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**WISCONSIN HEALTH AND
EDUCATIONAL FACILITIES
AUTHORITY**

**10TH ANNUAL
INSIGHTS INTO CAPITAL
FINANCE**

***Recent Tax Development
and
Post-Issuance Compliance***

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RECENT TAX DEVELOPMENTS AND POST-ISSUANCE COMPLIANCE

I. RECENT DEVELOPMENTS.

IRS Enforcement Initiatives: In 2006 the IRS launched the first stage of an enforcement initiative targeting tax-exempt bonds issued on behalf of 501(c)(3) organizations, particularly hospitals and other health care organizations. The IRS selected bonds issued in the last half of 1997 and in 1998 for examination of post-issuance compliance with federal regulations, including use of tax-exempt bond financed facilities, change of use of financed facilities and maintenance of an organization's 501(c)(3) status. The second stage of the initiative was launched in 2007 and will review a larger pool of bond issues for post-issuance compliance. The second stage initiative may commence with a detailed written inquiry by the IRS and may not rise to the level of a formal examination unless the responses to the initial inquiry cause it to be concerned about post-issuance compliance by an organization.

IRS Final Private Activity Bond Regulations for Refunding Bonds: On December 16, 2005, the IRS issued final regulations that provide guidance regarding the application of the private activity bond tests to refunding bonds. The final regulations generally apply to bonds sold on or after February 17, 2006 and affect the measurement of private use of bond financed facilities in a refunding. Prior to such final regulations, there was no specific guidance as to how the private activity bonds tests were to be applied in connection with a refunding of tax-exempt bonds. In the absence of guidance, the private activity bond tests (including private use of financed property) were applied at the time of refunding to the refunding bonds on a going forward basis, and thus there was no need to demonstrate past compliance with the private activity bond tests for the bonds to be refunded. Under the new regulations, in general, with respect to 501(c)(3) bonds, the private activity bonds tests are generally applied to a combined measurement period, so that the measurement period begins on the issue date of the refunded bond or the date the facility financed with the proceeds of such bond is placed in service, whichever is later, and ends on the date the refunding bonds are retired.

II. OVERVIEW OF PRIVATE ACTIVITY BONDS AND QUALIFIED 501(C)(3) BONDS.

Private Activity Bonds: Bonds are private activity bonds if they meet either (a) the private business use test and the private security or payments tests of §141(b) of the Internal Revenue Code of 1986, as amended (the "Code"), or (b) the private loan finance test of §141(c) of the Code.

- *Private Business Use Test.* This test is met if more than 10% of the proceeds (5% of the net proceeds in the case of qualified 501(c)(3) bonds) of the bonds is used, directly or indirectly, in a trade or business carried on by any person other than a governmental person.
- *Private Security or Payments Test.* These tests are met if the payment of the principal or interest on more than 10% of the proceeds (5% of the net proceeds in the case of

qualified 501(c)(3) bonds) of the bond issue is directly or indirectly (i) secured by property used or to be used for a private business use or payments in respect of such property or (ii) to be derived from payments in respect of property used for a private business use.

- *Private Loan Finance Test.* This test is met if more than the lesser of \$5 million or 5% of the proceeds of the bonds are to be used to make or finance loans to persons other than governmental units.

Qualified Private Activity Bonds: The interest on private activity bonds is not excludable from federal gross income under §103(a) of the Code, unless it is a “*qualified private activity bond.*” Qualified private activity bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are used for a defined qualified purpose by an entity other than the government issuing the bonds. Such an entity is referred to as a “conduit borrower.” For a private activity bond to be tax-exempt, 95% or more of the net bond proceeds must be used for one of the qualified purposes set forth in §§142-145 of the Code. §141(e)(1)(G) provides that “*qualified 501(c)(3) bonds*” are qualified bonds.

Qualified 501(c)(3) Bonds: Bonds issued on behalf of a 501(c)(3) organization would constitute private activity bonds on which the interest would be subject to federal income taxation if there was no exception for “*qualified 501(c)(3) bonds.*” Qualified 501(c)(3) bonds must meet a number of requirements of §145 of the Code in order for the interest on such bonds to be excludable from federal income tax. Two of the tests are the ownership test and the 95% test (there are also other requirements which are not enumerated below).

