

ROBERT G. HUTCHINS - LEGAL BULLETINS

June 2006 - Securities Offerings by Non-Profit Organizations - Proof of Tax Exempt Status

Subject to various technical requirements, non-profit organizations devoted exclusively to charitable, educational, fraternal, religious or scientific purposes are exempt from federal taxation under Section 501(c)(3) of the Internal Revenue Code. Subject to similar requirements, the securities issued by these organizations are also exempt from registration under federal and state securities laws. The securities exemption can be an indispensable tool for the financing of extraordinary capital improvements or research projects. For example, churches with rapidly growing congregations regularly face capital costs for the expansion of their facilities that cannot be paid, except over time, from ordinary contributions. If a church cannot obtain an acceptable loan from a commercial or denominational lender, its only recourse may be to solicit capital from congregation members and other supporters who are already interested in its activities.

The resulting securities are comprised of debt instruments, such as building fund or property acquisition notes, that can be sold as a single issue or in series, and that usually bear fixed or variable interest at a rate comparable to the prevailing rate for municipal bonds. The notes can be secured by existing or project assets, or issued as general obligations, depending on the Church's financial position and the perceived tolerance for risk of its investors. Scientific organizations sometimes offer investment contracts conferring the right to exploit the organization's intellectual property, but these are negotiated transactions more akin to joint ventures than securities offerings.

The federal and Washington State securities exemptions for non-profit issuers are found, respectively, in Section 3.(a)(4) of the Securities Act of 1933 and RCW 21.20.310(11), a section of the Securities Act of Washington. For the most part, the two statutes frame the exemption in similar terms, i.e., the issuer must be organized on a non-profit basis exclusively for one or more of the prescribed purposes. The federal statute adds a limitation borrowed from the tax code to the effect that the assets of the issuer may not "inure to the benefit" of any private person. Washington imposes the same limitation obliquely by requiring that the organization be tax exempt. It then adds a supplementary requirement that the issuer file a "Notification of Claim of Exemption" with the Securities Division of its Department of Financial Institutions.¹

The Division does not review the issuer's disclosure to investors but "recommends" that the issuer conform to guidelines published by the North American Securities Administrators Association in its "Statement of Policy for Church Bond Offerings".² The Division does review

¹ Section 3.(a)(4) exempts "Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person ..." RCW 21.20.310(11) exempts "Any security issued by any person organized and operated as a nonprofit organization ... exclusively for religious, educational, fraternal, or charitable purposes *and which ...also possesses a current tax exempt status under the laws of the United States...*" (Emphasis added.)

² See, *Securities Act Interpretive Statement 07* adopted January 1, 1991 and available at www.dfi.wa.gov/sd/securitiesinterpretive.htm. The NASAA Policy referenced by the Division is actually captioned "Statement of Policy Regarding Church Bonds." A companion Policy covers "Church Extension Fund Securities," general obligation notes supported by a trust indenture and issued by a corporation organized by a sponsoring denomination. The note proceeds are reinvested in new loans to

the Notification of Claim of Exemption, which must specify “the terms of the offering.” The Division has up to 10 days to complete its review after which, in the absence of an order disallowing the exemption, the issuer is free to proceed.³

A separate requirement that the issuer possess tax exempt status might seem redundant since, given the common qualifications, a non-profit issuer entitled to an exemption for its securities would presumptively be exempt from taxation as well. Nevertheless, the Notification instructs the issuer to “**(i)nclude proof of current tax exempt status under the Internal Revenue Code**” and the Division has routinely assumed that “proof” means a favorable IRS determination letter.

The difficulty with that assumption is that nothing in the statute, the regulations, or the Division’s own interpretive or policy statements mentions a determination letter or explains what might otherwise be meant by “proof.” Determination letters are obtained by non-profit organizations to assure contributors that their gifts will be treated as deductible. Obtaining such a letter is not a prerequisite to tax exempt status for most churches, synagogues or temples, nor must those entities file informational tax returns on Forms 990 or 990-EZ.⁴

In short, for all that appears in Washington’s regulatory scheme, documentary “proof” of tax exempt status could be submitted in any form that would be admissible in a legal proceeding under applicable rules of evidence. An affidavit by a representative of the issuer accompanied by copies of the issuer’s organizational documents ought to suffice in most cases. Where the issuer engages in potentially controversial activities, e.g., sponsorship of a “get-out-the-vote” campaign that might be misconstrued as prohibited political activism, an explanatory affidavit submitted by a qualified tax expert familiar with the facts might also be necessary. In any case, nothing prevents the Division from rejecting proof reasonably deemed to be inadequate and that should satisfy the Washington statute.

I had occasion recently to make these arguments on behalf of a church that sought an exemption for its securities and filed an affidavit supporting its tax exempt status, but had not applied for a determination letter. To its credit, the Division responded by granting the exemption and is now considering whether it should publish anything to clarify matters. My own view is that an appropriate Interpretive Statement is necessary to clear the air. We shall see.

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provide a continuous source of financing for affiliated churches or other organizations. NASAA’s Policy Statements are available on its website at www.nasaa.org/corporation/finance.

³ RCW 21.20.310(11), supra, Note 1.

⁴ See, IRS Form 1023, “Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code.” The Form requires exhaustive narrative and financial disclosure that may be prohibitively complex, time consuming and expensive for smaller issuers.