C. TAX EXEMPT BOND FINANCING

by
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PART ONE

EO'S ROLE

> A classified advertisement in a recent issue of Contemporary Long-Term Care, a nursing home industry trade publication, reads "Cash for Nursing Homes/Hospitals. Convert your existing for-profit health care facility to cash by selling to qualified 501(c)(3)...Any discussion will be handled in complete confidence." Forbes, December 11, 1989 pg. 38.

1. Background

The default rate for bonds issued on behalf of IRC 501(c)(3) organizations is high. During the 1980's there were over five billion dollars in private activity bonds issued on behalf of organizations exempt under IRC 501(c)(3). The National Association of Attorneys General reports defaults of over one billion dollars. Once the bonds are in default, it may be inefficient and costly to the public and the treasury to rely solely on an audit program to uncover abuses by exempt organizations. The investors have already lost their money, the Treasury has lost the tax on the interest that would have been paid if the financing was taxable, and it is likely that private interests have been impermissibly served.

In News Release IR-90-60, dated April 3, 1990 (see Part Five of the article, Appendix), the Service explained that it is carefully examining situations involving tax-exempt bonds used to finance health care facilities to determine whether the organization on whose behalf the bonds are issued is furthering private interests to an impermissible degree. The news release describes several situations where such financing is part of a series of transactions in which exempt organizations are used by developers or others to acquire health care facilities at a cost in excess of the fair market value. These situations may involve unreasonable development or management fees paid to acquire or operate health care facilities. In addition to raising private benefit issues, such transactions may also endanger the financial integrity of the health care facility. Also, the news release suggests that there are situations where an exempt organization leases or sells a health care facility that it purchased with tax-exempt bonds to partnerships or other entities who maintain

some control over the exempt organization. This raises concerns about arm's length standards and the true owner of the health care facility.

News Release IR-90-60 was augmented by News Release IR-90-107, dated August 21, 1990 (see Part Five, Appendix) which announced the issuance of new examination and determination instructions to help Exempt Organizations specialists detect potentially abusive transactions in which charitable organizations finance facilities with tax-exempt bonds. These instructions are contained in Internal Revenue Manual sections 7668.(17) and 7(10)7(11) (see Part Five, Appendix).

Our review of organizations participating in tax exempt bond financing is an evolving program. Although the news releases expressed EO's heightened degree of review of cases involving health care facilities, the manual material notes that these guidelines have application to any organization that is financing with tax-exempt bonds. This is because the issue of private benefit is endemic to any transaction that involves private parties, such as a developer and a management company, obtaining access to cheaper bond financing through an exempt organization.

2. Bond Concerns

The Tax Reform Act of 1986 tightened the rules under IRC 103. IRC 103 provides that the interest earned from certain state and local government bonds and "qualified private activity bonds" will not be taxable to the bondholder. The 1986 Act sets forth these stricter rules in IRC 141 through IRC 150. IRC 145 specifically applies to "qualified 501(c)(3) bonds". "Qualified 501(c)(3) bonds" are bonds issued by a state or local government on behalf of an organization described in IRC 501(c)(3). To be a "qualified 501(c)(3) bond" (so that the bondholders interest is excludable from gross income under IRC 103) the bond must meet all of the applicable requirements of IRC 103 and IRC 141 through IRC 150.

The prior law reflected an attempt to encourage financing of government type projects with tax exempt bond funds. The result was a plethora of tax exempt financed projects that only marginally achieved governmental purposes. The 1986 change in the treatment of tax-exempt bonds, particularly the bonds issued to finance projects owned by organizations described in IRC 501(c)(3), was intended to insure appropriate use of bond proceeds by exempt organizations. However, experience has shown that abusive situations still exist necessitating that EO

specialists become actively involved in the review of organizations participating in tax exempt bond financing.

Because there is no requirement that the Service rule on the qualification of a bond as being in compliance with the rules governing tax-exempt bonds set forth in IRC 103 and IRC 141 through IRC 150 before it is issued, one effective means of controlling the situation is by controlling access to the bond market. Governmental issuing authorities will not issue bonds unless the organization on whose behalf the bonds are issued has an outstanding, favorable, exemption letter from the Service as an organization described in IRC 501(c)(3). It is just that simple: no letter - no bonds. While we can not determine that the bond financed facilities will always be used in the manner described in the application, we are in the position to initially determine whether the applicant is created and will be operated to serve private or public interests. If we determine that the public interest is being served and that no private party, such as a developer or management company, can control the operations of the organization, there will be more assurance to the public and to the tax revenue that the bonds are being used for purpose(s) described in IRC 501(c)(3). The risk of default should be reduced.

We have asked our EO specialists to scrutinize these cases for their private benefit issues. Now we are asking that EO specialists also be aware of bond issues. Although bond qualification issues are not within the jurisdiction of EO, a knowledge of taxation rules applicable to tax-exempt bonds is important for the following reasons. First, some taxation rules applicable to bonds do affect exempt organizations matters. Second, EO should be in a position to effectively coordinate with the appropriate Service function that has regulatory authority for tax-exempt bonds. Finally, knowledge about tax-exempt bonds can provide insight into the motivation behind the transaction being reviewed.

3. Scope of Article

Thus, an understanding of bonds and the steps necessary to market a bond is essential to the review process. Therefore, in the second part of this article, a bond scenario will be discussed which will introduce the basic players who participate in a bond transaction, the steps necessary to market a bond, and some areas of special concern in the exempt organizations and tax exempt bond areas. The third part of the article will focus on the process of reviewing bond cases from an exempt organizations perspective. In the fourth part of the article, the technical rules for qualification of bonds will be discussed. The fifth part of this article is an appendix. It contains significant published material. We hope this five part article

will serve as a comprehensive handbook for review of these cases. Additional guidance will be issued as determined by our experience in this area.

PART TWO

BRINGING A BOND TO MARKET

1. Introduction

The purpose of this part of the article is to impart a basic understanding of how the municipal bond market works, who the principal participants are, and how a bond comes to market.

This part of the article considers a hypothetical bond scenario. It will take the bond from the first idea to finance with bonds and follow it through issuance and, in this case, its rocky road to disaster. This focus on a "bad bond" scenario should not imply that all or even a majority of exempt organizations that finance projects with qualified 501(c)(3) bonds are engaged in abusive transactions. But abusive and poorly thought out transactions exist. This scenario may seem improbable; unfortunately, it is not. The facts presented are derived from a number of securities cases where the injured investor is suing all parties involved in defaulted municipal bonds. This scenario only demonstrates one fact pattern leading to abuse, there are many others. The role of EO in preventing abuse in the qualified 501(c)(3) bond area is significant. It is the desire of EO, particularly in the application process for recognition of exemption under IRC 501(c)(3), to identify questionable bond financing transactions so that they can receive a higher level of scrutiny before the bonds are marketed.

Although the parties identified in this scenario have questionable standards, this is not to imply that bond professionals are normally unethical. This is clearly not the case. But, when bonds go bad from the outset, one often finds that the participants have not exercised reasonable care and prudence.

2. Scenario and Participants

A. Developer

Bad bond cases often seem to be instigated by a developer as opposed to starting with an exempt organization that has a charitable history, community representation, and a specific charitable agenda. The developer is frequently

undercapitalized and is searching for alternative financing mechanisms for a normally for profit venture. In many cases, the developer has already participated in a number of failed financial transactions, perhaps even involving bonds. The developer for this scenario has purchased property for $100,000. Let's call the developer Mr. Green and the property Greenacre.

Mr. Green decides that the best way to make some money is to build a facility for retarded persons and take advantage of tax exempt bond financing. Mr. Green has two options at this point, he can create an organization to operate Greenacre Rehabilitation Center, or he can find an existing exempt organization willing to pick up the activity. Mr. Green is familiar with the requirements for exemption and the process, so he decides it would be much easier to find a willing exempt organization with an outstanding exemption letter. It just so happens that he has relatives that are the directors of an IRC 501(c)(3) bingo fund raiser, Gambling for Charity, which has been exempt since 1963.

B. Feasibility Study

With some property and a willing exempt organization, Mr. Green is ready for the next step. What he needs now is a feasibility study. A feasibility study can be performed by an accounting firm or a firm that specializes in doing feasibility studies. It is a study of the financial feasibility of the project, which strives to answer the question "Would the project as it is currently constituted generate enough revenue to pay the bondholders?" It cannot be emphasized enough how critical the feasibility study is. Every other professional that comes to the project later relies on the feasibility study. For our purposes, we must also turn a critical eye to the feasibility study. It is important to gather as much information as possible to gauge the legitimacy of the feasibility study. Some questions to be asked would be:

1. What are the credentials of the feasibility consultant?

2. How recent is the feasibility study?

3. Is this the only feasibility study that has been commissioned on this project?

4. Are there any assumptions in the study that don't make sense? If so, they should be asked about.

5. Has the organization ever received a feasibility study containing unfavorable comments?

6. Is the feasibility consultant related in any way to any other participant in the case?

In this scenario, Mr. Green goes to a reputable feasibility consultant, Reputation, Inc. This consultant gives a negative report. Apparently the state where the property is located does not favor large facilities for the retarded, the organization has no working capital because it is dependent solely on medicaid, and the operators have no experience running this type of facility.

