I. ELEMENTS OF TAX-EXEMPT REVENUE BONDS

A. *Revenue Bonds, generally.* A bond issued by a governmental agency (the “Issuer”), but payable solely from loan or lease payments received by the Issuer from the borrower (the “Borrower”). The Issuer normally has no liability for debt service on the bonds except to the extent of payments received from the Borrower.

B. *Governmental Purpose.* Revenue bonds are usually issued for economic development, housing, and cultural, health and educational facilities.

C. *Source of Payment.* Payments from the Borrower are typically assigned directly to the bond trustee with those payments held in trust for distribution to the bondholders. Payments can be secured by a mortgage of the Borrower’s real property and/or receivables/gross revenues. Payments may also be secured by letters of credit, bond insurance and/or reserves.

D. *Interest.* Interest on tax-exempt revenue bonds is excluded from the gross income of the bondholder for federal income tax purposes (and state income tax purposes in many states).

II. DOCUMENTATION

A. *Bond Indenture.* A trust agreement between the Issuer and a bank, which acts as bond trustee. The Issuer grants and pledges to the bond trustee, in trust for the benefit of the bondholders, the loan repayments and any other revenues or assets pledged by the Borrower for the repayment of the bonds. Issuer assigns the loan repayments, and most of its rights against the Borrower, to the bond trustee in the bond indenture or in a separate assignment agreement.

B. *Loan Agreement.* A loan agreement between the Issuer and the Borrower. Issuer loans the proceeds of the sale of the bonds to the Borrower; and the Borrower agrees to make repayments at the same time and in the same amount as the payment of principal and interest on the bonds (as well as indemnify the Issuer against any other cost or expense associated with the bonds).
C. **Continuing Disclosure Undertaking.** Often a one-party agreement. Borrower agrees to provide to bondholders annual and quarterly financial information, including performance ratios and management’s discussion and analysis. Financial information is provided to bondholders by posting the information on the Municipal Securities Rulemaking Board’s EMMA website.

D. **Tax Agreement.** Agreement among Borrower, bond trustee and Issuer pursuant to which Borrower makes certain representations (e.g., ownership of bond-financed facilities) and covenants (e.g. restrictions on use) in order to establish basis for tax-exempt status of bonds; and the bond trustee and Issuer agree to cooperate with the Borrower in maintaining such status.

E. **Bond Purchase Agreement.** Agreement between Issuer and underwriter in which the underwriter agrees to purchase the bonds upon issuance. Borrower is either a party to the Bond Purchase Agreement for purposes of making certain representations and warranties regarding its status and intended use of the bond proceeds, or it delivers a separate representation letter to the Issuer and underwriter.

F. **Official Statement, including Appendix A.** A comprehensive disclosure document, distributed to potential investors, describing the structure of the bonds, the nature of the security and other relevant features.

   (1) The body of the Official Statement includes description of the plan of finance, the structure of the bonds, the security, the tax status of the bonds and a long description of the risks inherent in investing in bonds backed by healthcare providers. The body of the Official Statement is typically prepared by the underwriter’s counsel or separate disclosure counsel to the Borrower.

   (2) “Appendix A” is a comprehensive description of the Borrower, including a description of its facilities, short profiles of its management team, financial information and utilization statistics, and a management discussion and analysis section. Appendix A is prepared by Borrower’s counsel or separate disclosure counsel to the Borrower.

   (3) “Appendix B” is a copy of the Borrower’s audited financial statements for the three most-recent years.

   (4) Other appendices include the form of bond counsel opinion (i.e., an unqualified legal opinion as to the tax-exempt status of the bonds), summary of the terms of the bond indenture, loan agreement, master trust indenture and continuing disclosure undertaking, form of letter of credit or bond insurance policy, if any, and summary financial statements for letter of credit bank or bond insurance company, if any.

G. **Master Trust Indenture.** A security and intercreditor agreement between the Borrower and a bank, acting as master trustee. The Borrower pledges certain
assets (typically, its gross revenues) to secure payment on “obligations” issued to guarantee or secure indebtedness; and makes certain financial covenants (e.g., maintenance of a certain level of “days cash on hand” or “debt service coverage ratio”). A master trust indenture may also “pool” the credit of multiple nonprofit operating entities that are under common control.

(1) Master Indenture tries to consolidate all financial covenants into a single document that is then used for each bond issue.

(a) Financial covenants try to provide security necessary to market the bonds to potential buyers. Examples of common covenants are restrictions on incurring additional debt unless minimum debt service coverage ratios are met, restrictions on transferring property outside of group, restrictions on placing liens on certain property, restrictions on mergers.

