goode, reaches out to his board. A CSC board member, Douglas Elliman, who fortuitously happens to be a residential real estate broker, knows all about redevelopment in the area and confirms that the offered renewal is likely to be short-lived. He has even heard rumors that the landlord may sell the building to Ronald Trump as part of a new redevelopment project to be known as Trump Arms. Mr. Elliman reports that he has seen a 20,000 SF commercial condominium floor in a 18-story building in the garment center—West 36th Street between Seventh and Eighth Avenues. Since the project is being converted by award-winning developer, Larry Silverstar Associates, and agented by his broker friend at Wussman & Cakefield, Mr. Elliman offers to donate his co-brokerage commission to CSC, no strings attached. Upon further inquiry, Dr. Goode learns that the building is being upgraded with a new lobby, elevators, floor and wall coverings and lighting, resulting in a very presentable B+ building. The asking price is $400/SF, or $8,000,000 for the second floor, which seems low for such nice space, but reflects the changing nature of the neighborhood. Mr. Silverstar has arranged with Citibank to provide 90 percent financing with a 30-year amortization schedule at seven percent (7%) fixed for 10 years. The annual mortgage payment on the $7,200,000 mortgage (90 percent of $8,000,000) would be about $574,820.

Another banker board member, S. Paine Webber, tells Dr. Goode that his New York branch of a prominent Swiss bank would also lend to CSC at very competitive rates, and would extend a second lien loan for the $800,000 down-payment for 10 years, interest only, at prime, currently 7.75 percent. However, Mr. Webber insists that Dr. Goode hire his son, Hubie, as a program consultant. He adds that the carrying cost on this interest-only loan would be only $62,000 per year, and CSC could repay the down-payment over 10 years or longer with pending grants and/or capital campaign receipts, which would be pledged to the bank. After extensive consultation with CSC's Finance Chair, Ernst N. Young, the board authorizes the purchase. However, due to Dr. Goode's ethical concerns about hiring Hubie, he declines Mr. Webber's offer, and asks Mr. Young to pursue financing options with Citibank. Mr. Young reports that due to Citibank's relationship with Silverstar, and CSC's credit, Citibank would also make the second lien loan.

Not including new fit-out and equipment costs, which would be comparable in both alternatives, or moving costs, which are considered inevitable even if CSC renews its lease, the total annual cost to CSC of owning its own condominium floor in the converted building would be only about $636,820. This is slightly more than the proposed renewal rent, with very important differences. First, CSC would acquire another 5,000 SF—33 1/3 percent more space—to grow its operation and could immediately absorb its satellite agency currently renting 3,000 SF at $35/SF across town. Considering the $105,000 in saved rent, CSC's total future rent would be reduced from $720,000 to $636,820. The saving of about $85,000 approximates the $90,000 real property tax saved ($6.00 times 15,000 SF) because the record owner is exempt from local property tax as a qualified 501 (c)(3) non-profit organization, instead of a for-profit commercial entity.

Stand-Alone Properties

Here's another example, this time with a stand-alone building. Shadyside Pre-School runs pre-school and summer programs for 200 students at an average annual tuition of $15,000/year. They presently net-lease a four-story 14,000 SF brownstone on East 76th Street for $50/SF, plus a pass-through of property taxes of about $60,000, on a year-to-year basis, after their initial 10-year term. The owner has received a definitive, but conditional (subject to approvals), offer from a developer to buy the building ''as is'' for $550/SF, or $7,700,000.[5]

The owner notifies Shadyside of its right to match the offer pursuant to the right of first refusal in its lease, and Shadyside's Headmistress, Ms. Mary Poppins, turns to her board. A realtor board member, Hal Stead, advises that values are rising and so, too, are rents, and suggests bidding. He offers to represent Shadyside and offers to donate any commission received to be dedicated to the new rear playroom. After a cost-benefit analysis overseen by the board treasurer, P. W. Coopers, the board agrees. Mr. Stead enters a bid of $7,300,000 which is countered back and forth until the parties agree on $7,500,000. A board member, P. J. Morgan III, offers to obtain a 10-year mortgage for 90 percent, or $6,750,000 from his great-grandfather's bank, JPM Chase, at seven percent, with a 30-year amortization and to lend the $750,000 down-payment at prime.

