21st Annual Health Sciences Tax Conference

Tax-exempt bonds and Schedule K

7 December 2011
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IRS positions from questionnaires and first round of filing Schedule K
IRS structure

- Tax Exempt and Governmental Entities (TE/GE) Division – responsible for Form 990

- Tax Exempt Bond (TEB) Division – responsible for tax-exempt bonds

- Working together on tax-exempt bonds since Schedule K on Form 990
IRS TEB work plan for 2012

► Review of Schedule K for 501(c)(3) bonds

► Audits of small governments issuances (less than $15 million)

► Public–private partnership agreements
  ◆ Specific facilities, naming rights, etc.

► Questionnaires sent to qualified school exempt bonds
IRS TEB focus area for 2012

► Advanced refunding issues of post-2005 bonds
► Follow up on 2004 bond issues with no Form 8038-T
► Post-issuance compliance procedures
Form 990, Part IV – Checklist of required schedules
Line 24a – Tax-exempt bond issues

- $100,000 outstanding – 31 December 2002
- Parent or affiliates may report (not both)
- Not limited to “tax-exempt bonds” (other tax-exempt obligations)
- Be aware of any “reissuance”
Line 24b – Temporary period exceptions

► Temporary period exceptions to yield restriction
  ► Capital projects: three years
  ► Certain certified construction projects: five years
  ► Investment proceeds: one year (from receipt), etc.

► Yield reduction payments allowed when temporary period exceeded
Line 24c – Escrow account and Line 24d – On behalf of issuer

- Instructions distinguish “defeasance escrow” from “refunding escrow”
- Line 24c key: “other than refunding escrow”
- “On behalf of” issuer:
  - Rev. Rul. 63-20 corporations
  - Constituted authority organized to issue bonds for public purposes
Schedule K – an overview

► Transition relief
   ► Bonds issued after 31 December 2002
   ► Special rules for refundings of pre-2003 issues
► Flexible “reporting years”
Schedule K, Part I – Bond issues
Columns (a) – (e) should be consistent with Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues

<table>
<thead>
<tr>
<th>Part I Reporting Authority</th>
<th>Check if Amended Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Issuer’s name</td>
<td></td>
</tr>
<tr>
<td>2 Issuer’s employer identification number</td>
<td></td>
</tr>
<tr>
<td>3a Name of person (other than issuer) with whom the IRS may communicate about this return (see instructions)</td>
<td>3b Telephone number of other person shown on 3a</td>
</tr>
<tr>
<td>4 Number and street (or P.O. box if mail is not delivered to street address)</td>
<td>5 Report number (For IRS Use Only)</td>
</tr>
<tr>
<td>6 City, town, or post office, state, and ZIP code</td>
<td>7 Date of issue (MM/DD/YYYY)</td>
</tr>
<tr>
<td>8 Name of issue</td>
<td>9 CUSIP number</td>
</tr>
<tr>
<td>10a Name and title of officer or other employee of the issuer whom the IRS may call for more information</td>
<td>10b Telephone number of officer or other employee shown on 10a</td>
</tr>
</tbody>
</table>
Schedule K, Part I – Bond issues (cont.)

- Column (e) – issue price: see Part III, Form 8038

<table>
<thead>
<tr>
<th>Part III</th>
<th>Description of Bonds (Complete for the entire issue for which this form is being filed.)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(a) Final maturity date</td>
</tr>
<tr>
<td>21</td>
<td>$</td>
</tr>
</tbody>
</table>

- Column (f) – purpose
  - Multiple purposes: state each purposes
  - Refunding prior issues: include issue date
  - Use Part V or Schedule O for lengthy descriptions
Schedule K, Part I – Bond issues (cont.)

