Debt Profile

• Harvard is the 5th largest issuer of debt in higher education (1st among privates) as of fiscal year 2019
  – $5.2B debt outstanding as of 6/30/19

• As a 501(c)3 nonprofit institution we are afforded the privilege of issuing tax-exempt debt. Investors are not required to pay tax on tax-exempt debt, meaning they are willing to accept a lower interest rate.
  – Of our $5.2B in debt, 52% is tax-exempt and 48% is taxable

• The bad news is, we have to behave...

1. As of FY19 year-end
In order to retain the debt’s tax-exempt status we must document that all projects financed with tax-exempt debt support the University’s non-profit academic mission. Use not related to the University’s mission is referred to as “private business use (PBU)” or “bad use”.

• Limited amounts of PBU are permitted: IRS regulations stipulate that each individual tax-exempt bond series must maintain PBU levels below 5% (or 25% for certain debt series issued before 2003), averaged over the life of the bond series.

• Possible consequences of non-compliance are significant: Potential retroactive taxability on outstanding bond series (bondholder returns reduced, with Harvard liable for the difference)
Private Business Use (PBU)

Private business use typically occurs in the following categories:

<table>
<thead>
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<th>Category</th>
<th>Example</th>
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<tr>
<td><strong>Leases</strong> of bond-financed space to commercial entities or unaffiliated nonprofit entities</td>
<td>Starbucks rents retail space in a Harvard-owned building</td>
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<tr>
<td>Ongoing <strong>building management or service contracts</strong> with commercial entities regarding bond-financed space</td>
<td>Restaurant Associates manages the operations of a University Cafeteria</td>
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<tr>
<td><strong>Commercially sponsored research</strong> performed in bond-financed space</td>
<td>A pharmaceutical company sponsors faculty research</td>
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<td><strong>Unrelated business activities</strong> performed in bond-financed space (whether or not they give rise to “UBIT”)</td>
<td>The University receives revenue from cars unaffiliated with Harvard parking in its garages</td>
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<td><strong>Joint ventures</strong> with commercial entities using bond-financed space</td>
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<tr>
<td><strong>Naming rights</strong> with respect to bond-financed space granted to commercial entities</td>
<td>Pepsi Co. pays to change Harvard Stadium’s name to Pepsi Stadium</td>
</tr>
<tr>
<td>Use of bond-financed space for <strong>religious</strong> purposes (technically not private use, but restricted for other reasons)</td>
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In most circumstances a management or service contract involving bond-financed space will be assumed to constitute PBU unless it qualifies for the “safe harbor” of IRS Rev. Proc. 2017-13. To qualify for the safe harbor, very generally:

1) The compensation must be reasonable, and the agreement **must not provide the service provider with a share of the net profits (or losses) from the bond-financed property**

   “Share of net profits” has a special definition under the Revenue Procedure, and this is where issues most typically arise. For example, a contract that contains both revenue- and expense-based incentives is considered a net-profits contract and is ineligible for the safe harbor.

2) The term of the contract, including renewal options, must be no greater than the lesser of 30 years or 80% of the expected economic life of the managed property

3) The service provider must not have any role or relationship with the University that limits the University’s ability to exercise its rights under the contract (e.g. overlapping board of directors)

4) The University must exercise a significant degree of control over the use of the managed property, and the University must retain the risk of loss upon damage or destruction of the managed property

5) The service provider must agree that it will not take a tax position inconsistent with being a service provider (e.g., will not claim depreciation)

**Exclusions:** Service contracts that are “incidental” to the exempt uses of the facility are not treated as management contracts, and do not give rise to PBU. Examples include elevator maintenance, janitorial services, security services, office equipment repair, hospital billing services, routine IT support, and groundskeeping.*

*Outside of these examples, please do not assume that a contract is an “incidental” contract. Contracts should be submitted to OTM for review.*
In most circumstances an agreement will be assumed to constitute private use unless it qualifies for the “safe harbor” of IRS Rev. Proc. 2007-47. To qualify for the safe harbor, very generally:

1) The research must be “basic”: any original investigation for the advancement of scientific knowledge not having a commercial objective.