Ms. Poppins readily agrees, and proposes a new $1,500,000 capital campaign and building fund to repay the down-payment and start an endowment fund. She suggests a black-tie musical revue gala to kick off the campaign and offers to sing and dance to Shadyside's theme song, ''A Spoonful of Sugar,'' in full costumed regalia. Each of the 15 board members is asked to ''swallow the medicine'' and pledge $10,000, payable over three years, to which they agree, with surprising delight.

Under the financing program offered by Chase, the annual mortgage payment would be about $445,375, plus the $58,125 annual interest expense on the $875,000 loan, or $503,500. Since Shadyside is a qualified 501 (c)(3) non-profit organization, it would pay no property tax to the city. Thus, its annual ownership cost of under just over $500,000 would be much less than its present occupancy cost of $760,000 ($700,000 rent plus the $60,000 property tax pass-through). However, another knowledgeable board member, Barney Smith, suggests that Mr. Coopers look into the possibility of obtaining tax-exempt financing that might be even more attractive than the mortgage loan.

Tax-Exempt Financing For Qualified Non-Profit Organizations

The financing numbers get even better for CSC and Shadyside, as credit-worthy non-profits eligible for tax-exempt financing. In addition to the benefits of long-term ownership for suitable facilities, a financially sound non-profit can obtain tax-exempt bond financing through government agencies that serve as conduits to issue tax-exempt bonds and lend the proceeds to the non-profit.

Tax-exempt bonds[6] are issued by conduit agencies like the New York City Industrial Development Authority (the ''NYCIDA''), the New York Dormitory Authority, the New Jersey Economic Development Authority and the California Statewide Communities Development Authority to promote economic development[7] and charitable purposes for legitimate non-profit organizations to assist them in fulfilling educational, healthcare, housing and social services functions. These governmental agencies issue ''special limited obligation'' revenue bonds, some of which may be federally taxable,[8] totaling many billions of dollars that are paid solely from the proceeds of back-to-back loans to the non-profit or private borrowers, and are not directly or indirectly supported by the agencies' governmental parent or taxing power.

In addition, specialized statewide agencies in most states issue conduit bonds for non-profit healthcare and higher educational institutions. These agencies are staffed by professionals with extensive backgrounds in credit and facilities needs of their non-profit beneficiary organizations.

In our two cases, the NYCIDA might be an appropriate conduit issuer of tax-exempt bonds for both CSC and Shadyside. Once the bonds are issued—usually a three to four month process[9]—the issuer would lend the proceeds under a loan or installment sale Agreement,[10] secured by a first lien on their properties and such other collateral—capital campaign pledges, governmental grants, etc.—as may be available. This tax-exemption of interest income from federal, state, and local tax can be worth 25 percent to 35 percent in high-tax states like New York, New Jersey, and California.

Credit Factors

The credit issues can be tricky, but the tax-exempt markets can sometimes be more flexible than conventional lenders. Established non-profits like CSC and Shadyside can issue bonds directly, with or without a credit rating, or turn to several different sources to support their credit. In lieu of making a direct loan to the non-profit, a bank lender can purchase the tax-exempt bonds directly, but unlike certain ''bank-eligible'' governmental bonds, banks no longer get the full benefit of tax-exempt income.[11] Bank lenders still obtain certain regulatory credits under the Community Reinvestment Act (''CRA Credits'') for mortgage loans made in low-income areas or to agencies that serve a low-income population, and the need for CRA credits to ensure regulatory approval of acquisitions makes those loans relatively more attractive—an estimated 25 basis points (0.25 percent) worth—once minimum credit standards are met.[12]

Non-profit entities with relatively large endowments, fund balances, or committed government funding sources that generate annual income in excess of annual debt service may be able to obtain an investment grade rating on their own. Typically, rating agencies are looking for an established cash flow stream after operating costs of at least 1.5 times annual debt service, but strong mortgage collateral values of at least 1.25 times the outstanding bonds can supplement coverage ratios. A debt service reserve fund sized at the lesser of 10 percent of the principal bond amount or the highest annual debt service requirement may be added to the bond proceeds used for the original loan and financing costs. Not surprisingly, the Ivy League and other top-tier universities have ''AAA''/''Aaa'' ratings, based upon both their ability to recoup costs through tuition increases[13] and implicit support from massive endowment funds.[14]