(b) Benefits:

(i) Provides single set of financial covenants; no need to renegotiate for each succeeding bond issue. (Not always the result as bond insurers or liquidity banks may ask for additional covenants or what the “market” will require from a particular credit may change.)

(ii) By “pooling” the entities into a single credit, you have the potential for increasing the creditworthiness of the group as a whole and decrease borrowing costs.

(2) Master Indenture also operates as an intercreditor agreement, allowing various creditors secured by the Master Indenture to share on a pro rata basis in collateral subject to the Master Indenture (e.g., revenues or mortgaged facilities). This avoids relegating future creditors to subordinate or junior lien status.

(3) Issues raised by Master Indenture structure.

(a) Fraudulent conveyance/bankruptcy issues – if one group member must pay debt service on indebtedness from which it received no benefit, transfer may be voidable under bankruptcy law or treated as fraudulent conveyance.

(b) Violation of “public charity” doctrines – possibility of reluctance of court to enforce joint and several obligation if the corporation is not able to carry out its charitable purposes or if it’s insolvent because it was forced to pay debt service for another member’s debt.
(4) “Corporate Style” Master Indentures. Limited financial covenants and remaining covenants are tested based on the financials of the “System” (i.e. all of the entities that are controlled directly or indirectly by the primary borrower).

III. BASIC REQUIREMENTS OF SECTION 145.

A. Section 145(a)(1): Ownership requirement. All property to be financed must be owned by a Section 501(c)(3) organization or a governmental unit. Distinguish from 95% use requirement discussed in II.C. below.

1. What are the requirements to be a Section 501(c)(3) organization?

   a. General Rule:

      i. The organization must:

         a) Be organized and operated exclusively for exempt purposes (No Private Benefit);

         b) Permit no part of its net earnings to inure to the benefit of any private shareholders or individuals (essentially “insiders” (i.e., those in a position of significant influence or control, such as officers and directors)) or other private parties other than members of charitable classes of persons (No Private Inurement);

         c) Not engage in substantial lobbying activity; and

         d) Not engage in any political campaign activity.

   b. Evidence of 501(c)(3) status:

      i. A determination letter issued by the IRS in response to the filing of a Form 1023 application; or

      ii. Participation in a group ruling (e.g., many hospitals operated by Catholic order and certain housing organizations). For organizations created since 1969, filing Form 1023 or similar application for inclusion in a group ruling is a requirement for exempt status.

B. Section 145(a)(2): Use Requirement.

1. At least 95% of net proceeds (i.e., net of debt service reserve fund but including certain earnings on the investment of bond proceeds) must be
used only by Section 501(c)(3) organizations engaged in exempt activities, or by governmental units.

(a) **Use of property equals use of proceeds.** Multiple uses of the same property must be allocated.

(b) Costs of issuance count against the 5% “bad money” limitation.

(2) Use by a Section 501(c)(3) organization engaged in an “unrelated trade or business” (without regard to whether the Unrelated Business Income Tax (“UBIT”) tax applies) is not a “good” use, so it counts towards the 5% “bad money” limitation together with other private use.

(a) An activity will be characterized as an “unrelated trade or business” if it is:

(i) A trade or business;

(ii) Regularly carried on; and

(iii) There is no substantial causal relationship to furthering the organization’s exempt purposes (merely raising income to support exempt purposes is not a substantial causal relationship).

See Section 513(a) of the Code.

(b) “Unrelated trade or business” does not include:

(i) Activities conducted by the organization primarily for the convenience of the organization’s members, students, patients, officers or employees (e.g., hospital gift shop, cafeteria, campus bookstore).

(ii) Activities in which substantially all the work in carrying on the trade or business is performed for the organization without compensation.

(iii) The selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

(c) Common unrelated trade or business includes:

(i) Hospital lab work or pharmacy sales to persons who are neither patients nor employees of the hospital.
A Section 501(c)(3) organization that provides administrative or other support services to unrelated Section 501(c)(3) organizations or to its for-profit affiliates.

(iii) Rental of museum or school facilities after hours for private events.

(iv) Operation of a parking lot open to the public or open during hours that the exempt organization is closed.

(3) Common types of “use” include leases (note that both lessee and lessor are users), management contracts, “other” service agreements, and cooperative research agreements.

C. **Section 145(c):** A qualified hospital bond is a bond at least 95% of the proceeds of which are used with respect to a “hospital”.

(1) The term “hospital” includes a facility that primarily provides to inpatients diagnostic and therapeutic services or treatments by or under the care of physicians.

(2) The facility must be accredited by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO), the American Osteopathic Association, or a governmental program recognized by the Secretary of Health and Human Services.

