

EICHNER & NORRIS PLLC

ATTORNEYS AT LAW
THE JEFFERSON BUILDING
1225 19TH STREET, N.W., 7TH FLOOR
WASHINGTON, D.C. 20036
TEL: (202)973-0100
FAX: (202)296-6990
WEBSITE: www.enbonds.com

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Introduction to Tax-Exempt Student Housing Bonds¹

R. Wade Norris, Esq.
wnorris@enbonds.com

Background

The past several years have seen a substantial increase in the issuance of tax-exempt bonds to provide housing for students in public and private colleges and universities. This trend is being fueled in part by the substantial increase in the projected enrollment in colleges and universities created by the “baby boom echo” generation, who are just beginning to enter their prime college years. For example, recent statistics from the U.S. Department of Education project that total enrollment in all institutions of higher education, after hovering between 14 and 14.5 million during the years from 1991 through 1997, began to rise in 1998 at a rate of about 250,000 per year, and is projected to lead to total enrollment of approximately 17 million by the year 2008. These trends have created a dramatic increase in the demand for student housing in colleges and universities across the country. In some areas, particularly the West Coast, Southeast and Southwest, this surge in enrollment is even greater than that suggested by the national averages.

At the same time, much of the existing housing stock owned by colleges and universities is obsolete and/or deteriorated by modern housing standards. For example, much of the student housing built in the immediate post-World War II era comprises dormitories consisting of large numbers of small individual rooms with large group or “gang” restroom facilities and substantially no facilities for cooking, recreation or other similar activities. When the “baby boom” generation began to hit college campuses in the 1960's, colleges and universities often responded by building massive high rise structures, which tend to be relatively impersonal and not conducive to creating the type of social, educational and recreational atmosphere which is sought by many of today's students. In addition, the increasing budgetary constraints which colleges and universities have faced over the past several decades have resulted in substantial deferred maintenance, which has further eroded the quality of the existing student housing facilities at many colleges and universities.

¹ By its nature, any memorandum of this nature provides only a general description of the material covered. The descriptions of legal standards and financial structures set forth herein are intended to represent only general guidelines which may or may not apply in certain situations or which may vary depending upon the facts and circumstances of a particular financing. Persons contemplating a tax-exempt student housing bond financing should confer with their attorneys and advisers as to the applicability of these and other requirements to a particular financing.

Current Dilemma

This combination of increasing demand and outdated facilities has presented many colleges and universities with a dilemma. While they desperately need to modernize and expand their student housing stock, most colleges and universities face severe limitations on their ability to do so. The first of these limitations often is budgetary. While most colleges and universities are authorized to issue tax-exempt bonds, or can have tax-exempt bonds issued on their behalf, for the provision of student housing facilities, they may be reluctant to engage in this type of financing where the college or university will be directly liable for payment of the resulting debt service payments. In many instances, higher priority may be given to using the university's balance sheet to obtain financing for classrooms, research facilities and other facilities which are essential to the college or university's mission, but are not revenue producing enterprises which are capable of being financed on a "stand-alone" basis. In addition, where colleges or universities undertake these types of capital projects themselves, they may be subject to a number of constraints which would not apply if the facilities are developed by a private party or another non-governmental entity. These constraints may include the requirement of building to 100-year property standards, compliance with complex and time consuming public procurement regulations, requirements to pay prevailing wage rates in a market which might not otherwise demand such rates and other similar factors. These constraints can both substantially increase the amount of time required to finance and build new facilities and can dramatically increase the cost. For example, in some markets, as a result of these factors, college officials estimate that a non-governmental entity may be able to bring housing facilities on-line at a cost that is as much as 50% less than would be the case if such units were financed and built by the college or university directly.

Section 501(c)(3) Ownership Model

In response to these developments, the past several years have seen the evolution and increasing use of financing models which involve the ownership of the housing facilities by a separate Section 501(c)(3) nonprofit corporation, the charitable mission of which involves the assistance of the college or university in the achievement of its educational mission, including the provision of housing for students attending the institution. If certain requirements are satisfied, Section 145 of the Code permits the issuance of tax-exempt bonds by the college or by an appropriate governmental issuer in which the college or university is located and the loan of the bond proceeds to the Section 501(c)(3) owner, to be used by that entity pursuant to an agreement with the college or university for the construction or acquisition and rehabilitation of the student housing facilities. The principal advantage of these financings is that they provide low-rate, tax-exempt, long-term bond financing, while minimizing the increased cost and delays and the adverse balance sheet impact that might result if a college or university were to undertake these financings directly.