Dozens of tax-exempt bond funds and thousands of high tax-bracket retail investors routinely buy tax-exempt bonds issued by non-profit organizations. The vast majority of bonds purchased by retail investors are rated AAA (S&P) and/or Aaa (Moody's) because the timely payment of principal and interest is insured by one of six top-rated bond insurers—MBIA, AMBAC, FGIC, FSA, XL and CIFG. These well-capitalized mono-line insurers generally insure governmental bonds backed by the full faith and credit, and taxing power, of governmental units, or proven revenue streams for providing essential public services like water, sewer and public transportation. These bond insurers also insure conduit bonds issued by substantial healthcare and educational institutions which qualify on their own for investment-grade ratings of at least ''BBB''/''Baa.''[15]

Long-Term Fixed Rate Bonds

Smaller non-profits like CSC and Shadyside may find interest from high-yield tax-exempt bond funds that approve their credit and collateral profiles. In this case, they might pay fixed rates of 6 percent to 6.5 percent, instead of the seven percent offered for a taxable mortgage loan, for a 20-30 year bond term with an equivalent amortization schedule. A portion of the issue may be scheduled for earlier retirement if the non-profit is confident in receiving a grant, bequest or capital campaign receipts.

A viable option for non-profits with moderately strong credit profiles and well-connected boards would be to utilize the board's network of bank contacts. CSC has another board member, Lee Mann, an investment banker who claims his brother, can sell bonds which have been credit-enhanced, or guaranteed, by a highly-rated bank at very low rates. The bank might be a major New York bank seeking CRA credits in NY, or very possibly, Citibank, which has already approved the conventional mortgage loans for Trump's Silverstar's conversion. After meeting with Lehman's brother, Citibank offers to convert its conventional mortgage loan into a five-year irrevocable, direct-pay letter of credit (LOC)[16] to CSC at a rate of one percent annually. This would enable CSC to issue bonds through the NYCIDA at Citibank's long-term ratings of ''AA''/''Aa2,'' and short-term ratings of ''A1+''/''VMIG-1.''

If CSC's bonds are structured as 30 year fixed-rate bonds with a level debt service schedule and are rated ''AA,'' based on Citibank's LOC, they would probably yield an average interest rate of approximately five percent.[17] Due to the relatively small par amount of funds needed by CSC, a single term bond with annual sinking fund principal payments would be simplest. However, the overall rate can be reduced by five to 10 bps by including small serial maturities over the first five to 10 years (usually limited to the term of the LOC), and adding a term bond for later maturities.

The board considers a floating rate option for the bonds, but prefers the long-term security of a fixed rate, although it recognizes that the rate may have to be reset if the LOC is not renewed.[18]

In order to fix the rate for the longest term, the bonds may be structured as 30-year bonds with a 30-year fixed rate[19] of about five percent, with a weighted average maturity of 24 years, due to annual ''sinking fund'' amortization payments. Those bonds would be subject to a an extraordinary redemption in the event that the LOC is not renewed, although other bond issues may be structured to allow the bonds to remain outstanding without an extraordinary call so long as the LOC is replaced by another equally rated LOC. Another option however, is to use a five-year ''put-call'' structure in which the rate is reset every five years, based on the LOC. This would reduce the rate on the bonds to about 4.25 percent, but subject CSC to periodic rate resets—much like a five-year ARM in the residential mortgage market.

Floating-Rate Bonds

Shadyside moves in a slightly different direction. After discussions with Mr. Smith and Mr. Coopers, Mr. Morgan contacts Chase Bank and reports that they are willing to make either a conventional mortgage loan or provide a five-year, renewable LOC for an annual fee of 75 bps (.75 percent). Not to be outdone, another board member, Jacques Brugman, an investment analyst, offers to have one of his bank clients purchase and hold the tax-exempt bonds at a low rate to be determined—so long as Shadyside reserves a place in the class of 2011 for his soon-to-arrive baby son, Sandy. Ms. Poppins promises to consult with her Admission Director, Jewel E. Andrews, but says she must consult further with her financial advisers.