(3) The facility must require that every patient be under the care and supervision of a physician, and must provide 24-hour nursing services.

(4) The term “hospital” does not include nursing homes, day care centers, medical school facilities, research laboratories, or most free-standing ambulatory care centers (unless they are totally integrated with and assist the in-patient hospital).

**IV. OTHER TAX REQUIREMENTS**

A. As a type of private activity bond, qualified 501(c)(3) bonds must comply with:

(1) Section 147(b) maturity limits (120% of average remaining useful life).

(2) Section 147(e) prohibitions against financing airplanes, skyboxes, gambling facilities, and liquor stores. Section 147(e) also generally prohibits the financing of health club facilities with private activity bonds, but Section 147(h)(2) excludes qualified 501(c)(3) bonds from this prohibition.

(3) Section 147(f) notice and public approval requirements (aka “TEFRA” requirements).
Section 147(g) limit on costs of issuance (“2% rule”).

V. ISSUES ARISING IN CONNECTION WITH PRIVATE USE OF BOND FINANCED PROPERTY

A. General. "Private business use" is only generally defined in the Code. Pursuant to applicable Treasury Regulations, private business use generally arises only if a nongovernmental person has special legal entitlements to use bond-financed property under one of the following types of arrangements:

1. Ownership;
2. Lease;
3. Management or service contract (safe harbors available);
4. Research agreements (safe harbors available); or
5. Comparable arrangements.

B. Management Contracts. Under the applicable Treasury Regulations, a management contract is a management, service, or incentive payment contract between the exempt person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. A management contract does not include a contract for services solely incidental to the primary functions of a financed facility (e.g., janitorial, office equipment repair, hospital billing, or similar services), the mere granting of admitting privileges by a hospital to a doctor, or a contract to provide for services if the only compensation is the reimbursement of the service provider for actual and direct expenses paid to unrelated third parties. In addition, although structured as a management contract, an arrangement may also be characterized as a lease under federal income tax principles, and thus would result in private use regardless of the form of compensation.

1. Safe Harbors: Generally, a management contract will not result in private use if it meets certain term and termination limits, based on the form of compensation chosen. A management contract will result in private use if compensation is based, in whole or in part, on a share of net profits from the operation of the facility. Rev. Proc. 97-13 sets forth safe harbors where private use will not be found.

2. Under Rev. Proc. 97-13, in order to meet the safe harbors, the service provider must not be in a position to substantially limit the borrower’s ability to exercise its rights under the contract because of its role or relationship with the borrower. A provision in the Rev. Proc. establishes that there is no such substantial limitation if (1) the service provider and its officers and directors do not have more than 20% of the voting power of the governing body of the exempt person (2) overlapping board
members do not include the CEOs, and (3) the service provider and the exempt person are not related parties.

(3) Compensation must be reasonable and must not be based on a percentage of net profit. The following are not considered arrangements based on net profit: (1) a percentage of gross revenues or a percentage of expenses, but not both; (2) a capitation fee (a fixed fee per person, regardless of services performed); or (3) a per-unit fee (a fixed fee based on the service provided). In addition, a one-time productivity award based on increases or decreases in gross revenues or total expenses (but not both) does not cause compensation to be treated as based on a percentage of net income.

(4) Length of contract term depends on the type of compensation. Longer term contracts are permitted where the relative portion of fixed compensation is increased: generally, if compensation is (1) 95% fixed, the term can be up to 15 years (or 80% of useful life, if shorter); (2) 80% fixed, up to 10 years (or 80% of useful life, if shorter); (3) 50% fixed fee, or all based on a capitation fee, or a combination of capitation fee and fixed fee, up to 5 years, as long as the exempt user has the right to cancel without penalty or cause at the end of the third year; (4) all based on per-unit fee, or a combination of fixed fee and per-unit fee, up to 3 years, as long as the exempt user has the right to cancel without penalty or cause at the end of the second year; and (5) all based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee, up to 2 years, as long as the exempt user has the right to cancel without penalty or cause at the end of the first year.

(5) Renewal options solely in the hands of the exempt user are not counted in determining the term of the contract. Additionally, automatic renewal provisions subject to cancellation by either party are also not counted. Other renewal options count toward the maximum term of the contract.

(6) Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated third parties is not by itself treated as compensation. How should expenses (i.e., salary and benefits) of service provider’s employees be treated?

(7) Contractual arrangements between 501(c)(3) organizations and service providers are constantly evolving, and in many instances Rev. Proc. 97-13 seems outdated. The IRS for several years announced an intention to update Rev. Proc. 97-13 and interested organizations have submitted suggested changes. To date, no changes have been made to this Rev. Proc.