Finding of Need; Cooperation Agreement; Rental Exclusively to Students

In order to be eligible for this type of tax-exempt student housing bond financing under Section 145 of the Code, one of the principal requirements is a formal finding by the college or university that it has substantial unmet housing needs and that the ownership and operation of the proposed facility by the Section 501(c)(3) organization will be of material assistance to the college or university in meeting those needs. This finding or resolution, while not financially binding the college or university, will typically pledge the institution's support and cooperation with the Section 501(c)(3) owner to assure that the housing is operated in accordance with the institution's policies and needs. Internal Revenue Service guidelines also typically require arrangements to assure that the units be rented exclusively to students. In other words, one cannot have 85% or 90% of the units rented to students, with the remaining 10% or 15% rented to non-professionals or others in the community who are not affiliated with the college or university.

Description, Location and Operation of Student Housing Facilities

In order to meet the Internal Revenue Service guidance and credit enhancement concerns, it is essential that the facilities not only be rented exclusively to students, but they also must be designed for students, and there must be a close connection, both physically and programmatically, between the operation of the facility and the college or university's educational mission. These guidelines generally require that the facility be located on or immediately adjacent to the college or university campus or, if such a site is not available, a short distance away from the campus at a location which is readily accessible to the campus by public transportation and/or by developer/university provided transportation services.

Physically, these facilities often more closely resemble a specially designed modern apartment complex than a traditional college dorm facility. A typical configuration may involve some combination of one, two, three or four-bedroom units, clustered around a central living room and kitchen facility. Often, each bedroom will have its own bathroom, or possibly two bedrooms will share a bath in the larger units. Generally, one student occupies each bedroom. Many of the units coming on-line today provide substantial clubhouse facilities for recreation, social and educational functions. Study and computer rooms are common, as are exercise facilities, sports courts, swimming pools, video rooms and other facilities of the type demanded by many students in today's marketplace. The units will typically have high-speed internet connections to the college or university's computer system and, in many instances, the college or university will promote the use of the facility in its recruiting publications, will operate various educational programs at the facility in cooperation with the 501(c)(3) owner, and may provide residential advisers, especially in undergraduate facilities. As a general rule, food service is not provided in these facilities. Rooms are typically rented to students by the bedroom (rather than making students jointly and severally liable for the entire unit), often with a guarantee of rent

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payments from the parents. Units are typically leased on an academic year or full year basis, and payments are typically required in one or two installments.

Eligible Section 501(c)(3) Ownership Entities; Relationship to College/University; Independence from Developer

The legal theory behind this financing model is that the Section 501(c)(3) entity, by owning the student housing facility, is assisting the college or university in the college's or university's charitable mission – education. This charitable mission should not be confused with that of other Section 501(c)(3)'s, which may provide affordable housing as a means of serving the different charitable mission of “providing relief to the poor and distressed.” As a result, student housing facilities are not required to comply with “20/50” or “40/60” targeting or other affordable housing guidelines under Section 42 or Section 142(d) of the Code, nor would most of these facilities be able to do so, since in order to qualify as a lower income housing tenant under affordable housing guidelines, students must be married and filing a joint return. On the other hand, in order to satisfy IRS guidelines, the rents on tax-exempt bond financed student housing facilities must generally be set somewhat below market rates and must be affordable to students. The Service may also require that rents on units generally be set no higher than is necessary to pay operating expenses and to cover debt service by a margin sufficient to cover applicable rating agency and/or credit enhancer requirements, as discussed further below. Notwithstanding these constraints, normal operations will still be expected to produce some operating surplus. IRS guidelines typically require that a majority of any such surplus be returned to the college or university, with only a minor portion being retained by the Section 501(c)(3) for its purposes.

Internal Revenue Service rulings and pronouncements also require that the Section 501(c)(3) entity either be established and/or controlled by the college or university and/or the community in which it is located or otherwise have a close relationship with the college or university and/or community. Those guidelines also prohibit any significant control of the Section 501(c)(3) entity by a developer or other private party involved in the student housing project, as is further discussed below.

Many colleges or universities have a separate Section 501(c)(3) corporation or foundation which is authorized, among other things, to enter into transactions to assist the college or university in financing its activities. Since the rating agencies and most credit enhancers require that the project be owned by a “bankruptcy remote” special purpose entity, in many instances this financing foundation might set up a separate entity (often a single member limited liability company), the sole purpose of which would be the ownership and operation of the proposed student housing facility. That subsidiary entity might also be set up a nonprofit partnership or limited liability company, although in some jurisdictions (such as California), ownership of the property by a limited liability company may jeopardize a real estate tax-exemption, which is

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often a major factor in the financial feasibility of these financings. It should be noted that if the parent entity does not have a so-called “group exemption,” it may be necessary to submit an application to the Internal Revenue Service to obtain a charitable designation under Section 501(c)(3) for the special purpose ownership entity.

