25th Annual Health Sciences Tax Conference

Living with your tax-exempt bonds

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Presenters

► Steve Gilmore  
Ascension Health Alliance  
St. Louis, MO

► Jerimi Ullom  
Hall, Render, Killian, Heath & Lyman  
Indianapolis, IN

► Kendall Schnurpel  
Ernst & Young LLP  
New York, NY  
kendall.schnurpel@ey.com  
1 212 773 6583

► Jacob Zehnder  
Ernst & Young LLP  
Chicago, IL  
jake.zehnder@ey.com  
+1 312 879 2702
Outline

► Hypothetical bond issue
  ► Pre-issuance planning
  ► Useful issuance information for ongoing post-issuance compliance
  ► Written post-issuance compliance procedures
  ► Final allocation of proceeds/equity allocations
  ► Preparing for the first Schedule K filing
  ► Remediation and Voluntary Closing Agreement Program (VCAP)
  ► Refunding the bonds
Hypothetical 20XX bond issue

► ABC Health System, Inc. (ABC) has identified roughly $90m in capital needs and has obtained board approval for the issuance of tax-exempt bonds to finance the expenditures. The bonds will be issued in two series (Series A and Series B). Summary details for the bonds are as follows:
  ► New money only (no refunding)
  ► New Emergency Department building and equipment ($50m)
  ► Expansion and renovation of existing cafeteria space ($20m)
  ► New parking garage construction (reimbursement of $10m of prior expenditures)
  ► HVAC/power plant ($10m)
Pre-issuance planning and issuance data

Post-issuance monitoring can be simplified through proper project scoping and with the use of data collected in the issuance process.

- Careful selection of assets for financing
- Identification of financed assets
  - List of assets from 120% test
  - Reimbursement listing
- Bond counsel due diligence results
- Location of assets/Tax Equity and Fiscal Responsibility Act (TEFRA) Notice
- Cost center/department code charges
Pre-issuance planning: selection of assets

- Careful selection of assets for financing:
  - Land – no assigned life means tracking until maturity
  - Movable equipment
    - Mobility leads to difficult usage tracking
    - Relatively short useful lives mean shorter measurement period
  - HVAC/power plant
    - Use of facilities serviced by asset may give rise to private use
    - Requires tracking private use in serviced facility space
  - Existing and anticipated private business use
    - Be aware of calculation complexities
    - Consider financing some or all of related asset with cash or taxable debt
Pre-issuance planning: asset identification

► Identification of bond-financed assets:
  ► It is tested by bond counsel to ensure compliance with 147(b) requirement.
  ► Weighted-average maturity of bonds is limited to 120% of estimated life of financed assets.
  ► Calculation will utilize detailed listing of reimbursement expenditures and estimate of project expenditures.
  ► Listings can be utilized to track bond proceed expenditures and anticipated expenditures.
Pre-issuance planning: asset identification

- Identification of bond-financed assets
  - Form 8038
    - Required by section 149(e) of the Code
    - Disclosure to IRS of use of proceeds and asset life breakdowns
  - Location of assets/TEFRA Notice
    - Required by 147(f)
    - Requires public approval or voter referendum
    - Public notice must include general functional description of facility to be financed, including location and/or street address
  - Cost center/department code charges
    - Allocation of proceeds to expenditures
    - Identification of related private activities
Pre-issuance planning: private use

► Private business use monitoring can be facilitated with pre-issuance planning and the use of data collected in the issuance process.
  ► Anticipated private business use
  ► 5% or $15,000,000
  ► Leases, management contracts, unrelated activity and research
  ► Movable equipment
  ► Infrastructure/common space/power plant
  ► Equity financing and final allocations
  ► Bond counsel due diligence to identify existing private use
Hypothetical 20XX bond issue

► ABC closes on the bonds in the amount of $89.5m and finances the remaining $500,000 in capital needs with qualified equity, due to anticipated use of the parking garage by private physicians in the adjacent Medical Office Building (MOB):
  ► Estimate that 5% of the available parking will be reserved for private physicians, with offices located in the adjacent MOB, and their patients
  ► Cafeteria continues to be operated by ABC.
  ► Anticipated unrelated trade or business activity is limited to reference lab activity (not part of 20XX bond project).
  ► Bond counsel due diligence review reveals no management/services contract nor any sponsored research agreements with terms outside of applicable safe harbors.
Written post-issuance tax compliance policies and procedures

What should post-issuance tax compliance policies include? The IRS recommends the following provisions:

- Due diligence review/compliance check at regular intervals (at least annually)
- Identification of the official or employee responsible for review and the nature of the review procedures required
- Description of required training of the responsible official(s)/employee(s)
- Retention of adequate records to substantiate compliance (e.g., records relating to expenditure of proceeds)
- Procedures reasonably expected to timely identify non-compliance
- Procedures ensuring that the issuer will take steps to timely correct non-compliance
- An awareness of the availability of tax-exempt bonds (TEB) VCAP and other remedial actions to resolve violations
Written post-issuance tax compliance policies and procedures