C. Research Agreements. Governed by Rev. Proc. 2007-47 (formerly Rev. Proc. 97-14). The issue is whether the business (or federal governmental) entity that provides the funding for (or sponsors) the research gets particular benefits from
the research. This is an issue primarily for universities and specialty healthcare facilities such as cancer centers.

(1) Safe harbor for corporate-sponsored research: Generally, a research agreement relating to property used for corporate sponsored basic research will not result in private use if any license or other use of resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by an unrelated, non-sponsoring party, i.e., the sponsor must pay a competitive price for its use. The price paid for that use must be determined at the time the license or other resulting technology is available for use, not at the outset. The recipient need not permit persons other than the sponsor to use any license or other resulting technology, but the price paid by the sponsor must be a competitive price.

(2) Safe harbor for cooperative research agreements: Generally, a research agreement relating to property used under a joint industry-governmental cooperative research arrangement will not result in private use if (a) a single sponsor agrees, or multiple sponsors agree, to fund governmentally performed basic research (or basic research performed by a Section 501(c)(3) organization within its exempt purpose); (b) the research to be performed and the manner in which it is to be performed, e.g., selection of the personnel to perform the research, is determined by the qualified user; (c) title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user; and (d) sponsors are entitled to no more than a non-exclusive, royalty-free license to use the product of any of that research. The rights of the federal government and its agencies under the Bayh-Dole Act will not cause a research agreement to result in private business use, provided that the license granted to any party other than the qualified user to use the product of the research is no more than a non-exclusive, royalty-free license and the requirements of (b) and (c) above are met.

(3) Note that Rev. Proc. 2007-47 covers research agreements for basic research, which is defined as "any original investigation for the advancement of scientific knowledge not having a specific commercial objective." Thus, under Rev. Proc. 2007-47, the testing of a product of a private company is not basic research and would not be analyzed under the safe harbors of Rev. Proc. 2007-47. This may provide helpful guidance relating to the question that comes up from time to time in which a 501(c)(3) health care provider performs clinical testing services on a cost reimbursement or per-unit basis for a for-profit corporation. However, research activities that are paid for by for-profit entities and that do not relate to basic research must not run afoul of the facts and circumstances test under Treas. Reg. 1.141-3(b)(6)(i) and must not constitute unrelated trade or business.
D. Joint Operating Agreements and Other Joint Ventures. Joint venture activity involving 501(c)(3) organizations can raise challenging questions, including whether joint venture (either with another non-profit entity or with a for-profit entity) will affect the tax-exempt status of the 501(c)(3) organization or their bonds.

The Service has provided guidance in various private letter rulings. See PLRs 9609012, 9623011-13, 9839016 and 199929041. In circumstances in which the joint venture is a partnership made up only of 501(c)(3) organizations and none of these organizations' involvement in the venture constitutes an unrelated trade or business, the Service has concluded that the partnership deemed to be created by the joint operating agreement could be effectively ignored by treating it as an aggregate rather than an entity. Only the deemed partners would be treated as users of the financed facilities. See PLR 200313007. In reaching this conclusion, the Service focused on the status of a partnership under the Code, alternately (a) as a separate person or (b) as a pass-through that is no more than the "aggregate" of the individual undivided interests of the partners. In choosing the second approach and ignoring the partnership as a separate person that would otherwise be a private user, the Service appears to have focused primarily on whether the creation of the partnership would have the effect of transferring the benefits of tax-exempt financing to the partnership and whether the partnership activity of each of the 501(c)(3) organizations would constitute an unrelated trade or business.

It is not clear why the Service cares about the transfer of the benefits of tax-exempt financing to the partnership if the partnership is composed solely of 501(c)(3) organizations whose interests in the partnership do not constitute unrelated trades or businesses. However, the conclusion that there is no transfer of benefits to the partnership may be easy to reach if the ownership of the financed facilities and the obligation to repay the debt, both in form and in substance, remain with the original owner/debtor.

Can the reasoning in these private letter rulings be applied to allow a 501(c)(3) organization to finance its ownership interest in a partnership with a for-profit entity? If the 501(c)(3) organization and the for-profit entity are each treated as owning individual interests in partnership assets, the for-profit entity may not be considered a user of the 501(c)(3) organization's tax-exempt bond financed facilities. (Treas. Reg. § 1.103-7(c), Example 13, permits the issuance of tax-exempt governmental bonds by governmental entities to finance undivided ownership interests in electric generating facilities jointly owned with private entities.) In many circumstances, such a joint venture would not be an unrelated trade or business of the 501(c)(3) organization because the activity is substantially related to the organization's exempt purpose. The private activity bond regulations reserve the provisions addressing mixed use facilities and the preamble notes that the Service and Treasury are considering more flexible rules to accommodate public/private partnerships.
E. **Change in Use.** Bonds can be retroactively taxable as a result of a post-closing deliberate action by the borrower that causes the use of the bond-financed facility to change from a qualifying use to a non-qualifying use.