In any event, it is important that the college or university have substantial involvement in and control over the Section 501(c)(3) ownership entity, perhaps together with members of the local community. This is to be contrasted to a fact pattern of “roving” developer-control Section 501(c)(3)’s, which was attacked by the Service in a training publication released in the fall of 2000. The fact pattern described by the Service in that publication involved the ownership of tax-exempt bond financed student housing facilities by Section 501(c)(3) corporations having a nationwide or other multi-jurisdictional purpose to assist colleges and universities generally in meeting their educational, including housing, needs. In many instances, the officers and directors of the Section 501(c)(3) corporation had no significant relationship to each other, to the college or university served by the proposed student housing bond facility or to the community in which the student housing was to be located. In some instances, these Section 501(c)(3) corporations had been organized by and/or received initial funding from the developer and other private parties who were active in the development of the student housing facilities to be owned by the charitable corporation. The development firm or other private parties might also have had one or more persons on the board of directors and, in a number of instances, the same developer and group of other private participants would participate in multiple financings for facilities at different colleges and universities.

In its publication, the Service challenged the tax-exempt status of this type of nonprofit corporation under Section 501(c)(3) and, potentially, the tax-exempt status of any bonds issued to finance the facilities owned by such a corporation. Subsequent to that publication, the Service has brought at least one investigative proceeding involving a series of student housing bond financings by a Section 501(c)(3) organization which embodied some of these characteristics. As a result of these developments, almost all bond and Section 501(c)(3) counsel involved in these financings now require that the Section 501(c) entity be organized by or substantially controlled by the college or university where the project is located and/or by representatives of the local community, as compared to various persons who may have expertise in real estate, education or financing, but who have no clear connection with the college or university or community in question or to each other. In addition, most law firms will not render clean opinions where there is significant evidence of developer control or involvement in the governance and affairs of the Section 501(c)(3) entity, and they will insist that any contracts between the Section 501(c)(3) entity and developers or other private participants have competitive terms and not have the overall effect of giving a developer or another private party significant control over the Section 501(c)(3)’s governance or activities.

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Roles and Compensation of Developer and Other Private Parties

In a typical structure, a university may actually own the land on which the project will be built. In many instances, the university will lease this land to the Section 501(c)(3) entity under a long-term lease, the terms of which will cause the land and any improvements to revert to the university at the end of a 30- 35-year term after the bonds have been repaid. In some instances, this arrangement may instead be structured so that the college or university has an option to acquire the facility for a nominal price (*e.g.*, \$10) at that time or whenever sufficient funds are on hand to retire the outstanding debt. In some instances, the Section 501(c)(3) organization will enter into a development agreement with the developer to pay the developer a competitive fee in return for its development services relating to the facility. In other cases, the developer may develop and build the facility with its own funds or the proceeds of a taxable construction loan on a “turnkey” basis and then sell the facility to the Section 501(c)(3) corporation at a price not exceeding its appraised fair market value, with the 501(c)(3) corporation using the proceeds of the tax-exempt bonds to finance that purchase.

In a number of instances, the developer may have an affiliated contractor, who will build the facility and may also be affiliated with a management company which may manage the facility on behalf of the university through a qualifying management contract meeting Internal Revenue Service guidelines. In some instances, the 501(c)(3) entity will enter into some type of operational agreement with the college or university to operate the facility in accordance with the university’s policies. In some cases, the management company retained by the Section 501(c)(3) entity will lease units to the students; in others, the management company may take care of physical maintenance but the renting of units may be handled by the college or university. In other instances, the Section 501(c)(3) entity may lease the facility back to the college or university, which will retain control over the rental and/or physical management functions. In many of these financings, particularly those involving a management or operating agreement rather than a lease-back to the university, the university’s credit will not be pledged to repayment of the bonds; instead, the bonds will be supported by the pledge of the net operating income derived from the operation of the facility and a first deed of trust of the property, as further described below.