- Written policies are not required by the Code or Regulations; however, they have become a focused area for IRS inquiry:
  - Compliance questionnaire to 501(c)(3) organizations (Aug. 2007)
  - Questionnaire to governmental issuers (Jan. 2009)
  - Revised Form 990, Schedule K in 2012 and subsequent years
  - Forms 8038, 8038-B, 8038-TC, 8038-G
  - Previous version of Internal Revenue Manual (IRM) 7.2.3.4.4 stated that additional VCAP relief was provided for an issuer that had adopted written post-issuance procedures for tax-advantaged bonds by applying a more favorable tier of resolution standards
  - Revised IRM 7.2.3.4.4, dated Sept. 30, 2015, removes this additional relief for requests submitted after March 31, 2016
Completion of 20XX project

- After minor delays, the expansion and renovation to ABC’s cafeteria is now complete. It has been six months since the completion of the ABC parking garage and the renovation and equipping of ABC’s ER. ABC now desires to complete and document the final allocation of proceeds for the 2016 bonds.
Final allocation of proceeds

- Treasury Regulations section 1.148-6 allows for the use of any reasonable and consistently applied accounting method.
- Failure to elect an allocation method, or to maintain books and records to establish that method, will result in the “specific tracing” method being applied.
- Allocation method must be made within 18 months after the later of the date the expenditure is made or the date the financed project is placed in service.
- There is no required form of documentation for final allocation.
Project equity allocations – final regulations

► Treasury Regulations 1.141-6 require that allocations under sections 148 and 141 must be consistent with each other.
► Under the Final Regulations issued October 26, 2015, allocation of proceeds to expenditures generally may be made using any reasonable, consistently applied accounting method.
► “Project” covers all capital assets financed by a single issue of bonds.
► The final regulations generally apply to bonds sold, and deliberate actions that occur, on or after January 25, 2016.
► However, partnership provisions and the allocation and accounting rules may be applied in whole, but not in part, to any bonds to which the 1997 regulations apply.
Final regulations: “floating use”

► “Undivided portion allocation methodology” is now the exclusive allocation method for mixed use projects.
► The undivided portion allocation method inherently allows “floating allocations” without further action or special tracking.
► Eligible “mixed use project”: a project financed with proceeds of tax-exempt bonds and qualified equity.
► Qualified equity does not include:
  ► Equity interests in real property or tangible personal property
  ► Tax-advantaged taxable bonds (e.g., tax credit bonds)
  ► Amounts (other than the tax-exempt bond proceeds) used to redeem bonds
Final regulations: partnerships

► The regulation treats a partnership as an aggregate of its partners for purposes of the ownership requirement and private use limitations that apply to qualified 501(c)(3) bonds.

► The amount of private use resulting from the use of bond-financed property by a partnership that includes non-exempt partners is based on the non-exempt partners’ greatest percentage share of certain specified partnership items.

► They differ from proposed regulations that require 100% ownership by 501(c)(3) organizations for aggregate treatment.
Completion of 20XX project

► Using the undivided portion allocation method, ABC allocates the $500,000 of equity to the project in recognition of that portion of the parking garage to be used by the private physicians and their patients.

► ABC is now preparing its first Form 990 Schedule K filing for the 20XX bonds.
Form 990 – Schedule K

► $100,000 outstanding and issued after 12/31/2002
► Not limited to “tax-exempt bonds” (report other “tax-exempt obligations” as well)
► Signed under penalties of perjury
► Not the same authority standard as bond counsel’s opinion (“Will”/90% versus “More Likely Than Not”/50%)
Schedule K filing

- Part I completed using Form 8038 (each issue)
- Part II involves more detailed reporting of uses of proceeds
- Part III – Private Business Use
  - Requires accurate records of where proceeds spent
  - Measurement period considerations
  - Percentage of “financed property” used
  - Contract reviews
  - Written procedures
- Part IV – Arbitrage
  - See Tax Certificate and Form 8038
  - Five-year filing deadline for Form 8038-T (if applicable)
Hypothetical: management contract

► After a thorough review of related costs, ABC determines that it is no longer cost effective to operate its newly remodeled cafeteria on its own and the decision is made to enter into a service contract with a well-known vendor to manage and operate the food service function for ABC, including its cafeteria. ABC enters into contract negotiations with Food Service, Inc. (FSI) to provide these services.
Management contracts – general rules

► Management contracts
  ► Any management, service or incentive payment contract between a governmental person (or 501(c)(3) entity in the case of qualified 501(c)(3) bonds) and a service provider for all, or a portion of, any function of the facility
  ► Examples: food services; parking and valet services; provision of certain medical services within the hospital, etc.
  ► Does not include: incidental services (janitorial, IT, hospital billing); granting of admission privileges to a physician; public utility facility or system; contract for services, provided that only compensation is for reimbursement of expenses