Demonstrating his expertise in the bond markets, Mr. Morgan explains to the board that VRDNs are issued in $100,000 minimum denominations and are usually purchased by tax-exempt money-market funds and corporations as short-term investments, since they can be tendered or put back to the LOC bank on seven days' notice. He adds that large money market funds often retain their investments in weekly or longer reset VRDNs for long periods of time, so long as they provide an attractive market yield, while daily VRDNs are typically purchased by corporations, and other institutional investors needing liquidity with slightly lower rates but greater frequency of tenders. He adds that the rates are usually lower if the bonds are structured as variable-rate demand bonds or notes (collectively, ''VRDNs''), with the rate reset daily, weekly or monthly[20] by a remarketing agent who is a securities broker-dealer. Adding the recent weekly rate of 3.60 percent to the .75 percent and .125 percent remarketing fee, the total interest cost to Shadyside would be only 4.475 percent.

Shadyside's Treasurer, P. W. Coopers, checks with Goldie Sax, Shadyside's investment adviser, and reports back to the board that the weekly VRDN rate has averaged below three percent over the past 15 years.[21] He continues that the VRDB rate has risen from below one percent to 3.60 percent while the Fed has raised the Fed Funds rate to 4.75 percent, and that they are expected to fluctuate back and forth over time.[22] Mr. Morgan had also stated that Chase would be pleased to offer Shadyside an interest rate swap or other interest rate protection program,[23] but so long as they budgeted or reserved for higher average rates, and had strong operating cash flow, the bank would be comfortable. Coopers also suggested that Mr. Brugman's bank's direct purchase was unlikely to be competitive, since banks do not derive full benefits from holding tax-exempt investments.[24]

Assuming, somewhat conservatively, a long-term average VRDB rate of 4.25 percent, an LOC fee of .75 percent and remarketing costs of .125 percent, it is reasonable to estimate that Shadyside would pay an average total interest expense of 5.125 percent. Using a 30-year level-debt amortization schedule, total principal and interest would average only about $445,375. If we add the $58,125 in interest on the down-payment loan from Chase, the total cash cost of owning the property is reduced to about $503,500. This compares so favorably to the school's current rental cost of $760,000 that Shadyside's operating budget would be able to find room for theater trips, and new computer and playground equipment. Mr. Coopers notes that it could also budget $75,000 per year to pay off the $750,000 down-payment loan over 10 years, to create an interest reserve with savings below the targeted rate; and to enhance the endowment fund to support the scholarship program. The board agrees, and clarifies the capital campaign materials to permit proceeds to be moved, in the board's discretion, from the building fund to the endowment fund.

Conclusion

The names are obviously fictitious—indeed, quite silly—but the principles of tax exemption for property taxes and equally important, the ability to borrow at tax-exempt rates, are very real. The fear of long-term commitment to a particular location may lead a tenant—private, public, or non-profit—to continue renting for long periods at much higher costs. Once a suitable long-term location has been found, however, ownership affords a non-profit organization control over its destiny and lower operating costs by saving all or most of the property taxes paid by a commercial landlord, and then, by reducing taxable financing costs which are ultimately passed through to the tenant.

Most importantly, tax-exemption from property tax and access to low cost tax-exempt financing enables them to make an informed choice between owning and renting. They can control more of their own destiny in a budget-crunching, pledge cutting world and avoid the disruption and cost of future relocations, and displacement by redeveloping neighborhoods.

The ability to obtain low, tax-exempt interest rates is a significant benefit to non-profit organizations. Unfortunately, the apparent complexity and somewhat higher closing and financing costs often discourage non-profits from pursuing tax-exempt bonding. Although many accountants and attorneys are not experienced in the issuance of tax-exempt bonds, most large commercial and investment banks that work with non-profit organizations or have middle-market lending groups can be good sources of preliminary information. In order to obtain the best terms, however, all options should be objectively analyzed. Most major cities or counties, and some states, have conduit bond agencies that can provide referrals to experienced attorneys and financial advisers. These advisers and agency staff can work with the non-profit organization to evaluate competing proposals. Referrals from board members—particularly those who have no conflicting personal interests—and from the agency's accounting and legal professionals are also invaluable resources.