2) Transfer of any license or other use of the resulting technology to the sponsor is priced at fair market value, and fair market value is determined at the time the technology is available for use, not before.

*This area can be complex, and the Office of Technology Development (OTD) or OGC should be consulted on all commercially sponsored research agreements performed in bond-financed space.
Measuring Private Business Use

OTM measures University-wide private use to produce PBU percentages on a aggregate level for each individual bond series. In most cases a bond series will fund multiple projects across different schools/units. Therefore, PBU in excess of the limit in one space may be offset by lack of PBU in other spaces. Similarly, low PBU in one space does not necessarily mean the bond series is compliant, as there may be PBU elsewhere.

Measuring PBU is often a complex task. Elements of the analysis most commonly required include:

- Total amount of the bond series issued
- Gross/net square footage of space financed with tax-exempt debt
- Gross/net square footage of private business use space
- Time period over which PBU occurs

In buildings funded with a combination of tax-exempt debt and equity (anything other than tax-exempt debt), PBU can sometimes be first allocated to the equity funding

- For example, if building construction is funded 75% with tax-exempt debt and 25% with University reserves, up to 25% of the building’s square footage could be used for private business without driving PBU non-compliance for the tax-exempt debt.
Example 1: Leases & Space Rentals

**Situation:** A commercial or unrelated nonprofit entity enters into a lease (or sub-lease) for bond-financed space owned by the University, or rents bond-financed space for an event.

**Example:** Starbucks rents retail space in Harvard-owned building.

**Elements of Analysis:**

- % of building space occupied by Starbucks: 10%
- % of building costs financed with tax-exempt debt: 95%

**PBU Calculation for this Lease:**

- For individual years during the lease period: 10% – (100%-95%) = 5%

*Note: The economic value of the lease contracts is not a determining factor. For example, a below-market lease to Starbucks would not change the private use analysis.*
Example 2: Management and Service Contracts

**Situation:** A commercial enterprise enters into a management or service contract related to University-owned bond-financed facilities that does not qualify for the safe harbors described on slide 5 and is not an “incidental use” described on slide 5

**Example:** Restaurant Associates manages the operations of a University Cafeteria

**Elements of Analysis Include:**
- % of building space occupied by cafeteria: 20%
- % of building costs financed with tax-exempt debt: 90%

**PBU Calculation for this Management Contract:**
- For individual years during the lease period: 20% – (100%-90%) = 10%
Example 3: Commercially Sponsored Research

Situation: A for-profit corporation enters into a research agreement with a University principal investigator performed in bond-financed space that does not qualify for the safe harbor described on page 6

Example: A pharmaceutical company sponsors faculty research

Elements of Analysis Include:
- % of building space occupied by research activities: 20%
- % of building costs financed with tax-exempt debt: 90%
- Agreement as % of researchers total sponsored portfolio¹: 50%

PBU Calculation for this Sponsored Research Agreement:
- For individual years during the lease period: \((20\% - (100\%-90\%)) \times 50\% = 5\%\)

Note 1: either measured by agreement revenue divided by total PI revenue or agreement-related expense divided by total PI expense
Demonstrating Tax-Exempt Debt Compliance

Over the life of each tax-exempt bond series we must:

• Allocate at least 95% of bond proceeds to support the University’s core academic, teaching, and research mission (i.e. limit any PBU to 5% or less of the total bond proceeds)

• Monitor the use of space and equipment financed with tax-exempt debt for the life of the debt series, and retain relevant records in accordance with IRS regulations.
  – Records must be retained for the life of the bond series and any refinancing series, plus three years

• Report private use levels on Form 990, Schedule K of our annual tax filing
Responsibilities of the Schools/Units

- Work with OTM and/or OGC before entering into agreements that may constitute private use.

- Collect and submit the following, both at the time of the initial transaction/agreement, and on an ongoing basis for the life of the tax-exempt debt:
  - Relevant contracts (leases, management or service contracts, joint venture agreements, etc.) and details on spaces impacted by those contracts (for all spaces, not just those financed with tax-exempt debt)

- Comply with OTM’s annual debt compliance data collection process:
  - Annual survey on space usage, leases, management contracts, etc.
  - Various other specific requests of certain departments with knowledge private use components (e.g. commercially sponsored research data)