Mr. Green is incensed. He offers to change the purposes of the facility to retirement homes for the elderly. Reputation, Inc. does not change its opinion. Mr. Green threatens to sue; in response to the pressure, Reputation, Inc. withdraws its feasibility study. Mr. Green then goes to a feasibility consultant operating out of a small accounting and bookkeeping firm. Bookkeeping, Inc. has no problem issuing a favorable feasibility study.

C. Bond Counsel

With a favorable feasibility study in his hand, Mr. Green now acquires bond counsel. Bond counsel is an important participant. Bond counsel writes an opinion letter that the interest paid to the bondholders is not includable in gross income for federal income tax purposes. Without this opinion, the bonds would not be marketable. This opinion may be printed on the bond. There is no requirement that the IRC 501(c)(3) organization or the governmental issuer obtain a ruling or determination from the IRS that the bonds are qualified 501(c)(3) bonds. The opinion of bond counsel is all that is needed. It is important to understand that bond counsel often does not get paid unless the bonds are sold. A reputable bond counsel will produce a reliable opinion provided the client fully discloses all the facts. In this case, Mr. Green does disclose the prior negative feasibility study. What he fails to disclose is that he has sold Greenacre, property purchased for $100,000, to a sham Cayman corporation (Cayco) which he controls. The sale price was $150,000. Cayco has resold the property to Gambling for Charity for $2,500,000 to be paid out of bond proceeds. This transference creates a tremendous gain for Mr. Green and severely undercuts the financial viability of the project.

D. Governmental Issuing Authority

With the bond counsel and the feasibility study in hand, the project now needs a governmental issuing authority. A governmental issuing authority is a

government instrumentality designed to facilitate the tax exempt status of the bonds. In most instances one would expect the governmental issuing authority to be a permanent agency but the authority can be created for one transaction. For example, if Mr. Green has political connections in Small Town, he can encourage them to set up the Small Town Redevelopment Authority for the purpose of issuing these bonds. Why would Small Town want to engage in a deal with such a shady operator or with any other private party? Small Town is probably not at risk because these bonds will not be government bonds and the credit of Small Town will not be backing these bonds.

E. Government Purpose Bonds

Government purpose bonds are just what they sound like, bonds that are issued for government purposes and are typically backed by the credit of the governmental unit. Also, the governmental unit may be limited by local ordinance or state constitution in the amount that can be issued or the purpose.

F. Revenue Bonds and Beneficiary

On the other hand, tax exempt municipal bonds are most likely revenue bonds. Revenue bonds pay off the bondholders from the revenue generated by the project. If there is not enough revenue the bonds are in default because the governmental unit does not back them up. A governmental unit can issue revenue bonds on its own behalf or on behalf of a private party, the beneficiary. In this case the beneficiary would be the exempt organization, Gambling for Charity. Thus, the governmental issuing authority issues the bonds. The bond proceeds are loaned to an exempt organization pursuant to a loan agreement between the issuer and the exempt organization. The bonds are repaid solely from loan payments that are made to the governmental issuing authority by the exempt organization out of income from the project or other resources.

The only real concern expressed by the Small Town Redevelopment Authority is whether Gambling for Charity is exempt under IRC 501(c)(3) of the Code. Both state and local bond issuing authorities look to the exemption determination under IRC 501(c)(3), placing a great deal of reliance on the determination made by the IRS that the organization is a charitable entity. If Small Town Redevelopment Authority is astute, it may notice that this project represents a marked change in purpose for Gambling for Charity. The authority should require that the organization notify its key District Director of the change to obtain an updated exemption determination.

Whenever an exempt organization undertakes a new activity not described in its application for recognition of exemption, it is advised in the exemption determination letter or ruling to notify its key District Director. If the organization fails to notify the IRS, it will not have reliance that the IRS has approved the activity as furthering its exempt purpose.

G. Appraisal

The Small Town Redevelopment Authority surprised Mr. Green. It has a requirement that any project involving real property must submit an appraisal. How is Mr. Green going to get an appraisal for $2,500,000 on property he purchased for $100,000? It may take a little leg work, but he can do it. There are "qualified real estate appraisers" who may be willing to issue valuations based, not on an appraisal of the fair market value of the property, but on the client's request for a specific "appraised" value. Careful scrutiny of an appraisal is necessary for a proper review of a bond financing case. A bad appraisal can be identified.

1. Look closely at the comparables. Is the property truly comparable? Is it zoned the same or is it of similar size? Are the comparables recent sales? Are there comparables? An appraisal that claimed that there were no comparable sales of retirement facilities in Arizona would be highly suspicious!

2. If the organization is purchasing an existing facility bought out of bankruptcy or similar circumstances, how does it expect to turn the project around? One should be highly suspicious of organizations representing that the change in financing itself will turn the facility around.

3. Look at the income projections. Does the projection of the appraiser agree with the organization's projection of how it will be able to operate?

4. It is reasonable to require an additional appraisal if the appraisal does not contain comparables or value is not determined by a number of different methods.

5. Request assistance from IRS valuation experts where there are substantial questions concerning the appraisal. IRM 7(10)25 sets forth procedures for requesting engineering assistance or consulting on valuation issues. Applications containing questionable appraisals may be forwarded to the National Office. In the National Office, technical assistance may be obtained from the Office of Appraisal Services, Financial/Engineering Services, within the jurisdiction of the Office of Chief Counsel, Appeals.

H. Underwriter

It is now time for Mr. Green to find an underwriter. An underwriter is crucial. The underwriter agrees to purchase the entire bond issue for less than face value, this is the underwriter's discount. The underwriter resells the bonds to investors who may be institutions (e.g. mutual bond funds) or individual investors. The underwriter's discount covers the commission to the underwriter's salesmen and the underwriter's cost of preparing the bonds and the offering statement. Individual investors usually purchase bonds through their own broker. The broker contacts the underwriter and obtains the bonds.

Because of the manner in which bonds are marketed, in many instances it may be difficult for individual investors holding defaulted bonds to recover their losses in litigation. Typically, the first sale of an issue when it is offered to the public is offered for three hours in a morning or afternoon. The underwriter might get 500 orders in the space of a few hours. The significance of this is that most individual investors never look at the offering or disclosure statement; there is no time for even the most cursory questioning of the underwriter. This becomes important when the investor tries to sue because of material misrepresentations in the offering statement or disclosure document. Large institutional investors would have a much better knowledge of the particulars of the transaction and would take the time to examine the offering and disclosure statement.

I. Negotiated Sale and Open Bid

There are two basic ways the underwriter can market the bonds. A negotiated sale is when the investors, usually one or two, are identified before the issuance. A price for the bonds can be negotiated with them and the bonds may never really be sold on the open market. The other way is by open bid, which is when orders are taken from any investor who wishes to participate.

J. Underwriter's Counsel

Underwriters have their own counsel, underwriter's counsel. Underwriter's counsel prepares the offering statement. The offering statement is the document usually relied on by investors for disclosure of significant matters relating to the bond issuance.

K. Problem Underwriters

There are a number of extremely reputable underwriters. But, as with any other player in the bond scenario, there are also underwriters of questionable repute. In one case, a subsidiary of the underwriter was a partner in the deal. In another case, the underwriter was already under investigation by the SEC and numerous state agencies. These facts were not disclosed in either the disclosure or offering statements.

The underwriter in this case, Bonds R US, is more inexperienced than crooked. It looks at the feasibility study prepared by Bookkeeping, Inc. and is a little nervous although it does not inquire as to any other feasibility studies. It is concerned that this really is not a good market for selling high priced residential retirement units. For its own comfort, it insists that 50% of the units be sold before the bonds are sold. Mr. Green advertises them for sale but has very few takers. Smiling in the face of adversity, he removes the requirement for a deposit and "sells" 50% of the units to his friends, family and assorted henchpersons. While the underwriter knows that no deposits were required, the bond issuance goes forward.

L. Bond Trustee

Another major player to come on board is the bond trustee. The bond trustee represents the bond holders as a group. The trustee maintains and invests whatever reserve funds are established in the trust indenture. The bond trustee pays out the interest to the bondholders. In bankruptcy the Bond Trustee represents the bondholders.

The relationship with the bond trustee and the other participants must be examined. If the developer does a significant amount of business with the bank that is functioning as bond trustee, there is the potential for a conflict of interest. One should be very suspicious if there is any commonality between the organization, the management company, and the bond trustee. In one case, the bond trustee released bond proceeds before the entire bond issue was subscribed. This was in direct conflict with the trust indenture, and the result was that the developer absconded with the money before the project was ever built.

M. Bearer Bonds

Prior to the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, most municipal bonds were bearer bonds. The interest on bearer bonds was paid to whomever was holding the bonds. So that interest was only paid once, each bond came with coupons that were redeemable for the interest. This presented all sorts

of problems for the IRS in tracking down who received income. The bearer bonds were also part of an illegal underground economy: the bonds were used instead of cash. Congress enacted legislation to cure these abuses in 1982.