► Compensation may not be based on “net profits.”
  ► Treas. Reg. § 1.141-3(b)(4)(i) states that no part (i.e., in whole or in part) of the compensation paid to the service provider may be based on the net profits from the operation of the facility.
Hypothetical: sale of adjacent land

- Having completed the construction of the parking garage, ABC turns its attention to a parcel of land adjacent to the main campus. The land was originally purchased for development of an MOB but as the MOB was constructed elsewhere, the adjacent parcel is no longer needed and ABC decides to sell the property. Unfortunately, the land turns out to have been financed by much older tax-exempt bonds. ABC contacts its bond counsel to discuss the impact on the earlier bonds.
Remedial action, anticipatory redemptions and Voluntary Closing Agreement Program (VCAP)

► Remediation provisions under Treasury Regulations 1.141-12(a)
  ► Redemption of non-qualified bonds
    ► Within 90 days of deliberate action (redemption or escrow)
    ► Sale exclusively for cash and redeem at earliest call date
    ► Written notice to IRS within 90 days of escrow
  ► Alternative use of disposition proceeds
    ► Cash sale
    ► Alternative use within two years of sale
  ► Alternative use of facility (e.g., governmental hospital sold to 501(c)(3))
► Under the 2015 final regulations, bonds may be redeemed or defeased at any time in advance of a deliberate action that would cause the private use limitations to be exceeded.
Remedial action, anticipatory redemptions and VCAP

► For anticipatory redemptions, the hospital must declare its intent to redeem or defease the potentially non-qualified bonds and identify the financed property.

► The 2015 final regulations reduce the amount of non-qualified bonds that must be redeemed or defeased to an amount necessary so that the remaining bonds satisfy the private use limitations.

► VCAP
  ► Not available if under exam
  ► Settlement amount based on taxpayer exposure
  ► Statute of limitations applies to calculation of exposure
Hypothetical: refunding the 20XX bonds

► As a result of a favorable change in interest rates, ABC decides to refinance the 20XX bonds in 20YY. The new bond issue will have no new money component and will be accomplished as a current refunding of the 20XX bonds.
Refunding: general rules

- Current refunding occurs when the redemption of the prior bonds occurs within 90 days after the issuance of the new bonds.
- If the redemption of the prior bonds occurs more than 90 days after the issuance of the new bonds, the refunding is an advance refunding.
- This will require additional due diligence on the part of bond counsel, including private use review and review of section 501(c)(3) status.
- Bond counsel may rely on the opinion of borrower’s/hospital counsel with respect to the 501(c)(3) status.
- Upon the effective date of the final regulations under section 501(r), in addition to reviewing the determination letter, articles, bylaws, financial statements, tax returns and board minutes, counsel must now perform additional procedures to determine compliance with 501(r).
Section 501(r) and the due diligence process

► Section 501(r) requires a tax-exempt hospital organization (or a hospital organization seeking exemption) to satisfy:
  ► Community Health Needs Assessment (CHNA) rules
  ► Financial Assistance Policy (FAP) rules
  ► Limitation on charges to amounts generally billed (AGB)
  ► Billing and collection rules

► Effective date of final regulations
  ► They are effective for taxable years beginning after December 29, 2015.
  ► Prior to the effective date, hospital organizations could rely on a reasonable, good faith interpretation of section 501(r).
  ► Understanding section 501(r) will be critical for diligence performed in connection with tax-exempt bonds.
Consequences for non-compliance

- Minor errors and omissions due to reasonable cause and non-compliance that is neither willful nor egregious will be excused if it is corrected and disclosed.

- Correction and disclosure procedures – Rev. Proc. 2015-21:
  - The IRS provided correction and disclosure procedures for failures that are neither willful nor egregious.
  - The correction must be made in accordance with four principles: (1) restoration of affected persons; (2) reasonable and appropriate correction; (3) timing; and (4) implementation/modification of safeguards.
Consequences for non-compliance

- Non-compliance may result in a $50,000 excise tax and/or loss of tax-exempt status, based on all circumstances.
- For hospital systems, only the facility that failed to comply would be penalized for the failure to comply with the CHNA requirements.
- Final regulations make clear that where a hospital organization with multiple hospital facilities maintains its 501(c)(3) status, the imposition of a facility-level tax due to non-compliance will not in and of itself cause the organization’s qualified 501(c)(3) bonds to be taxable.
501(r) due diligence process

► Review policies and procedures for ensuring compliance and detecting non-compliance
► Review procedures for taking corrective action
► Review “minor” failures that have not been disclosed
► Interview compliance personnel
Questions?
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