Non-profit leaders and staff should also remain open to alternative paths. Faced with serious competition, a landlord or owner may, in some cases, sweeten a rent renewal, or offer a future purchase option along with favorable lease terms in order to avoid losing a tenant. This is unlikely in the CSC example above, but could happen in other situations. The non-profit entity's ability to obtain tax-exempt financing can also induce its regular bank to offer more attractive terms. While smaller community lenders are not accustomed to providing LOCs in support of tax-exempt bonds, and other banks may prefer to book a portfolio loan,[25] initiating competition among landlords and lenders will almost always produce the best result for the non-profit. In most cases, direct loans which are not made through governmental conduits to achieve tax-exempt status will not be as attractive as tax-exempt bonds sold to tax-exempt investors, with or without credit enhancement.

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[1] For example, common issues regarding unrelated business taxable income, or UBTI, received by non-profits from ancillary, often integrated operations, are not discussed here. In some cases, the relative amounts of such income, the operators of revenue-producing activates on the premises owned by the non-profit, or the primary purpose of the facilities being financed, may preclude the tax benefits of exemption of property tax and deny access to tax-exempt financing.

[2] One major issue reserved for future discussion and analysis is the extent to which the religious affiliation, charter and activities of a non-profit entity affects its access to the benefits of tax-exempt status, other than fund-raising.

[3] A large percentage of commercial mortgage loans to develop or acquire residential, commercial, industrial, and retail properties are originated and sold to large banks and investment banks for securitization through huge pools of commercial mortgage-backed securities (''CMBS''). This trillion- dollar market has reduced interest rates on most commercial mortgage loans, but generally excludes so-called ''special-purpose'' properties which require unusual configurations, access, parking requirements or whose operation requires specialized management. Certain industries, e.g., hospitality, have spawned their own CMBS pools and REITs, but movie theaters, industrial plants, and many health-care, educational and recreational facilities are not readily financed through low-cost, securitizable loans. Lenders required to hold and service those loans in portfolio would typically require stronger collateral and charge higher fees and rates than a CMBS-eligible loan.

[4] CAM refers to common area maintenance charges allocable to tenants on a per SF basis for cleaning, security, utilities, insurance, and other common charges.

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[5] This offer seems realistic at recent New York apartment rates based on the following assumptions: eight large, modern condominium apartments with three bedrooms, 2½ baths in about 1,700 SF of living space; a renovation cost of about $2,300,000 for a new elevator, laundry chutes, new stairways, front entrance, security, basement; design, financing and legal costs of about $1,000,000; and an average sale price of $1,800,000, or just over 1,000/SF. The developer would earn an estimated profit of $3,800,000, on an initial equity investment of about $1,500,000.

[6] Generally, interest income on obligations of qualified non-profit organizations is exempt from gross income tax under Sec. 61 of the Internal Revenue Code, and is not an item of tax preference subject to the alternative minimum tax on individual taxpayers under Sec. 57 of the Code.

[7] Other governmental entities like cities and counties set up conduit issuing agencies to confer Federal and/or local tax-exempt status on bonds issued for non-profit organizations and, in some cases, private developers or companies promoting economic development, housing or public benefit projects. Local ''improvement authorities'' and county industrial development authorities also issue bonds on behalf of non-profit and for-profit entities.

Generally, small issue industrial development bonds (IDBs) may be tax-exempt if they are issued to finance projects for companies whose capital expenditures within a particular municipality do not exceed $10,000,000 within a period three-years back and three years forward from the date of issuance. This 20-year old capital expenditures limitation for ''small issue IDBs'' is finally, after many unsuccessful bills, being increased to $20,000,000 for 2007. IDBs, for-profit multifamily housing projects and other private activity bonds like pollution control, wastewater treatment, stadium and arena projects, airport facilities and housing bonds are private activity bonds subject to alternate minimum tax but obtain significantly lower tax-exempt rates. Private-activity bonds are also subject to annual statewide volume caps based on population, so each state must provide a mechanism to allocate tax-exempt authority to competing private activity projects.

[8] Conduit agencies may issue bonds on behalf of development projects operated on a for-profit basis, for mixed-use facilities like arenas and stadiums, and for ancillary facilities for non-profits, like medical office buildings for hospital-affiliated doctors, or privately owned housing adjacent to a college campus.

[9] In order to preserve the tax-exempt status of loans or bonds issued on behalf of non-profits, the non-profit cannot expend significant project proceeds prior to the adoption of an inducement resolution of the governmental conduit agency. If necessary, however, the non-profit may borrow on an interim basis, so long as it records in its records or minutes of proceedings that it intends to repay the interim financing with the proceeds of tax-exempt borrowing.