N. Registered Bonds

TEFRA required that all municipal bonds subject to its provisions be in registered form. This means that ownership is recorded and the bond trustee pays the interest by mail. This requirement has been the subject of much constitutional litigation because the states feel that it infringes on their sovereign immunity. In South Carolina v. Baker, 485 U.S. 505, 109 S. Ct. 1355 (1988), the Supreme Court upheld the constitutionality of this requirement.

O. Management Company

1. Management Contract

The next entrant is the management company. The management company is essential to the project where the exempt organization has no experience in the type of facility it wants to build. In fact, it is fairly safe to say that there can be more confidence in a project if an experienced exempt organization is managing the facility itself. The management company is often the alter ego of the developer who may have also created the exempt organization. Thus, the management contract should be analyzed closely. What is seen in an abusive contract that serves private interests is a manager who may be receiving unreasonable compensation for the duties performed and/or a manager that really has a proprietary interest in the facility. The following are some of the indicia of a bad management contract. They should be read together; any one characteristic standing alone may not be fatal.

a. The contract term is lengthy, over five years.

b. The contract requires that if the exempt organization terminates, the manager gets paid a premium.

c. The manager has fundamental powers, such as hiring and firing, setting rates, and setting policy.

d. The exempt organization is not located in the same state as the project.

e. The manager can spend large amounts, such as $50,000 to $100,000 on his/her own.

f. The manager has control over the budget.

h. The manager or any one related to the manager, sits on the exempt organization's Board of Directors.

i. The manager is compensated by a share of the net profits.

j. Less than 50% of the manager's fee is fixed.

2. Rev. Proc. 82-14

There is some guidance in reviewing a management agreement. For purposes of IRC 103 and IRC 145, it is necessary to determine if the manager has a proprietary interest in the facility. (See Part Four of this article, at section 3.C, for further discussion of this topic.) Rev. Proc. 82-14, 1982-1 C.B. 459 and G.C.M. 37641 (August 16, 1978) consider whether certain terms of a management agreement result in the proprietary use of a facility by the management company. The following factors indicate that the manager has a proprietary interest in the facility. The revenue procedure establishes a safeharbor to show that for purposes of bond qualification, a management contract does not cause the facility to be a private use facility.

(1) Compensation is based on a fixed fee rather than a percentage of profits. (New facilities without a financial history may use a percentage of gross receipts on which to base compensation for the initial year.)

(2) The exempt organization has the right to cancel the management agreement.

(3) The management company has a limited role on the board of directors.

(4) The management contract is for a reasonable length of time.

(5) Substantial control over policies and directives is not delegated to the management company.

Section 1301(e) of the Tax Reform Act of 1986 contains changes to Rev. Proc. 82-14 directed by Congress. Section 1301(e) directs the Treasury to modify its advance ruling guidelines contained in Rev. Proc. 82-14. The management contract will not be considered a private use (the manager is not considered the owner) if the contract including extensions does not exceed five years, at least 50%

of the manager's compensation is on a fixed fee basis, no compensation is based on net profits, and the owner can terminate the contract without penalty at the end of any three-year period.

Rev. Proc. 82-15, 1982-1 C.B. 460, pertains to a percentage of fee based contract between an exempt hospital, nursing home or similar facility financed with tax exempt bonds and physicians. In certain circumstances, the percentage arrangement will result in a conclusion that the facility is being operated for a private use.

In EO, the review is not limited to the principles expressed by these rules. This is because, for the issue of initial exemption or continued qualification, the review is to determine whether private interests are served. EO review is not limited to determining if the manager has a proprietary interest in the facility. Even if technically the manager does not have a proprietary interest in the facility, the exempt organization may still be operating for the private benefit of the developer or the management company.

P. Contractor

The last participant to discuss is the contractor. The contractor obviously builds the project. The contractor can be reputable or can be an alter ego of the developer. In one case the contractor was bribed by the developer to share the construction money with the developer. In this same case the developer bribed the jury and then appealed that his conviction should be overturned because the jury was tainted! It is a fair question to inquire if there is any business or family relationship between the developer and the contractor. Both the management agreement and the agreement with the contractor should have been the subject of competitive bidding. It is reasonable to ask that the competitive bidding process be explained to you and the request for proposals be submitted. The lack of competitive bidding should raise a flag.

The parties are now all assembled to float some bonds. It is important to remember that the exempt organization does not issue bonds. The bonds are issued by the governmental issuing authority on behalf of the exempt organization beneficiary. In our case, the underwriter, Bonds R US, is selling the bonds competitively.

Q. Bond Date

It is appropriate to note that bond dates are fluid concepts; any one of a number of things can cause the date to be extended. The bond date is that date the organization, bond counsel, the underwriters, etc. would like to market the issue because they feel they can get a favorable rate. This is not to say that in processing applications or ruling requests an attempt should not be made to meet the taxpayer's bond date. While an effort should be made, bond dates should not be met if all issues have not been resolved or if the organization has not met its informational burden.

R. The Investment

1. The Victims

The only absent ingredient is a willing investor or two. In this case, they are Joe and Jane Victim. The Victims are eager to buy these bonds because of their tax shelter advantages. (See Part Four of this article, at section 4 for a discussion of this issue.) They call their broker who tells them she has some reputable municipal bonds just going on the market. She tells them that the bonds are going like hotcakes, although the Victims are the first customers she has approached. Joe and Jane buy three $5,000 bonds which are the most common denomination. They do not look at an offering statement or any other documentation because they are dealing over the phone.

2. The History of the Project

The bond proceeds are distributed and a small but pricey retirement facility is built. $2,500,000 goes directly to Cayco in the Cayman Islands, directly into Mr. Green's pocket. Because of this diversion the exempt organization has no working capital. The 50% bogus purchasers have all rescinded their contracts and the project can not pay the interest payments on the bonds. The project stays afloat for a short while on the reserve fund which was established when the bonds where issued. Shortly thereafter, the bond trustee declares that the bonds are in default and demands full payment on behalf of the investors. The exempt organization seeks Chapter 11 bankruptcy protection and the project is sold for a fraction of its cost. The bond holders get about $.30 on the dollar. Mr. and Mrs. Green are vacationing in the Cayman Islands and the Victims are fighting mad. Can they sue someone, who, and will they recover?

3. The Law Suit

The Victims, of course, will sue everyone that ever touched these bonds. The more pertinent question is who participated in the fraud. Likely candidates would be:

1. Reputable, Inc. the feasibility consultant because they withdrew their feasibility study knowing that the project would go forward without it.

2. Bookkeeping, Inc. because they issued a favorable feasibility study without credentials and with knowledge that the first study was negative.

3. Bond Counsel because he or she knew that the feasibility study had been withdrawn and had a duty to inquire.

4. Bonds R US because they knew that the statement in the Offering Statement to the effect that the project was 50% subscribed was inaccurate and misleading. One can try to sue the underwriter's counsel for a misleading offering statement but it is unlikely that there will be a recovery.

4. The Remedy

This section discusses some of the possible remedies for the bondholders when a transaction fails. The purpose of this discussion is not to review Securities law. The purpose is to demonstrate how important it is for EO personnel to identify private benefit and inurement when reviewing applications or ruling requests. The bondholder's recoveries are limited. This means that litigation may not serve as a good deterrent to unscrupulous activities. Thus, the public as a whole would benefit from the early identification of transactions that impermissibly benefit private parties.

Most of the case law centers around Rule 10b-5 of the Securities Act of 1934 although the bondholders may sue on a number of other theories, such as state securities law violations. The following elements are required to make out a claim under Section 10(b), which is based on the common law action of deceit. The plaintiff must establish: (1) a misstatement or an omission; (2) of material fact; (3) made with scienter [a degree of knowledge that makes an individual legally responsible for the consequences of his/her actions]; (4) on which the plaintiff relied; (5) that proximately caused his injury.

It would probably not be too difficult to prove a misstatement or an omission of material fact that was made with scienter. Proximate cause could also be proved.

The problem which led to the ultimate defeat of the plaintiff is reliance. It is extremely difficult for the defrauded investor to prove reliance on a misrepresentation or omission in an offering statement when many small investors never see the offering statement.

5. Fraud on the Market

The courts appear well aware of this problem as they are well aware of how bonds are customarily marketed. In recent cases there has been a developing theory called fraud on the market place. When the plaintiff can not prove reliance but the bonds are so flawed due to fraud that they were not entitled to be marketed, perhaps the plaintiff could satisfy the reliance burden. The plaintiffs would be arguing that they relied on the market to set the price but that the market was deceived due to the fraud. Unfortunately, the most recent cases would make this theory inapplicable to the situation the Victims are in.

6. Established Market

The first sale of bonds, either by negotiated sale or by open bid, is considered a sale on the primary market. If bonds were resold by the first investors, that would be a sale on the secondary market. The courts refer to the secondary market as an established market. In an established market, the market sets the price by trading. In a primary market, the price is really set by the issuer and the underwriter. So, the fraud on the market place theory does not work in a primary market because there is no real market to defraud. In almost all cases, the plaintiff loses.