- *Ownership Test.* §145(a)(1) of the Code provides that 100% of the property financed by the net proceeds of a qualified 501(c)(3) bond issue must be owned by either a 501(c)(3) organization or a governmental entity. *No part of the property financed may be owned by a private business.* This requirement applies for the entire life of the bonds. The sale of bond-financed property to a private business during the term of the bonds or the loss of status as a 501(c)(3) organization by the owner would violate this requirement. Problems with the ownership test could arise in connection with (1) facilities to be owned by joint ventures or partnerships consisting of more than one 501(c)(3) organization, (2) ownership by limited liability corporations under certain circumstances and (3) financing of leasehold improvements.
- *95% Test.* §145(a)(2) of the Code contains the 95% requirement for qualified 501(c)(3) bonds. This section modifies the requirements of the private business use test and the private security or payment test of §§141(b)(1) and (2) of the Code for purposes of determining whether a 501(c)(3) bond is a qualified private activity bond:
 - ✓ the 10% thresholds for private business use and private security are changed to 5% and
 - ✓ the 5% threshold is applied against “*net proceeds*” (proceeds of the issue less amounts invested in a reasonably required reserve or replacement fund) rather than “*proceeds*” and

- ✓ 501(c)(3) organizations are treated as “governmental units” only with respect to their exempt activities, but not with respect to activities unrelated to their exempt status.

The interest on a 501(c)(3) bond issue is not tax-exempt if it meets *both* the modified private business use test *and* the modified private payment or security test, or if it meets the private loan finance test. For purposes of applying these tests, the 501(c)(3) organization is treated as a state or local governmental entity to the extent that the use of the proceeds is not considered an “unrelated trade or business use.”

The foregoing rules are complicated, and thus the generally accepted approach is to (i) prohibit the 501(c)(3) organization from loaning the bond proceeds to another entity so that the private loan finance test is not met and (ii) ensure that the private business use test is not met by restricting private business use to less than 5% of the net proceeds of the bonds. *This limits post-issuance compliance to tracking the amount of any private business use for each year and keeping the maximum private use below the 5% limit in order to simplify the demonstration of compliance with the regulations.*

III. PRIVATE BUSINESS USE:

The private business use test for 501(c)(3) bonds is met if more than 5% of the net proceeds of the bonds is used in a trade or business carried on by a nongovernmental entity. A 501(c)(3) organization is treated as a governmental entity to the extent that the use of the proceeds is not considered an “unrelated trade or business use” for the organization. Private use counted against the allowable 5% includes:

- the amount of bond proceeds used for costs of issuance;
- direct or indirect use of bond proceeds or bond-financed property by a 501(c)(3) organization in an unrelated trade or business (determined in accordance with §513(a) of the Code) and
- direct or indirect use of proceeds or bond-financed property by a *nongovernmental person*, other than by a 501(c)(3) organization within the scope of its exempt purposes (i.e. for profit entity).

Relationships that can give rise to private business use of bond-financed property include:

- sale of financed property;
- leases of financed property (the duration of the lease does not affect whether or not private use arises);
- nonqualifying management or other service contracts with respect to all or a portion of financed property (IRS Rev. Proc. 97-13; see attached summary);
- nonqualifying research arrangements that relate to the financed property (IRS Rev. Proc. 97-14);

- loan of bond proceeds by the conduit borrower;
- use of bond-financed property by limited liability corporations, joint ventures and partnerships under certain circumstances;
- grant of certain legal entitlements for the beneficial use of the financed property.

In general, private business use does not include (i) use as a member of the general public, (ii) certain arrangements pursuant to which the use by a nongovernmental person does not exceed 100 days or 50 days, depending upon the circumstances, (iii) temporary use by a developer, (iv) certain nonpossessory uses that do not exceed 2.5% if not functionally related to some other use of the facility by the same person, (v) contracts for services incidental to a facility's primary function (janitorial, hospital billing) and (vi) granting of hospital admitting privileges to a doctor as long as such privileges are available to all qualified physicians in the area.

Specific examples of private use of bond-financed property:

- ✓ sale of a nursing home facility by a hospital to a for profit entity;
- ✓ lease of space for a bookstore in a student union either (i) to a for profit entity or (ii) to a 501(c)(3) organization if it generates unrelated trade or business income to the 501(c)(3);
- ✓ lease of space in a hospital for a gift shop either (i) to a for profit entity or (ii) to a 501(c)(3) organization if it generates unrelated trade or business income to the 501(c)(3);
- ✓ allowing a for profit beauty salon operator to use space in an assisted-living facility to provide services to residents (regardless of whether the salon operator pays for the use of such space);
- ✓ allowing Starbucks or Subway to use a portion of a hospital facility or college for its retail establishment;
- ✓ a contract with a for profit entity to provide food service for students on a college campus, for residents of an assisted-living facility, for patients in a hospital or nursing home if such contract is not a qualifying contract under IRS Rev. Proc. 97-13;
- ✓ use of a portion of a medical office building/clinic by for profit doctors;
- ✓ sharing of a parking facility with a medical office building used by for profit doctors or retail facility;
- ✓ contracts that do not qualify under IRS Rev. Proc. 97-13 for the provision of services by for profit entities to a hospital, such as radiology, anesthesiology, ER, physical therapy, cardiology, etc. or
- ✓ research in a hospital, research or educational facility sponsored by a for profit entity to test or support such sponsor's product.