- Column (g) – defeasance
  - Defeasance escrow or refunding escrow
  - Indicates refunded bonds are listed (if post-2003 issue)

- Column (h) – on behalf of issuer
  - Rev. Rul. 63-20
  - Includes “constituted authorities” organized by state/local government
Schedule K, Part II – Proceeds
Schedule K, Part II – Definitions

- Retired bonds
- Legally defeased bonds
- Reserve fund
- Capitalized interest
- Credit enhancement
- Refunding escrows
- Final allocation of proceeds
## Schedule K, Part II – Proceeds

- Part I row corresponds to Part II columns
- Aggregate amounts on Lines 4–12 may not equal Line 3
- Line 4 requires “gross proceeds” – see Form 8038, Part IV

### Part IV: Uses of Proceeds of Issue (including underwriters’ discount)

<table>
<thead>
<tr>
<th>Part</th>
<th>Uses of Proceeds of Issue</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>Proceeds used for accrued interest.</td>
<td>22</td>
</tr>
<tr>
<td>23</td>
<td>Issue price of entire issue (enter amount from line 21, column (b))</td>
<td>23</td>
</tr>
<tr>
<td>24</td>
<td>Proceeds used for bond issuance costs (including underwriters’ discount)</td>
<td>24</td>
</tr>
<tr>
<td>25</td>
<td>Proceeds used for credit enhancement</td>
<td>25</td>
</tr>
<tr>
<td>26</td>
<td>Proceeds allocated to reasonably required reserve or replacement fund</td>
<td>26</td>
</tr>
<tr>
<td>27</td>
<td>Proceeds used to currently refund prior issue (complete Part VI)</td>
<td>27</td>
</tr>
<tr>
<td>28</td>
<td>Proceeds used to advance refund prior issue (complete Part VI)</td>
<td>28</td>
</tr>
<tr>
<td>29</td>
<td>Add lines 24 through 28</td>
<td>29</td>
</tr>
<tr>
<td>30</td>
<td>Nonrefunding proceeds of the issue (subtract line 29 from line 23 and enter amount here)</td>
<td>30</td>
</tr>
</tbody>
</table>
Schedule K, Part II – Proceeds (cont.)

► Unspent proceeds – not in reserve fund or escrow
► Current/advance refundings: check Form 8038
► “Substantial completion”: last year, if multiple projects
► “Final allocation” of proceeds: within five years (at latest)
Part III – Private business use
Pre-2003 refunding: example

At 31 December 2008:

- 2008
  - $1,000,000

Refunding

\[ \circlearrowleft \]

1998

For 2008 filing:

- List refunding bonds in Part I and include issue date for refunded bond
- Need not complete Parts II–IV for the refunding bonds (optional)

Beginning with 2009 filing:

- Complete Parts I, II and IV for the refunding bonds
- Need not complete Part III for the refunding bonds or the refunded bonds
Schedule K, Part III – Private business use

- Lines 3a and 3b – report **existence** of contracts even if safe harbor is available
- Line 3c – does bond/outside counsel review contracts during the reporting year
- Average percentage of private use – during the reporting year
- Do not **calculate** use from safe harbor contracts
- Only use of “bond-financed” property – consider “equity”
Schedule K, Part III – Private business use (cont.)

► Lines 4 and 5 – average percentage of private use – during the reporting year

► Do not include the private use from safe harbor contracts

► Only use of “bond-financed” property – consider “equity”
Schedule K, Part III – Private business use (cont.)

- Not required for refundings of pre-2003 bonds
- Requires quantification of private use
- Types of private business use requiring disclosure:
  - Partnership or limited liability company – any time during year
  - Leases
  - Management/research contracts
Management or service contracts
Private business use
Management contracts and Rev. Proc. 97-13

- A management, service or incentive payment contract with §501(c)(3) under which contractor provides services involving all, a portion of, or any function of, a facility
  - Cafeteria
  - Radiology services
  - Emergency room services
- Incidental services exception (e.g., janitorial, office equipment repair, hospital billing or similar services) or the mere granting of admitting privileges by a hospital to a doctor
Private business use
Management contracts and Rev. Proc. 97-13 (cont.)

► Permitted compensation
  ► Must be reasonable
  ► Must not be based on a percentage of net income

► See 97-13 template and related resources

► Permitted contract term
  ► Permitted term depends on type of compensation
  ► Longer term contracts are permitted where the relative portion of fixed compensation is increased
Sources of private business use
Management contracts

- Periodic fixed fee
  - Stated dollar amount for services for a specific period

- Capitation fee
  - Fee for each person for whom provider assumes responsibility

- Per-unit fee
  - Based on a unit of service specified
  - May increase by a specified external standard
Sources of private business use
Management contracts (cont.)