S. Conclusion

One of the purposes in following the bond from its inception to its ultimate collapse is to demonstrate the vital role EO plays. Without a favorable IRC 501(c)(3) letter none of this can take place. EO review has some impact on the bonds because of the interplay between IRC 501(c)(3) and IRC 145. But this is not the most dramatic role.

Before bonds are issued and before the investors or the federal treasury is harmed, potential private benefit can be identified. There should be identification of bad management contracts, relationships among parties where there should be no relationship, appraisals and feasibility studies that are old, incomplete or don't make sense, or any one of a number of other flags that will indicate that there

should be an in depth review of the transaction. EO's review is to determine if exemption should be denied because the organization is operating to further private interests. Situations may arise, such as inexperienced management or economic conditions, that will affect the credit worthiness of the bonds and result in the organization's default on its loan payments to the governmental issuing authority. However, EO does not review the credit quality of the bonds.

Not all bond financing is bad and not all bond cases need to be subject to endless scrutiny. The more cases that are reviewed, the easier it will be to determine which cases need a high level of scrutiny.

Nevertheless, exemption and examination cases involving qualified 501(c)(3) bonds should be scrutinized to insure that the organization is operating for public rather than for private purposes and that the bonds are likely to be qualified.

The third part of the article discusses EO's role in reviewing exempt organization determination and examination cases involving projects financed with "qualified 501(c)(3) bonds".

The fourth part of this article contains the technical rules of IRC 103 and IRC 141 through IRC 150. The technical rules need to be understood in order to work these cases. While an audit program may be able to examine organizations that have participated in defaulted bonds, the harm to the public and the treasury has already taken place. Careful review of these cases, both to determine whether the organization should be exempt and to be reasonably assured that the bonds initially qualify under the provisions of IRC 103 and IRC 141 through IRC 150 is both necessary and beneficial. It is much more efficient to intercept a bad bond before it is marketed, instead of waiting for the public to be injured. Any bond qualification questions should be coordinated in the manner indicated in Part Three of this article, at Questions 11 and 12.

PART THREE

THE REVIEW PROCESS

This section explains in a question and answer format how bond cases should be worked. The section contains a number of "caveats" to be used in favorable ruling letters. Presently, the caveats should only by used by National

Office personnel. Additional guidance will be given to district office personnel through the IRM.

1. What if the organization represents that it cannot produce bond documents until it obtains an IRC 501(c)(3) favorable determination?

This question comes up frequently in reviewing bond cases. From our experience, the organization's claim is highly questionable. Experience has demonstrated that the organization can proceed with most of the steps towards bond financing without a favorable determination letter. The organization may submit its bond documents in draft, with the following proviso. While we will review documents in draft, draft does not mean a document with all the essential terms left blank. The document has no validity and is unacceptable for review purposes if the essential terms are left blank. In one case, an organization submitted another organization's bond documents as a model. This is clearly unacceptable. If the organization can or will not produce bond documents, a proposed denial based on the organization's failure to establish its exempt status is appropriate. The determination letter or ruling can be based, in part, on the following authority.

> Organizations described in section 501(c)(3) are exempt from federal income taxation under section 501(a). In order to be described in section 501(c)(3), an organization must be organized and operated exclusively for charitable or educational purposes.
>
> Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order for an organization to be exempt under section 501(c)(3) of the Code it must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.
>
> Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.
>
> Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more of the purposes specified in section 501(c)(3) of the Code unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is

necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Rev. Proc. 91-4. 1991-4 I.R.B. 20, at section 8, provides that the service may decline to issue a ruling or a determination letter whenever warranted by the facts or circumstances of a particular case.

Rev. Proc. 90-27, 1990-1 C.B. 514, provides, in part, that exempt status will be recognized in advance of operations if proposed operations can be described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. A mere restatement of purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement. The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned, and the nature of contemplated expenditures. Where the organization cannot demonstrate to the satisfaction of the Service that its proposed activities will be exempt, a record of actual operations may be required before a ruling or a determination letter will be issued. In those cases where an organization is unable to describe fully its purposes and activities, a refusal to issue a ruling or determination letter will be considered an initial adverse determination from which administrative appeal or protest rights will be afforded.

Rev. Rul. 76-91, 1976-1 C.B. 149, provides that the purchase, in a transaction not at arm's length, of all the assets of a profit-making hospital by a nonprofit hospital corporation at a price that includes the value of intangible assets, determined by the capitalization of excess earnings formula, does not result in the inurement of the hospital's net earnings to the benefit of any private shareholder or individual or serve a private interest precluding exemption under IRC 501(c)(3). The revenue ruling states that where the purchaser is controlled by the seller or there is a close relationship between the two at the time of the sale, the presumption that the purchase price represents fair market value can not be made because the elements of an arm's length transaction are not present.

Rev. Rul. 76-441, 1976-2 C.B. 147, ruled that a nonprofit organization that purchases or leases at fair market value the assets of a former for-profit school and employs the former owners, who are not related to the current directors, at salaries commensurate with their responsibilities is operated exclusively for educational and charitable purposes. An organization that takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the director's private interest and is not operated exclusively for educational and charitable purposes.

In News Release IR-90-60, dated April 3, 1990, the Service explained that it is carefully examining situations involving tax-exempt bonds used to finance health care facilities to determine whether the organization on whose behalf the bonds are issued is furthering private interests to an impermissible degree. The news release describes several situations where such financing is part of a series of transactions in which exempt organizations are used by developers or others to acquire health care facilities at a cost in excess of the fair market value. These situations may involve unreasonable development or management fees paid to acquire or operate health care facilities. In addition to raising private benefit issues, such transactions may also endanger the financial integrity of the health care facility. Also, the news release suggests that there are situations where an exempt organization leases or sells a health care facility that it purchased with tax-exempt bonds to partnerships or other entities who also maintain some control over the exempt organization. This raises concerns about arm's length standards and the true owner of the health care facility.

In News Release IR-90-107, dated August 21, 1990, the Service announced the issuance of new determination instructions to help Exempt Organizations specialists detect potentially abusive transactions in which charitable organizations finance facilities with tax-exempt bonds. These instructions are contained in Internal Revenue Manual section 7668.(17).

2. What if there are relationships among the parties, such as where the developer controls the applicant and has representatives sitting on the applicants board of directors, or representatives of the management company sit on the board?

Simply put, you ask them to leave. During the review process a potentially "bad" bond case can be reformed. Just because a developer or a management company conceived of a facility and created an exempt organization, there still may be public benefit if the control by private parties is removed or substantially diminished. If the management company wishes to stay on the board, the organization can be asked if it is willing to get a new management company. If the management contract provides that the manager is really in control of the project (See Part Two of this article, section 2.0 and Part Four at section 3.C), the organization can be requested to renegotiate the contract to remove the offensive provisions. Authority for the requested changes can be derived from a number of sources. In particular, Rev. Rul. 69-545, 1969-2 C.B. 117, provides two situations which illustrate that control by private parties of an exempt organization is frequently indicative of operations that serve the interests of such private parties through, for example, favorable agreements at other than arm's length standards and adoption of policies detrimental to the promotion of charitable interests. If the

organization declines to modify its activities and private interests are served other than incidentally, consideration should be given to issuing a proposed denial.

3. What if all of the applicant's activities are in proposed form, it has definite plans to finance with the proceeds of tax-exempt bonds in the near future, and there are no bond documents? The applicant maintains that it needs its exemption before it can proceed with financing.

The general policy, in cases where the organization is financing its activities with tax exempt bond financing, is not to issue a ruling until the bond financing program can be reviewed. In certain circumstances, this may put the organization in an impossible situation. The organization may require its exemption for reasons other than its participation in bond financing.

Many times, the seller of property needs to sell to an exempt organization. The organization is in limbo, its needs the exemption to get the property but cannot start the bond financing without the property. In other circumstances, initial grant money is dependent on the organization's qualification for exemption. In these situations, we might issue a caveated ruling. The ruling will provide for exemption and private foundation status in routine fashion. It will provide, in the manner indicated below, that the organization will submit a request for a ruling to the Service prior to the issuance of the bonds. It should be emphasized that it is not intended that this become the normal ruling method. An organization that cannot describe its bond program should be issued a proposed denial because it has failed to establish its exempt status. (See Question 1 of this part for a discussion of this type of denial.) The caveated letter should only be issued when you are satisfied that the organization is an exempt organization in all respects, there is no indication of relationships among the parties or of private benefit, and the organization's need for the ruling is compelling. If a caveated determination letter or ruling is merited, the following language should be used. Before a letter is issued, the organization must agree in writing to request a ruling prior to issuing bonds.

CAVEAT

By your letter dated _____, you have indicated that you will not now finance your activities with tax-exempt bonds. You have indicated that you plan to finance your activities with tax-exempt bonds in the near future. You have agreed to request a ruling as to the effect of bond financing on your exempt status

from Exempt Organizations Technical Division, Internal Revenue Service, 1111 Constitution Ave., N.W. Washington, D.C. 20224, Attn: E:EO:R, according to the provisions of Revenue Procedure 91-4, 1991-4 I.R.B. 20, in a reasonable time prior to the bond issuance date.