Of course, all of the foregoing arrangements with private parties for development, construction, management and other services must pass the customary requirements applicable in all Section 501(c)(3) bond financings that the fees paid to private parties be reasonable and competitive as compared to the prices which would be paid for such services in transactions not involving Section 501(c)(3) organizations and/or tax-exempt bond financing under Section 145 of the Code. Failure to satisfy these tests could result in a finding of “private inurement,” which could jeopardize both the Section 501(c)(3) status of the ownership entity and the tax-exempt status of any bonds issued to finance the facility. Moreover, the Service has recently taken the position that even in the absence of any such private inurement, the Section 501(c)(3) structure

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of the ownership entity and the tax-exempt status of related bonds may be jeopardized if there is a finding of “excess private benefit.” Such a finding may occur if the benefits to one or more private parties are determined, when taken as a whole, to be excessive when examined in relation to the charitable purpose served by the Section 501(c)(3) entity in the related bond financing. Thus, if a project is located far from campus, maintain rents very close to market, and does not appear to serve a critical college or university housing need, but benefits numerous private participants involved in the financing, the Service may determine that an “excess private benefit” is involved, even though all private participant fees are reasonable and competitive and there is no finding of “private inurement.”

Financial Structure and Rating Agency/Credit Enhancer Considerations

A student housing bond financing is typically structured as a 30-35 year fixed rate, level amortization bond issue, supported primarily by the net operating income from the facility. In the recent past, a number of these bond issues have been credit-enhanced by ACA, an A-rated credit enhancer, or by Ambac, a AAA-rated institution. While the major rating agencies are developing rating criteria for these financings, none have published specific program guidelines to date.

Both ACA and Ambac show a strong preference for housing owned by bankruptcy remote special purpose entities of the type described above and for projects located on or adjacent to the college campus. In most instances, it is anticipated that ownership of the project will revert to the affiliated college or university at the end of the bond term, as described above, and that all or substantially all of any surplus cash generated from the operation of the facility will be distributed to the college or university. Both entities may insist on separate construction phase credit enhancement (such as a bank letter of credit), or a separate construction loan, to isolate the bond issue from any risk of default during the construction phase. Typically, these issues are required to show at least 1.2 times debt service coverage after stabilized occupancy is achieved, but the credit enhancers do not impose any specific loan-to-value requirements. In most instances, the credit enhancers will require funding of a debt service reserve fund at closing in an amount equal to 12 months’ maximum annual debt service and will also impose specific requirements for the funding of a replacement reserve. A capitalized interest account will be required during the construction period.

Credit enhancement fees may range from 1.25% to 2.75% of the total debt service on the bonds and which can equal about 5 to 8% of the principal amount of the bonds. These fees are generally payable at closing, but can be financed within the bond issue. In most instances, there is no ongoing credit enhancement fee. As in any real estate financing, credit enhancers will require marketing studies and other evidence of strong housing demand, as well as environmental studies, a property condition report, an appraisal and other typical third-party reports.

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In some instances, it may be possible to place bonds without credit enhancement to institutional buyers, particularly if construction risk is covered through a letter of credit or other separate construction phase credit facility and the project financing benefits from related completion, payment and other guarantees during this phase.

Other Considerations

Developers, investment bankers and others who are active in student housing bond financings, generally advise that these financings are significantly more complex, varied and time consuming than a typical affordable or elderly housing bond financing. This is due in part to the very complex array of operating and capital program requirements to which most colleges and universities are subject, as well as to the complex political environment which surrounds the development and financing of these types of facilities on or adjacent to a modern college campus. For example, while students, parents, trustees, alumni and/or some college administrators may feel there is a substantial need for new, modernized housing facilities of the type described above in order to recruit and maintain students of the caliber the college or university seeks, officials in charge of the college's or university's existing housing may see the development of such facilities as a threat which will cannibalize the college's existing housing stock. University development officials, architects and others may also view the involvement of private parties in the development and ownership of these facilities on or adjacent to the campus as a threat to the functions they would otherwise perform. Concerns regarding job security and other factors may require more steps in the decision-making process than are encountered in many other multifamily housing bond financings projects and may require the building of more consensus and the imposition of longer delays than are experienced in the most developer-driven apartment financings. Finally, the development, construction and financing of any particular facility may trigger any number of system wide requirements to which a particular college or university is subject, and the Internal Revenue Service guidelines on these types of financings are perhaps more complex and restrictive than those for most affordable and/or seniors housing bond finance.

As a result, these financings are best undertaken by participants who have the background, skills and staying power to pursue extremely complex, lengthy financings of this type. However, where participants can be found that have these skills, the dramatic increase in demand for these facilities described at the outset of this article suggests that the marketplace will see substantial growth in the use of tax-exempt bonds for the financing of student housing facilities owned by Section 501(c)(3) corporations in the months and years ahead.