IV. POST-ISSUANCE COMPLIANCE REGARDING PRIVATE USE.

Why Necessary:

- in order to maintain tax-exempt status of bonds;
- may be able to avoid IRS formal examination of bonds if post-issuance compliance procedures are in place;
- may not be able to refund bonds if adequate records are not available or if private use limitations have been exceeded.

Compliance Should Include:

- ✓ designate a person or persons to be responsible for compliance;
- ✓ maintain copies of all records after the project is complete to show how bond proceeds, including investment proceeds, were actually spent, when the assets were placed in service and remaining useful lives;
- ✓ maintain records as to the amount and use of equity contributions to a project;
- ✓ monitor amount of use of financed facilities; restrict personnel from entering into any type of use arrangement without the approval of someone qualified (i.e. trained compliance officer, in-house legal counsel, outside legal counsel) to determine whether such use will constitute private use and the measurement of such private use;
- ✓ keep copies of all records on expenditures of bond proceeds, investments of bond proceeds, rebate, and private use contracts, leases, etc. until 3 years after the bonds (or the bonds refunding such bonds) have been retired (this includes use of facilities that have been refunded);
- ✓ keep track of the ownership of all bond-financed property; do not allow the sale of any bond-financed property without first consulting with qualified legal counsel to ensure that the change of use requirements of the federal regulations, as well as applicable bond financing documents, have been complied with;
- ✓ maintenance of 501(c)(3) status compliance.

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Summary of Revenue Procedure 97-13

Generally, under the Rev. Proc. 97-13, the provisions of services at bond-financed facilities by private persons or businesses will not constitute private business use if:

- the method or formula for compensation falls within one of the various defined categories or combinations of such categories described in the table below;
- compensation for services rendered under the contract is reasonable and is not based, in whole or in part, on net profits from the operation of the bond-financed property;
- depending on the compensation method, the term of the contract, including applicable Renewal Options (which does not include automatic rollovers absent termination by one party or the other) does not exceed, and the contract may be terminated without penalty or cause as set forth in the table below.

No compensation may be based, in whole or in part, on a share of the net profits. A “productivity reward” equal to a stated dollar amount based on increases in revenues or decreases in expenses (but not both) does not cause compensation to be based on net profits.

No circumstances may exist which limit the qualified user’s ability to exercise its rights, including cancellation rights. *Safe Harbor*: This requirement is met if not more than 20% of the voting power of the governing body of the qualified user if vested in the service provider or its directors, officers, shareholders and employees, the overlapping board members do not include the CEO of the service provider or its governing body or the qualified user or its governing body and the qualified user and service provider are not related persons.

- 501(c)(3) may hold more than 20% of voting power of service provider’s board
- but service provider may not hold more than 20% of voting power of 501(c)(3)’s board
- overlapping board members may not include CEO-s or board chairpersons
- entities cannot be members of same “controlled group” or be “related persons.”

Definitions:

“*Adjusted Gross Revenues*” means gross revenues less allowances for bad debts and contractual and similar allowances.

“*Capitation Fee*” means a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially.

“*Periodic Fixed Fee*” means a stated dollar amount for services rendered for a specified period of time.

“*Per-Unit Fee*” means a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. Separate billing arrangements between physicians and hospitals generally are treated as Per-Unit Fee arrangements.

Compensation Fee Structure	Contract Terms
95% Periodic Fixed Fee	Including all Renewal Options, the lesser of (i) 80% of the reasonably expected useful life of the financed property and (ii) 15 years. One-time incentive award under which compensation automatically increases if a revenue or expense target is met does not cause this test to be failed if the award is a single, stated dollar amount.
80% Periodic Fixed Fee	Including all Renewal Options, the lesser of (i) 80% of the reasonably expected useful life of the financed property and (ii) 10 years. One-time incentive award under which compensation automatically increases if a revenue or expense target is met does not cause this test to be failed if the award is a single, stated dollar amount.
Either (i) 50% Periodic Fixed Fee or (ii) capitation fee or (iii) a combination of a Capitation Fee and a Periodic Fixed Fee	Including all Renewal Options, not more than 5 years, terminable by the qualified user without penalty or cause at the end of the 3 rd year.
Either (i) Per Unit Fee or (ii) a combination of a Per Unit Fee and a Periodic Fixed Fee.	Including all Renewal Options, not more than 3 years, terminable by the qualified user without penalty or cause at the end of the 2 nd year.
Either (i) a percentage of fees charged or (ii) a combination of a Per Unit Fee and a percentage of revenues or expenses or (iii) during a start-up period, a percentage of gross revenues, Adjusted Gross Revenues or expenses.	Including Renewal Options, 2 years, terminable by the qualified user without penalty or cause at the end of the 1 st year. These terms are available only for contracts under which the service provider generally provides services to third parties (for example, radiology services to patients) and management contracts involving a facility during an initial start-up period.

Rev. Proc. 97-13 does not provide a safe harbor for the granting of any ownership or leasehold interest in bond financed property.