

MEMORANDUM

TO: University Borrowers

FROM: Office of Treasury Management
Craig McCurley, Deputy Director

RE: Debt Financing For Capital Projects

To obtain debt financing for capital projects, Treasury requires certain information in order to assure compliance with the rules relating to tax-exempt debt. This memo describes some of the items being requested and provides an understanding of why they are important.

The ability to use tax-exempt debt requires careful attention to the relevant tax rules concerning the uses of debt-financed property. The University, and in particular Treasury and the university-wide Debt Compliance Assurance Group, is committed to maintaining continued compliance with these rules.

Treasury may contact you with questions about the information provided in the loan application (within CAPS), and you should feel free to contact Treasury, as well. In certain circumstances, it may be appropriate to involve the Office of General Counsel or external bond counsel to gain a better understanding of the project.

As of October 2006, all loan applications are processed through the CAPS system. Treasury approves debt financing and determines the appropriate source of funding. Debt-specific questions about the CAPS forms should be addressed to Treasury. Specific questions about the CAPS form should be directed to the CAPS office (capsform@camail.harvard.edu).

Total Funding Sources for the Capital Project

Treasury needs to know all of the sources of funding for a capital project to ensure that a borrower does not raise funds to cover the costs of a project and simultaneously use tax-exempt debt to cover the same costs. Federal tax law restricts borrowers from using tax-exempt bond proceeds to replace other funds that have been raised and are restricted for the same purposes. This outcome can be avoided in two ways: (1) by specifically earmarking the uses of a gift for costs that are not expected to be debt financed or (2) by raising funds for a project in an unrestricted way so that they can be used to support operating costs of the facility and thereby free up other operating funds for paying debt service.

Debt Service Payment – Type of Fund(s) to be Used

The request to know what fund(s) a school or unit will use to pay debt service is due to concerns about arbitrage. Arbitrage occurs when a borrower invests funds that are used to pay for debt service at a higher yield than the interest rate paid on the debt. Generally, if funds are held outside of the General Operating Account (e.g., in the endowment), schools and units have the

opportunity to earn a greater return on those funds than the interest they are paying on their loans. In order to ensure compliance with this aspect of federal tax law, a school or unit should pay debt service from certain types of funds held in the GOA: unrestricted funds (undesignated or designated) only and unrestricted current use gift funds. More specifically, these funds include those in the ranges 000001, 000002, 000003-001999, 002000-054999, and 300000-301999.

Sponsored Research Activity – Funding Sources

Federal tax law generally requires that property financed by a nonprofit with tax-exempt bonds be owned by the nonprofit and used to further its charitable, educational or other exempt purposes. Only an insubstantial use of the property (generally 3%) may be for non-exempt, or private, business purposes. Such inappropriate usage includes use by persons other than the nonprofit for private business purposes and use of a Harvard facility or asset in an unrelated business activity. Use by state or local governments is considered appropriate, but use by the federal government can be deemed private business use.

When a university engages in privately-sponsored research in facilities or using assets financed with tax-exempt bonds, the Internal Revenue Service may view the arrangement as an indirect private business use of the facilities or assets by the sponsor. However, the IRS will not deem the conduct of such privately-sponsored research as inappropriate private business use under certain conditions. One such condition is when the research is considered “basic research” and the private sponsor has no rights to any resulting technology. Another is when the research is considered “basic research” and the private sponsor receives no more than a license to the results of the research activity for which a competitive arms-length rate is paid, determined at the time the technology becomes available for use.

Treasury would like to know whether sponsored research will be undertaken with the assets being financed and, if so, which funding sources are initially sponsoring the activity and the arrangements for use of the research product(s). Because funding sources can change over time, Treasury will also separately survey debt-financed projects that support research activity on an annual basis throughout the term of the loan to determine what sources are currently funding the research and under what arrangements.

Use and Management of a Project

Federal tax law also generally restricts the use of tax-exempt debt to fund assets that are used for activities that are not within the University’s general education and research mission and/or benefit external parties. This restriction also covers facilities operated by outside entities under certain contract arrangements. As a result, Treasury must know how and by whom a debt-financed project will be used and the structure of any management contracts in facilities proposed to be debt-financed. If the use or management of an asset change, schools and units should contact Treasury to discuss how to ensure continued compliance with the rules concerning tax-exempt debt.

Treasury also needs to know whether any portion of the debt-financed project will be leased to any non-University user. Such leases will generally give rise to private use, subject to a limited exception for leases to other 501(c)(3) entities that are affiliated with Harvard or whose use of the leased property directly advances Harvard's own tax-exempt purposes.

In addition, Treasury needs to know whether the space in which the project is being used is leased by the University. While the University is able to capitalize improvements to leased space regardless of whether the lease is a capital or operating lease, the term of the loan cannot extend beyond the termination date of the lease, and certain other requirements may apply.

Records Retention Policy With Respect to Tax-Exempt Debt

It is the policy of the University to comply with the applicable tax law relating to the retention of records with respect to tax-exempt debt. Current IRS policy requires that all records relating to tax-exempt debt shall be maintained for the life of the debt (or, in the event the debt issue is refunded by a subsequent issue, for the life of the subsequent issue) plus three years. This includes, but is not limited to all investment records, requisitions, information concerning private business use such as commercial sponsored research agreements, leases, and management agreements.

Any queries regarding this policy should be directed to Craig McCurley (Craig_Mccurley@harvard.edu or 617-495-1866) or Tom Balish (Thomas_Balish@harvard.edu or 617-495-4882).

Public Approvals

Treasury is not requesting information about public regulatory approvals in the CAPS system. In order to use tax-exempt debt, however, many projects must have regulatory approval from certain state agencies. Schools and units should seek this approval prior to the start of construction or an acquisition or they may jeopardize their ability to use tax-exempt financing. Each school and unit requesting the use of tax-exempt debt should contact the Public Approvals Unit within Harvard Planning + Allston Initiative to determine whether an individual project requires state approval and, if necessary, how to obtain it.

In addition, the process of issuing tax-exempt debt requires borrowers to provide specific information in public notices about certain projects for which schools and units wish to use tax-exempt debt. These projects typically include those that involve new construction or create additional gross square footage. If a project cannot be included in a public listing, it is ineligible for tax-exempt financing, and Treasury must find alternate sources of financing. Schools and units must coordinate with the Office of the Vice President for Government, Community and Public Affairs (VPGCPA) in order to ensure that projects can be announced publicly. Treasury, in turn, coordinates with VPGCPA to determine whether any given project can be included in the public notices.