4. What if the organization intends, in the future, to finance with tax-exempt bonds?

An organization may have a fully described program that does not depend on the current issuing of bonds but it may indicate that it wishes to finance some of its future activities with tax-exempt bonds. The organization is not currently engaging in any of the steps leading towards bond financing, it is just holding out the prospect of a future financing mechanism. If you are assured that the organization is not in the process of bond financing, the following caveat to a normal determination letter or ruling would be appropriate. It would alert bond issuing authorities that the organization has not been reviewed for bond purposes and it would alert the organization of its responsibility to request a ruling.

> Your application indicates that you have future plans to finance some of your activities with tax-exempt bonds. In the future, if you plan to finance your activities with tax-exempt bonds, you may request a ruling as to the effect of bond financing on your exempt status from the Exempt Organizations Technical Division, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224, Attn: E:EO:R, according to the provisions of Rev. Proc. 91-4, 1991-4 I.R.B. 20. Thus, bond issuing authorities should be aware that this exemption was recognized without consideration of the effect of bond financing.

5. What if the organization is purchasing facilities but has no appraisal or the appraisal is inadequate?

When an organization is purchasing land or an already operating facility, an appraisal is essential. Without the appraisal it cannot be determined whether the organization paid fair market value. Appraisals need to be examined closely. (See Part Two of this article, at Section G for a discussion of what to look for in an appraisal). If an appraisal will not be provided, consideration should be given to issuing a proposed denial based on the organization's failure to establish that it qualifies for exemption. (See Question 1 of this part for a discussion of this type of ruling.) If an appraisal will not be submitted and there is any relationship between the organization and the seller, the developer, or the manager, which indicates that

private interests are being served more that incidentally, consideration should be given to issuing a proposed denial.

6. What if the organization requests a group exemption?

The issuance of a group exemption letter is an administrative procedure which has been in existence for several decades. The procedures were instituted to relieve the Service from the burden of individually processing a large number of applications involving the exempt status of organizations that are affiliated with each other, and also are organized and operated for the same purpose. The procedures for obtaining and maintaining a group exemption letter are contained in Rev. Proc. 80-27, 1980-1 C.B. 677 and IRM 7667. It should be emphasized that these procedures were established for the convenience of the Service. Regardless of whether an organization is included in a group exemption or whether it has received an individual exemption letter, all organizations are subject to the same rules for maintaining their tax-exempt status.

The standards for issuing a group exemption letter or inclusion in a group exemption are not lower than those for issuing individual exemption determinations. This means that in the case of IRC 501(c)(3) rulings, the standards regarding a full description of the proposed purposes and activities including assurances covering inurement and private benefit have to be satisfied. In this respect, where facilities are being built or purchased with tax-exempt bond proceeds, we need to consider all the documents and facts and circumstances surrounding the construction or conversions before we are able to reach a conclusion as to an organization's qualification for recognition of exemption.

Because of the in depth review that is required before an organization that is participating in tax-exempt bond financing can be recognized as exempt under IRC 501(c)(3), the group exemption procedure is inappropriate for these cases. Unless all bond cases are subject to similar review, the group exemption procedures would constitute an easy method of access to the bond market by unscrupulous promoters. An applicant requesting a group exemption on behalf of a group of organizations engaged in bond financing should be informed that, pursuant to section 8.01 of Rev. Proc. 91-4, 1991-4 I.R.B. 20, the Service will not issue a group exemption ruling under these circumstances; but, will individually rule on each Form 1023 submitted by a subordinate.

7. What if the organization will not submit bond documents?

The first question to ask is whether the organization has a bond date. A bond date is the date the bonds are to be sold. If the organization does have a bond date, it should have the documents needed for a review of its program at least in the draft state. As previously stated, we will review documents in draft. This is with the understanding that all the essential terms of the documents must be completed. If the organization has a bond date but will not submit the documents requested, the applicant should be issued a proposed denial based on failure to describe its activities in sufficient detail. (See Question 1 of the part for a discussion of this type of denial.) If the applicant can not submit bond documents because it is just starting the bond process, consideration may be given to issuing a caveated exemption letter in the manner indicated in Question 3, above. This procedure should only be used when the specialist has determined that the organization can describe its charitable program with specificity, there is no question of private benefit, and the organization's need for the letter is compelling. If those factors are all not present, a proposed denial based on failure to describe activities with specificity should be issued.

8. What if an organization represents that it is buying its facility out of bankruptcy court but that it will turn the facility around and be able to pay off the bond holders?

We should view this metamorphosis with a great deal of skepticism. It is very difficult to turn a hospital or a nursing home around in a short period of time. In many cases, the applicant has claimed that the ability to be an IRC 501(c)(3) organization will make the difference between failure and success. You should be suspicious of this claim. If the organization was in bankruptcy, chances are it had no taxable income so that the tax benefits of exempt status would have very little impact. While an organization exempt under IRC 501(c)(3) could benefit from tax deductible contributions, most of these organizations do not depend on contributions. They receive most of their income from patient or tenant fees. We should look closely at the appraisal and the feasibility study to see how the organization plans to work the transformation. In a number of cases, the hospital in bankruptcy had a low occupancy rate. The organization projects that it will have a dramatically improved rate. The organization should be asked to explain in detail how it will improve its occupancy rate. The organization must be able to demonstrate how it will make the failed health system profitable and pay off the bond holders.

9. When should bond cases receive expeditious treatment?

All bond cases should be screened initially to determine how close the organization is to the bond issuance date. If the file does not contain the bond documents mentioned in IRM 7668.(17):2, those documents and additional information should be requested. We have prepared a "general information letter" (see below) that is suitable for most bond cases and can be used as an initial development letter. The purpose of this letter is to expedite the cases so that review time can be spent reviewing adequately documented files. When the information is returned, the file should be screened to determine if the documents necessary for review have been submitted. At this point, it is necessary to determine whether expeditious treatment should be granted. The Service is concerned that our review not interfere with qualified bonds being issued. Therefore, once all the information requested is submitted, it is appropriate that our review be performed on an expedited basis if possible. Where the organization has not submitted the information required for review, there is no reason to expedite the case. (See Question 3 of this part for a discussion of the issuance of a caveated letter if an organization can not acquire property or grants without a determination letter.)

General Information Letter

News Release IR-90-60 alerted the public to abusive transactions in which charitable organizations purchase or sell health care facilities financed with tax-exempt bonds. Tax exempt bond financing or certificates of participation are becoming increasingly popular methods of raising funds for charitable projects. While the majority of bonds are not used fraudulently, a number are. Without specific information concerning your method of operation and your use of bond proceeds, we will not be able to rule favorably on your request.

In order to process cases involving the issuance of tax-exempt bonds in an expeditious fashion, we would appreciate your careful responses to this standard letter. Your responses and the documents you submit should greatly assist the review process of your application.

1. Provide the following documents. We prefer to review documents in their final form. We understand that your documents may not be finalized at this stage. Please be aware that we will review draft documents only if all of the essential terms have been specified.

   a. Purchase agreement, if there will be a purchase of property or facilities.

   b. Settlement agreement if there has been a compensated sale.

   c. Filing with state or local agency for tax-exempt bonds.

d. Appraisal of any property to be purchased (the appraisal must be performed by a qualified real estate appraiser and value must be determined by more than one method).

e. Assignments

f. Development agreements

g. Offering statement

h. Opinion of council on exclusion of income

i. Feasibility study (this is essential)

j. Management contracts

k. Underwriter's agreements

l. Patient or resident contracts, if applicable

m. Mortgage and security agreements

n. Any guarantees

2. Have you established a bond date? If you have, please indicate the bond issuance date and also indicate the last date you can receive recognition of exempt status in order to have the bonds issued on that date.

3. Provide a brief resume of each of your officers and directors. The resume should disclose all business interests.

4. Will any of your officers or directors provide goods or services (directly or indirectly) to the facility you will operate? If they will, please describe in detail the goods or services that will be provided.

5. Are any of your officers and directors, officers or directors of any other entity that is participating in tax exempt bond financing? If they are, please provide the names of the organizations and, if IRC 501(c)(3) organizations, their dates of tax exemption.

6. If you are part of an affiliated group of organizations, provide a chart of the entire system including all affiliated organizations nationwide. Indicate the purpose of each organization and its tax status. Indicate the members of each organization and the shareholders of any closely held corporations. Indicate the relationships among the entities. If any entity in the system is paying bondholders

interest on tax-exempt bonds, disclose the amount of bonds outstanding for each entity and the date the bonds were issued.

7. If you are purchasing an existing facility, please provide the name of the seller and the names of the seller's principal shareholders, officers and directors.