[10] Some conduit issuers, particularly in New York, use an Installment Sale Agreement in lieu of a Loan Agreement and hold record title to the property being financed until the bonds are repaid, at which time title passes automatically to the borrower. This can help minimize or avoid property tax and, if the mortgage is later assigned, mortgage recording taxes.

[11] Prior to the Tax Reform Act of 1985 (''TEFRA''), banks could retain tax-exempt loans in portfolio and receive full benefit of tax-exempt income. Since TEFRA, however, under Sec. 265 of the Internal Revenue Code, banks can no longer deduct the interest expense or the ''cost of carry'' on funds borrowed (e.g., CDs) to generate funds to purchase tax-exempt bonds. The sole exception is for small governmental issues of ''bank-qualified'' bonds under Sec. 266 of the Code.

[12] CRA credit facilities may also receive priority attention and more personal credit reviews.

[13] The continuing decline in acceptance rates of the most selective colleges enables them to raise tuition and fees without losing attending students.

[14] Prior to the Tax Reform Act of 1985 (''TEFRA''), non-profit organizations frequently used the ''endowment fund'' exception from arbitrage restrictions and pledged their endowment funds to bondholders and credit enhancers while continuing to earn unlimited yields on those pledged funds. Post-TEFRA, however, all pledged investment funds were either yield-restricted to the arbitrage bond yield or subject to rebate of excess earnings.

[15] Due to recent and historical fluctuations in the level of federal and state governmental support for healthcare, and continuing managed care cutbacks, even large hospitals face constant budget pressures. As a result, bond insurers have become increasingly reluctant to provide long-term insurance for all but the strongest hospitals in each area, and may require an underlying credit rating of at least ''A-''/''A1.'' Private universities without substantial endowments or the assurance of governmental funding are also subjected to stricter insurability standards, often requiring underlying ratings of at least ''BBB+''/''Baa1.''

[16] An irrevocable direct-pay LOC is a form of ''standby'' letter of credit that guarantees timely payments of principal and interest on the bonds and enables the bonds to obtain the same credit rating as the LOC bank's own senior obligations. The bond trustee makes all payments of principal and interest through draws on LOC, which the borrower then reimburses, but bondholders receive bank funds, which are not subject to preference risk if the borrower should file for bankruptcy within the 90-day preference period.

[17] Based on prevailing rates for New York ''AA'' revenue bonds on May 3, 2006, plus a premium or penalty of 25 bps to allow for the increased risk of an early call due to non-renewal of the LOC.

[18] Generally, fixed-rate bonds sold with a shorter-term LOC will retain their original rate and payment terms so long as the original LOC is renewed. If, however, the LOC expires without replacement, the bonds will be put to the LOC Bank for purchase or redemption. If the LOC is replaced, the bonds will also be tendered but may be repurchased by the holder or sold to a new holder at the then prevailing market rate for the remaining bond term.

[19] Subject to some lower rates for smaller serial bonds maturing in earlier years at rates of, for example, four percent to 4.5 percent.

[20] The weekly reset structure is most common for small and medium size VRDN issues, while very large governmental issues may have tranches of daily reset bonds and set up as ''multi-modal'' to permit rate resets to vary from time to time.

[21] Daily rates tend to be 10-15 bps lower, but are not as common for small issues, and may be put back to remarketing agent with greater frequency and be carried by the agent or LOC bank.

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[22] Though the market anticipates a record 16th consecutive .25 percent increase at the FOMC meeting on May 9, 1006, the Fed has been sending signals that it may pause for an indefinite term to evaluate the longer-term economic effects of rate and energy increases.

[23] A common alternative to a swap is a cap and floor, or collar, in which the rate may float within parameters, based on either a tax-exempt index like the Bond Market Association Swap Rate (''BMA'') or a percentage of a taxable index like LIBOR.

[24] See note 11, above, and accompanying text.

[25] Some banks, particularly smaller community-based institutions, prefer to build their asset and deposit base with portfolio loans funded by inexpensive deposits, and may offer lower taxable rates and incentives. These banks often lack top-tier letter of credit ratings and compete on rate and terms.

Most highly-rated domestic and foreign banks are equally willing to provide LOCs to obtain fee income without funding the loans, and often offer lower ''credit spreads'' on LOCs due to more favorable leverage and regulatory capital.

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