97-13 safe harbor term limits:

- 95% fixed fee  
- 80% fixed fee  
- 50% fixed fee  
- 100% capitation fee  
- 100% per-unit fee  
- 100% percentage of fees charged (e.g., gross revenue)  
- 15 years  
- 10 years  
- 5 years (3 year “out”)  
- 5 years (3 year “out”)  
- 3 years (2 year “out”)  
- 2 years (1 year “out”)
Private business use
Management contracts and Rev. Proc. 97-13

- Renewal options
  - Disregard if solely in the hands of the exempt user
  - Disregard if automatic and subject to cancellation by either party
  - Other renewal options count toward the maximum term of the contract
Effective private business use limit

For 501(c)(3) issuers:

\[
5\% \text{ net bond proceeds}^{++} \\
(2\% \text{ cost of issuance})
\]

\[
3\% \text{ effective limit}^{**}
\]

++ Adjusted by original issue discount/original issue premium deposit to reserve fund

** Applicable to each bond issue
Line 7 – Private security or payment test?
Private security or payment test

- Two parts: security part and payment part
  - “Or” test

- Security part:
  - Met if more than 10% of the principal and interest payments are secured by an interest in the property used for private business use. For 501(c)(3) organizations, 5% limit applies.

- Example:
  - Where proceeds of a bond are secured by generally applicable taxes, and not by an interest in the bond-financed property, the private security portion of the test is not met.
Private security or payment test (cont.)

► Payment part:
  ► Met if more than 10% of the principal and interest payments are derived from payments in respect of the property used for private business use. For 501(c)(3) organizations, 5% limit applies.

► Example:
  ► The private payment portion of the test is met where a hospital is operated under a non-qualified management contract and hospital revenues are used for debt service, because the hospital revenues are payments in respect of bond-financed property used for a private business use.
Remember: Both the **private business use test** and the **private security or payment test** must be met to have a problem.

Thus, can have private business use in excess of 5% for 501(c)(3) organizations if private security or payment test is not met.

It is unlikely that a 501(c)(3) borrower would meet the private business use test and **not** meet the private security or payment test because 501(c)(3) bonds are typically secured by the financed property.
Written procedures
Written procedures for post-issuance compliance

► Tax-exempt bond compliance check questionnaires
► IRS strongly encourages adoption of “written” post-issuance compliance procedures or guidelines
► Adoption and consistent utilization of procedures is key
► Whenever possible, integrate with existing accounting systems
► Make record retention a priority
Implementing a monitoring process

- **Compliance**
- **Record retention**
- **Monitoring**
Record retention

Records to Retain

- Certificates of Pricing
- Demand Surveys
- Governmental Grants
- Annual Floor Plans
- Research Contracts
- Management Contracts
- Correspondence Emails
- Feasibility Studies
- Construction Draw Schedules
- Formal Elections

Closing Transcripts
Client action steps

► Assign responsibility
► Document inventory (see sample record retention policy)
► Management/research contract reviews
► Identify all sources of private business use
► Define bond-financed “projects”
► Quantify percentage of financed property used in private business use
► Adopt management practices and procedures to ensure post-issuance compliance
Voluntary Closing Agreement Program (VCAP) benefit to written policies for monitoring

- Violation assessed from the date of *discovery* rather than the date of *commission* of error
- “Good” written policies in place
“Good policies” – IRS article posted 11 August 2011

- Due diligence regulated
- Assignment of officer/employee for responsibility
- Training of officer/employee
- Retention of records
- Procedures to identify non-compliance
- Procedures for how to deal with non-compliance
Schedule K, Part IV – Arbitrage
Schedule K, Part IV – Definitions

- Arbitrage
- Yield reduction
- Arbitrage rebate
- Hedge
- Guaranteed investment contract (GIC)
Schedule K, Part IV – Arbitrage

► Answers may change from year to year
► Consider comparing Form 8038-T
► Qualified hedges
► GICs
  ► Safe harbor: 3 bona fide offers
  ► IRS investigations of “bid rigging”
Schedule K, Part IV – Arbitrage

- Investment beyond an available temporary period?
- Yield restriction
- Temporary period exceptions:
  - Capital projects – 3 years
  - Debt-service funds – 13 months
  - Working capital – 13 months
  - Other – seeRegs. 1.148-2(e)
Schedule K, Part IV – Arbitrage

- 6-month expenditure
- 18-month expenditure
- 2-year construction
Thank you!