8. If you will manage the facility yourself, please explain your expertise in managing facilities of this type.

9. If the facility will not be managed by you, please answer the following questions.

a. Explain how you chose the manager.

b. Did you submit requests for bids to any other entities? If you did, please provide a copy of the request. If you did not, please explain the factors which influenced your decision to only examine one manager.

c. How many facilities does your manager currently manage? Of the facilities it manages, what are the names of the facilities that are managed for organizations described in section501(c)(3) of the Code.

d. If your facility will be managed by anyone other than yourself, please disclose the names of the principal shareholders, directors, and officers of the manager. Also include a brief resume for each person.

10. If you are party to a management contract, please answer the following questions.

a. What is the contract term?

b. If you terminate the contract for any reason, are you required to make any payment to the manager? When and under what conditions can you terminate the agreement?

c. How much can the manager spend each year on its own discretion?

d. Who sets the budget, you or the manager?

e. Explain how the manager is compensated? Is the manager compensated by a percentage of net profits?

f. What percentage of the management fee is fixed?

11. Will anyone else be liable on the bonds to be issued on your behalf? Please explain in detail.

12. If you have not already done so, please provide a breakdown of how the bond proceeds will be utilized.

13. Does your facility require a Certificate of Need? If it does, please submit a copy.

14. Have you selected a project architect, engineer, construction manager, general contractor and interior designer? If you have, please submit copies of the contracts you have executed. Are any of the contractors affiliated or associated with you or the manager? Please provide the names of the principal shareholders, officers or directors, partners, or members of the entities you have chosen to contract with.

15. Please answer the following questions in regard to your feasibility study.

a. What are the credentials of the feasibility consultant?

b. When was the feasibility study performed? If the feasibility study was not performed within the past 18 months, it is highly likely that a new study or an update of the study needs to be performed.

c. Is this the only feasibility study that has been commissioned on this project?

d. If this is not the only feasibility study that has ever been commissioned, submit a copy of all other reports.

e. Who are the officers, directors, and principal shareholders of the feasibility consultant?

16. Has an underwriter been selected? What are the credentials of the underwriter?

17. Has the bond trustee been selected? Do you or any of the entities you have contracted with have a business or banking relationship with the bond trustee?

18. What is the name of the governmental issuing authority? When was the authority created?

19. Have the potential investors been identified or will the bonds be sold by open bid? Please describe the investors if they have been identified. If you prefer, you

can describe the investors by type, (pension fund, large corporation, etc.) instead of by name.

20. If the purpose of your facility is to house low and moderate income tenants, please answer the following questions.

a. Please define "low" and "moderate" income, as you will use those terms in selecting tenants. What percentage of median income will each classification represent?

b. What percentage of your tenants will be low income and what percentage will be moderate income.

c. Has the location of the facility been classified by a federal, state, or local governmental agency as blighted or deteriorated?

d. Submit the rate of unemployment for the area the facility will be located in.

e. What is the average rental for an apartment for a family of four in the area the facility will be located.

f. Will the tenants receive H.U.D. Section 8 housing assistance?

g. Please submit all contracts you are a party to with any federal, state, or local agency regarding housing.

21. If you will finance residential care facilities or apartments for the elderly with the proceeds of bond financing, please answer the following questions.

a. Please describe in detail how your facility will meet the special needs of the elderly as enunciated in Rev. Rul. 72-124, 1972-2C.B. 145.

b. What will be the average family income of your residents? What will be the average holdings (stock, property, and cash, etc.) held by your residents?

c. What is the median income for the area in which the property is located?

d. What is your policy concerning residents who can no longer afford to pay your charges?

22. If you are purchasing an existing facility, please answer the following questions.

a. Are you purchasing a facility that is in bankruptcy?

b. If you are purchasing a facility that is in bankruptcy, please describe in detail how you will be able to operate the facility so as to pay its expenses plus the additional expense of paying interest to the bondholders.

10. What should be reviewed when examining an organization that has participated in bond financing?

An exempt organization not only has to maintain its qualification under IRC 501(c)(3), but bonds issued on its behalf must continue to be qualified under the provisions of IRC 103 and IRC 141 through IRC 150. On audit, it can be determined if the organization actually used the bond proceeds for the purposes they were intended. It can also be determined if funds were syphoned off to private parties. Particular attention should be given to the provisions of IRC 150. This section contains penalty provisions for change in use. (See Part Four, section 5.C of this article for a discussion of the IRC 150 provisions.) The following questions should be addressed.

a. Has the management contract changed so that the manager has a proprietary interest in the facility?

b. Were any bond funds used to purchase facilities used by a private party or used in an unrelated business activity. If a private party is using any of the bond financed facilities, see Part Four, section 5.C for a discussion of the penalties under IRC 150.

c. If any bond funds were used to purchase low-income housing facilities or residential facilities for the elderly, are the IRC 142 percentages maintained? (See Part Four, section 3.E for a discussion of residential real property.)

d. Has the governmental issuing authority met the reporting requirements of IRC 149(e)? If it has not, the bond interest payments may be taxable. (See Part Four, section 5.B for a discussion of registration and reporting requirements.)

e. Review IRM 7(10)11 for a discussion of private benefit considerations where exempt organizations buy or sell facilities with tax-exempt bonds. Attention should be paid to excessive purchase and compensation arrangements to the developer, management company, other contractors, professional agents, or joint venture participants.

11. What if your review of a ruling or determination case discloses that the bonds may not be qualified under the rules of IRC 141 through IRC 150?

If facts lead to a conclusion that the bonds may not be "qualified 501(c)(3) bonds", appropriate coordination needs to be undertaken by the Exempt Organizations function. (See Part Four of this article for a complete discussion of "qualified 501(c)(3) bonds" and IRC 141 through IRC 150.) If information developed during the processing of an application for recognition of exemption or a ruling request on a proposed transaction indicates that the bonds may not be qualified, coordination with the Assistant Chief Counsel (Financial Institutions and Products) through the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) should be undertaken. Since District determinations involving tax-exempt bonds will be referred to the National Office if there are indications of potential abuse (See IRM 7664.31:(19), the coordination will be undertaken by the Exempt Organizations Technical Division.

In exemption determinations or rulings, there may besignificant doubt about the qualification of the bonds after coordination with Chief Counsel. But, an organization may, nevertheless, be entitled to a favorable determination or ruling concerning exempt organization matters. If bond concerns cannot be resolved satisfactorily, the determination or ruling should contain the following caveat.

> Your case has been reviewed for its bond financing program. During the review process, significant issues were raised which question the qualification of bonds to be issued on your behalf under IRC 145 and, thus, the tax exempt status of the bonds. While you are exempt under IRC 501(c)(3), bond issuing authorities should be aware that the characterization of the bonds as "qualified 501(c)(3) bonds" within the meaning of IRC 145 is in doubt.

12. What if your examination disclosed that the bonds may not be qualified under the rules of IRC 141 through IRC 150?

National Office Assistance must be obtained as provided by IRM 7(10)7(11).3. IRM 7(10)27 is being modified to indicate that technical advice must be requested when issues of the qualification of the bonds are raised during an examination. You should forward questions concerning the qualification of bonds or questions concerning the consequences to an exempt organization if the bonds are not qualified.

Similarly, if revocation of an IRC 501(c)(3) exemption letter is recommended and the organization has outstanding IRC 501(c)(3) bonds issued on its behalf, technical advice from the National Office must be sought.

13. Is there any special provision that should be included in a favorable determination letter or ruling to an organization that is having bonds issued on its behalf?

The following provision should be used in all letters in which the bond financing program of the organization has been reviewed and a favorable ruling is merited. There are three reasons to insert the following language. Our review can only determine whether the organization as described meets the requirements for exemption, not to determine if the bonds to be issued will be a good investment. We also wish to make it clear that no ruling under IRC 103 has been made that the income received by the bondholders would be excluded from gross income. We would like to alert bond authorities to the fact that we reviewed only one bond financing program of the applicant. If an exempt organization is presenting a determination letter to bond issuing authorities that is ten years old, we want the issuing authorities to be aware that we have not reviewed the current bond transaction.

> This letter expresses no opinion concerning the marketability, reliability, or value, of the bonds to be issued on your behalf. This letter expresses no opinion concerning whether interest you pay on the bonds would be excluded from the gross income of the bondholders within the meaning of IRC 103. In addition, no opinion is expressed concerning the accuracy of the bond documents you have submitted. This letter also does not make a determination regarding whether the purchase or lease of property is at fair market value. Bond issuing authorities should be aware that this letter is only based on information submitted on or before (insert the date the last information was submitted).

PART FOUR

TECHNICAL RULES

1. Introduction

This part of the article discusses the technical rules of IRC 103 and IRC 141 through IRC 150. The Tax Reform Act of 1986 made sweeping changes to the treatment of tax-exempt bonds. The liberal rules that were in place prior to 1986 had created a glut of government bonds that were only vaguely achieving legitimate government purposes. It seemed that anyone who wanted to go into

business could get a willing municipality to issue bonds. The interest would be tax exempt to the bondholder and the new business would get a very favorable interest rate. The big loser was the Treasury. Out of the sweeping changes made by the Tax Reform Act 1986, bonds issued on behalf of IRC 501(c)(3) organizations still retain many advantages.

