

Qualified 501(c)(3) Bonds

Notice 2002-10

PURPOSE

This notice clarifies the application of §§ 145(a)(2) and 514 of the Internal Rev-

enue Code to the investment of gross proceeds of qualified 501(c)(3) bonds described in § 145.

BACKGROUND

Section 103(a) provides that, with certain exceptions, gross income does not include interest on any state or local bond. One type of bond that is eligible for the exclusion under § 103(a) is a qualified 501(c)(3) bond described in § 145 that satisfies certain requirements, including the requirements contained in § 148.

In general, a qualified 501(c)(3) bond is a bond at least 95 percent of the net proceeds of which are to be used by no person other than an organization described in § 501(c)(3) (a “501(c)(3) organization”) or a governmental unit. However, under § 145(a)(2), a bond is not a qualified 501(c)(3) bond if more than 5 percent of the net proceeds of the issue of which it is a part are to be used by a 501(c)(3) organization in an unrelated trade or business under § 513(a).

With certain exceptions, § 148 and the regulations thereunder prohibit the use of gross proceeds of an issue of qualified 501(c)(3) bonds to acquire investment property (as defined in § 148(b)) that produces a yield that materially exceeds the yield on the issue. Section 1.148-1(b) of the Income Tax Regulations defines “gross proceeds” to include, among other things, amounts received from the sale of the issue, amounts received from investing proceeds of the issue, and certain other amounts with a nexus to the issue.

Section 501(a) exempts 501(c)(3) organizations from federal income taxation. However, notwithstanding this general exemption, § 511(a) imposes a tax on the unrelated business taxable income, as defined in § 512, of 501(c)(3) organizations, including certain income from debt-financed property, as defined in § 514.

DISCUSSION

Questions have arisen regarding the application of §§ 145(a)(2) and 514 to the investment of gross proceeds of qualified 501(c)(3) bonds in a manner that complies with the requirements of § 148. This notice clarifies that the use of gross proceeds of an issue of qualified 501(c)(3) bonds to acquire investments (as defined in § 1.148-1) in a manner that complies

with § 148 does not constitute an unrelated trade or business for purposes of § 145(a)(2) and does not result in income from debt-financed property under § 514. This notice does not affect the determination of whether the use of property financed with expenditures of proceeds of bonds constitutes an unrelated trade or business for purposes of § 145(a)(2) or results in unrelated business taxable income under § 512.

DRAFTING INFORMATION

The principal authors of this notice are Charles P. Barrett of the Tax Exempt and Government Entities Division, Exempt Organizations, and Sunita Lough of the Tax Exempt and Government Entities Division, Tax Exempt Bonds. For further information regarding this notice, please contact Mr. Barrett at (202) 283-8944 (not a toll-free number) or Ms. Lough at (202) 283-9774 (not a toll-free call).