1. “Use” is generally measured over time on an average annual basis under Treasury Regulations Section 1.141-3(g).

2. If the measurement rules do not provide relief, Treasury Regulations Sections 1.141-2, 1.141-12, and 1.145-2 provide that, so long as certain remedial actions are taken, change in use of a bond-financed facility from a qualifying use to a non-qualifying use will not cause interest on the bonds to become taxable.

3. Generally, under Treasury Regulations Section 1.142-12, remedial actions include (i) prompt redemption of the “non-qualified bonds” following the change in use, (ii) allocation of the proceeds of an asset disposition giving rise to the change in use to new 501(c)(3) assets and (ii) tracing the disposed asset to a new, qualifying use. For certain remedial actions, it may be necessary to treat some or all of the bonds as reissued and, as a result, it may be necessary to undertake steps including, for example, a new TEFRA approval.

VI. **TAX EXEMPT BOND ISSUES ARISING IN CONNECTION WITH HEALTH REFORM**

A. **Accountable Care Organizations.** The establishment of Accountable Care Organizations is raising challenging questions in the tax-exempt bond context. Does the creation of or participation in an ACO constitute a "special legal entitlement" that results in private business use? For example, an ACO may provide case management services to coordinate care among different providers participating in an ACO.

In response to the Service's solicitation for comments concerning whether guidance is needed regarding the tax implications for tax-exempt organizations participating in ACOS, the National Association of Bond Lawyers requested guidance from the Service concerning private use. NABL has requested that the Service provide guidance and implement the following safe harbors relating to ACOs:

1. **No Private Use via Creation of or Participation in an ACO if:**

   a. The terms of the 501(c)(3) organization's participation in the Medicare Shared Savings Program ("MSSP") through the ACO are set in advance in a written agreement negotiated at arm's length;

   b. The Centers for Medicare and Medicaid Services ("CMS") has accepted the ACO into, and has not terminated the ACO from, the MSSP; and
Any incentives based on cost savings are based exclusively on savings in operational costs (as opposed to the cost of capital of the tax-exempt health care borrowers).

Special Safe Harbor for Health Care Service Contracts. Create a new term of art "Health Care Service Contract" and define it as a management or service contract for health care or services that is between an ACO or qualified (as defined in Rev. Proc. 97-13) and a medical provider (doctors, nurses, physician assistants, medical directors, service providers at hospices and rehabilitation facilities, ACO executives, etc.).

For a "Health Care Service Contract," incentives features based on quality measures, patient or provider satisfaction, and efficiency or expense control, but not increased revenue or volume, will not cause the contract to give rise to private use if, but for these incentives, the contract would meet one of the safe harbors set forth in Rev. Proc. 97-13. Furthermore, for purposes of any requirements in the safe harbors of Rev. Proc. 97-13, regarding the maximum contract term and the ability to terminate a contract without penalty or cause, a Health Care Service Contract will be treated as satisfying such requirements as long as the term of the contract does not exceed the greater of either (i) the term of the agreement signed between the ACO and CMS, or (ii) 5 years.

Ideally, the requested guidance should make clear that this new safe harbor is designed to accommodate health care reform in general, including all programs created by the Affordable Care Act, and should not be limited to contracts with ACOs.

B. *Section 501(r) Requirements.* While continuing to meet the general requirements applicable to all Section 501(c)(3) organizations, hospital organizations must also meet four new qualification requirements, codified in new Section 501(r). The four new qualification requirements require Section 501(c)(3) organizations to: (i) conduct a community health needs assessment no less than once every three years, (ii) establish a written financial assistance policy, (iii) engage in reasonable efforts to determine whether an individual is eligible for assistance under the financial assistance policy before engaging in extraordinary collection actions and (iv) limit the amounts they charge for emergency or other medically necessary care provided to individuals eligible for assistance under the hospital's financial assistance policy. How do these requirements affect the ability of the Section 501(c)(3) organization to comply with its covenants with Bondholders and credit partners, e.g. rate covenant in Master Indenture?

C. *Market Forces.* Municipal bonds issued on behalf of hospitals and healthcare systems have been the market's biggest losers recently, according to Bloomberg News. Debt related to facilities in the 21 states that are not expanding their Medicaid programs would fare even worse.