In order to understand the technical rules that apply to bonds issued on behalf of IRC 501(c)(3) organizations, it is necessary to understand the statutory scheme that was put in place in 1986.

EO specialists already familiar with the differentiation between public charities and private foundations are also familiar with the various rules that are imposed on private foundations by Chapter 42 of the Code. The rationale for that differentiation is that while the public, by their participation and contributions, can police public charities, privately held foundations need vigilance on the part of the Service. A similar differentiation was made in the area of tax-exempt bonds.

2. Governmental Bonds and Private Activity Bonds

A. Governmental Purpose Bonds

First, the 1986 Act divides the universe of bonds into two broad categories, governmental purpose bonds and private activity bonds. For purposes of the Code, a governmental use is any use other than a private use. A typical governmental purpose bond is one in which the government issues the bond on its own behalf, such as bonds to build roads or schools. In this situation, the government is the user of the bond proceeds. IRC 103(a) provides that gross income does not include interest on any State or local bond. This is the fundamental section that governs the tax exempt status of bonds. If a bond is a governmental purpose bond, the interest is not included in the gross income of the bond holder and the bond itself is subject to fewer Code restrictions. Since these bonds finance State and local governments engaging in governmental functions, there is no need for the federal government to be heavily involved.

B. Private Activity Bonds

All other bonds issued by the government are private activity bonds. Thus, private activity bonds are all bonds that are not governmental purpose bonds. Mechanical tests that distinguish a governmental purpose bond from a private activity bond will be further discussed. Is the income on all private activity bonds

subject to tax? The answer is no. Congress established a subset of private activity bonds termed qualified private activity bonds. The interest earned on qualified private activity bonds is not included in the gross income of the investor unless the investor is subject to the alternative minimum tax (AMT). Qualified 501(c)(3) bonds are the only qualified private activity bonds not subject to the AMT. (See section 4.B.) Governmental bonds are also not subject to the AMT.

C. Qualified Private Activity Bonds

IRC 103(b)(1) provides that the exclusion of income contained in IRC 103(a) will not apply to any private activity bond unless it is a qualified bond that meets rules set forth in IRC 141 through IRC 150. The income derived from any bond that meets the technical rules of IRC 141 through IRC 150 will be excludable from gross income for federal income tax purposes. There are seven types of qualified private activity bonds. Each has its own governing Code section and there are general rules that apply to all of them to some extent. The following is a list of qualified private activity bonds and their governing Code sections.

1. Exempt Facility Bond (IRC 142)
2. Mortgage Bond (IRC 143)
3. Veteran's Mortgage Bond (IRC 143)
4. Small Issue Bond (IRC 144)
5. Student Loan Bond (IRC 144)
6. Redevelopment Bond (IRC 144)
7. IRC 501(c)(3) Bond (IRC 145)

This article will concentrate almost exclusively on IRC 145. But familiarity will also be necessary with a portion of IRC 142, exempt facility bonds. IRC 142 contains an extensive list of exempt facilities such as airports, docks, solid waste disposal facilities, etc. Most do not arise in an exempt organization context, except for IRC 142(a)(7), qualified residential rental projects. There are IRC 142(a)(7) bonds and there are organizations issued IRC 501(c)(3) bonds for residential rental real estate purposes. If qualified IRC 501(c)(3) bonds are issued for residential real estate purposes they will have to satisfy some of the rules of IRC 142. IRC 142(a)(7) will be discussed in detail at Section 3.E of this part.

D. Governmental bonds vs. Private Activity Bonds, A Statutory Definition

1. In General

The initial distinction to be made is between governmental bonds and private activity bonds. The purpose of IRC 141 is to make this distinction. IRC 141 contains two principal tests and sub tests. If the bond meets any of the tests, it is a private activity bond. Although this section speaks in terms of "meeting a test", in this case meeting any one of these tests has a negative consequence. If any of the tests are met, the bond is not a liberally treated governmental bond, it is a potentially taxable private activity bond. For the purpose of understanding the statutory framework, an understanding of these tests is necessary. But in practical terms, most of the bonds reviewed by EO specialists are clearly private activity bonds because they "meet" at least one of the tests.

2. Private Use

As the term "private activity bond" implies, we are testing for private use. Private use is use of the proceeds by anyone other than the government. An IRC 501(c)(3) organization is considered non-governmental and its use of the proceeds is a private use. It is easy to see that a bond issued by a governmental issuing authority on behalf of an IRC 501(c)(3) beneficiary would involve private use, the IRC 501(c)(3) organization is the user. In this situation, the bond is a private activity bond and the interest would not be excluded unless all applicable rules of IRC 141 through IRC 150 are complied with so that the bond is a qualified private activity bond.

A bond will be deemed a private activity bond if one of the following two principal tests are met. These principal tests are the (1) Private Business Use Test, and the (2) Private Loan Financing Test.

PRIVATE BUSINESS USE TEST

a. Private Business Use Subtest
b. Private Security Subtest

The private business use test is satisfied if both the private business use subtest and private security subtest are satisfied.

(i) IRC 141(b)(1) [private business use subtest] provides that the bond will be a private activity bond if more than 10% of the proceeds are used for a private business purpose or, as discussed at (iii) below, more that 5% of the proceeds are nongovernmental use proceeds.

(ii) IRC 141(b)(2) [private security subtest] is satisfied if either of the following requirements are met. The payment of principal or interest on more than 10% of issue proceeds is-

- secured, directly or indirectly, by an ownership interest in private business use property

- secured, directly or indirectly, by an interest in payments relating to private business use property

- derived, directly or indirectly, from payments relating to private business use property

- derived, directly or indirectly, from borrowed funds used for private business uses

Thus, if the government is not using more than 90% of the proceeds for its own purposes and more than 90% of the debt isn't serviced by government income or secured by government property, the bonds are private activity bonds. Any IRC 501(c)(3) bond should meet this test because use by a IRC 501(c)(3) organization is private use and the debt is serviced by the income from the property. Thus any bond issued on behalf of an IRC 501(c)(3) organization is normally a private activity bond. There are two exceptions to this rule for 501(c)(3) organizations that are acting in a quasi-governmental capacity. (See section 6 of this part for additional discussion of this issue.)

(iii) IRC 141(b)(3)focuses on the 10% that can be private business use. If the private business use is not related to the purpose for which the bonds were issued, no more than 5% of the proceeds may be devoted to such unrelated private business use. To be a governmental bond, only 5% can be truly unrelated to the governmental purpose. For example, assume 90% of the bond proceeds went to pay for public schools. It appears that 10% of the proceeds could be used to fund a new kitchen for the private contractor that provides meals to the schools. That would be a 10% private use, but it would be related. Conversely, if 10% were used to provide a loan to a minority business person to establish a radio station, that would be a private use, it would be unrelated and it would be more than 5%. The bond would be a private activity bond rather than an governmental bond.

PRIVATE LOAN FINANCING TEST

If more than the lesser of 5% of the bond proceeds or $5,000,000 is used directly or indirectly for loans to nongovernmental entities, the bonds are private activity bonds.

3. A Simple Formula

In a nutshell:

90% Government Use + Note More Than 10% Private Use (With the 5% Unrelated Ceiling) = Governmental Bond

The tests confirm that a bond issued on behalf of an IRC 501(c)(3) organization is a private activity bond because the IRC 501(c)(3) organization is considered a private user. The interest on the private activity bonds is not tax exempt unless the bond is "qualified". Qualification for 501(c)(3) bonds is derived from IRC 145. However, once the bonds are initially considered as qualified IRC 501(c)(3) bonds within the meaning of IRC 145, there are other requirements which must be met for the interest to be excluded and for penalties to be avoided.

3. IRC 145 Qualified 501(c)(3) Bonds

Let's first take a look at IRC 145(a). In the private business use discussion, it was stated that the bond would be a governmental bond, and therefore the interest received by the investor would be tax exempt under IRC 103, if at least 90% of the bond was used by the government to do governmental activities and the other tests of IRC 141 are not met. IRC 145(a) treats a private activity bond as a "qualified 501(c)(3) bond", and the interest earned by the investor is excludable from gross income under IRC 103, if the IRC 501(c)(3) organization is substituted for the government in the private business use equation and not more than 5% of the bond proceeds go to other private uses or for an unrelated trade or business. Thus, if 95% of the bond proceeds are used by an IRC 501(c)(3) organization itself, not in any unrelated trade or business or private use, the bonds will meet the requirements of IRC 145(a).

A. A Simple Formula

95% 501(c)(3) Use + No More than 5% Private or Unrelated Business Use = Qualified 501(c)(3) Bond

B. The Code

IRC 145(a) In General-For purposes of this part, except as otherwise provided in this section, the term "qualified 501(c)(3) bond" means any private activity bond issued as a part of an issue if:

> (1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a government unit, and
>
> (2) such bond would not be a private activity bond if:
>
> (A) 501(c)(3) organizations were treated as governmental units with respect to activities which do not constitute unrelated trades or businesses, determined by applying IRC 513(a), and
>
> (B) paragraphs (1) and (2) of IRC 141(b) were applied by substituting 5% for 10% each place it appears and by substituting net proceeds for proceeds each place it appears.

C. Caution - What if the EO isn't the Manager?

Many exemption applicants or exempt organizations requesting private letter rulings will meet the test laid out in IRC 145(a) because the IRC 501(c)(3) organization will be the user of the bond proceeds. This may not be the case, however, if a for profit manager manages the bond financed facility to such an extent that it has a proprietary interest in the facility or is a private user. In this situation, the bonds will not pass this test. Thus, the manager should not have too many of the indicia of ownership. These elements of private use or benefit are also important consideration in determining exempt status under IRC 501(c)(3) or in determining whether a proposed activity will affect exempt status. (See Part Two of this article, at section 2.0 for additional guidance on this issue.)

In addition to being on the look out for private use which would affect the qualification of the bond, unrelated business income is also a significant factor.

Private use of the bonds encompasses unrelated business use but goes further. What would be the consequences if a portion of the bond proceeds were used to provide facilities for a related IRC 501(c)(4) organization that was accomplishing the goals of the principal IRC 501(c)(3) organization? It is probable that the portion of the bond proceeds used in that fashion would be private use.

The General Explanation of the Tax Reform Act of 1986, "The Blue Book" indicates that a medical office building supplying private offices for doctors associated with the hospital would be considered a private use. The Blue Book specifies that this treatment applies even if the medical office building is considered a related activity within the meaning of IRC 513. This is an area where the definitions of unrelated trade or business may not coincide between IRC 513 and IRC 145. The Blue Book is not part of the legislative history but it contains a legislative explanation of the Tax Reform Act of 1986. (See Part Three of this article, at Questions 11 and 12, for a discussion of coordination where questions of bond qualification are raised.)

D. IRC 145(b)

The cap contained in IRC 145(b) is a cap on the amount of outstanding bonds any particular IRC 501(c)(3) organization can have issued on its behalf. The basic rule is that no IRC 501(c)(3) organization which is a test period beneficiary can have more than $150,000,000 in bonds outstanding. That may sound like a lot, but it may not be because of expansive aggregation rules in the Code section and the legislative history. The following is a discussion of the technical rules of IRC 145(b).

1. Test Period Beneficiary

A test period beneficiary is defined in IRC 145(b)(4) by reference to IRC 144(a)(10), but the definition in the Blue Book is a little easier to understand. Test period beneficiaries are all the owners and principal users of bond financed facilities. Each is allocated that portion of the facilities they own or use. Thus one bond issue can be allocated to more than one IRC 501(c)(3) organization. The following is an excerpt from the Blue Book which explains the administration of the $150,000,000 limitation.

> The $ 150-million limitation generally is to be administered in a manner similar to the continuing $40-million limitation for beneficiaries of small-issue bonds. For example, bonds generally are to be allocated only among those section 501(c)(3)

organizations who are test-period beneficiaries of the bonds in question. Test-period beneficiaries are defined as owners or other principal users of the facilities being financed by the issue at any time during the three-year period beginning on the later of (1) the date such facilities are placed in service, or (2) the date of issue. No portion of an issue generally is allocated to persons other than owners and principal users during this three year test period.

As under the $ 40-million limitation, all owners of bond-financed facilities during the three-year test period are allocated that portion of the issue that is equivalent to the portion of the facilities that they own. Additionally, all principal users of the facilities during the three-year test period are allocated a portion of the face amount of the issue equivalent to that portion of the facility used by them. (In certain cases, this may result in all or part of an issue being allocated to more than one section 501(c)(3) organization.)

2. Aggregation Rules

The aggregation rule contained in IRC 145(b)(3) provides that two or more organizations under common management or control shall be treated as one organization. The Blue Book provides that an IRC 501(c)(3) organization is related to any other person if it owns 50% of the capital or profit interests. Also, two organizations are related if they have common purposes and substantial common membership or have directly or indirectly substantial common direction. The example given in the Blue Book was a local chapter and its national organization. Two organizations will be considered related if the purpose was to avoid this section. This would prevent organization A with too many outstanding bonds from having unrelated organization B participate in bond financing on its behalf. If the Exempt Organizations function sees relationships between the exempt organization under consideration and any other organization that could trigger the section 145(b)(3) aggregation rules, appropriate coordination as previously described should be undertaken.

3. Three Year Test Period

The test period is three years from the later of the date the facilities are placed in service or the date of issue. If anytime during the three years the cap is violated, the interest on the bonds is taxable from the date of issuance. But, only that portion of the bonds exceeding the cap would be subject to this treatment.

4. How to Avoid the $ 150,000,000 Cap

There are two ways to avoid this cap. An IRC 501(c)(3) organization can elect out of this section if the bond issuance meets the requirements for qualification under any other provision of IRC 142 through IRC 145 such as qualified residential rental project bonds described in IRC 142(a)(7). But the principal method of avoiding the IRC 145(b) volume cap is by meeting the requirements of IRC 145(c).

5. 145(c) Special Treatment for Hospital Bonds

IRC 145(c) contains special rules for qualified hospital bonds. Qualified bonds are exempt from the IRC 145(b) cap if 95% of the issue is used in respect to a hospital. One has to turn to the Blue Book again, for the definition of a hospital. In order to be exempt from the IRC 145(b) cap:

a. A hospital has to be accredited by a hospital accrediting board.

b. The hospital has to primarily provide, under physician supervision, inpatient or therapeutic care.

c. Each patient has to be under the care of a physician.

d. It has to provide 24 hour nursing. There must be a licensed practical nurse or registered nurse on duty at all times and it must be supervised by registered professional nurses.

It is specifically stated that a hospital does not include rest homes, nursing homes, day care, medical school, research laboratory, ambulatory care facility, or surgicenters.

Therefore, in a exempt organization application or examination case where there is hospital bond financing, the exempt organization function would need to ask these questions. The specialist needs to ascertain if appropriate coordination as previously discussed should be undertaken to determine whether the organization is entitled to take advantage of the IRC 145(c) exception.

E. 145(d) Residential Rental Property

The last major portion of IRC 145 is IRC 145(d) which concerns residential rental property. The purpose of IRC 145(d) is to make the rules of IRC 142(d) for qualified residential rental property apply to bonds issued on behalf of IRC

501(c)(3) organizations. The rules of IRC 142(d) are modified for purposes of IRC 145(d).

1. 145(d)(1) The Exclusion

IRC 145(d)(1) takes all residential rental housing bonds out of IRC 145, so the bonds would not be qualified, but IRC 145(d)(2) puts three categories of bonds back in.

IRC 145(d)(1) provides that a bond which is part of an issue shall not be a qualified 501(c)(3) bond if any portion of the net proceeds of the issue are to be used directly or indirectly to provide residential rental property for family units.

2. 145(d)(2) The Inclusion

IRC 145(d)(2) provides that IRC 145(d)(1) shall not apply to any bond issued for:

(a) a residential rental property for family units if the first use of such property is pursuant to such issue (exception for NEW facilities);

(b) qualified residential rental projects where a significant portion of the housing is occupied by low income tenants (142(d) exception); or

(c) property which has been substantially rehabilitated (as defined in IRC 145(d)(4)) within the two year period ending one year after the date of the acquisition of such property (Substantial Rehabilitation Exception).

This section means that a bond used for residential rental units will not be a qualified 501(c)(3) bond unless the facility is new, substantially rehabilitated, or meets the low income rules of 142(d).

3. 145(d)(3) Expands Definition of New

IRC 145(d)(3) was enacted by the Omnibus Budget Reconciliation Act (OBRA) of 1989. It is a special addition to the normal definition of new for purposes of IRC 145(d). Property is new if the first use is pursuant to the financing, there is a reasonable expectation that taxable financing would be replaced with tax exempt financing, and it is replaced in a reasonable time. If, when the property was first used there was no State or local program for tax exempt bond financing, it will be considered new with the first use after tax exempt bond financing.

4. Continuing Care Facilities

IRC 145(d) was enacted by the Technical and Miscellaneous Revenue Act (TAMRA) of 1988. The Conference Committee Report, 1988-3 C.B. 615, provides that 145(d) is to be applied to the residential care facilities of a continuing care facility. This has direct application in the exempt organizations area because exempt organizations frequently purchase existing residential care facilities for the elderly. IRC 145(d) would require that the provisions of IRC 142 be complied with so that at least 20% of the housing units must be occupied by tenants having incomes of 50 percent or less of area median income or 40% of the housing units in the project must be occupied by tenants having incomes of 60% or less of the area median income for the qualified project period, generally 15 years.

For example, an exempt organization purchases an elderly care facility with separate apartment units. The facility was not new nor was it substantially rehabilitated within the meaning of IRC 145(d)(2). The facility would have to meet the special needs of the elderly for exemption under IRC 501(c)(3) and, in addition, it would have to comply with the low income housing requirements (the 20%/40% test) in order for the bonds to be qualified 501(c)(3) bonds. This is substantially different than exempt organization rules for elderly housing projects. (For additional guidance on low income housing, see the Low Income Housing article in this CPE Text.)

5. Housing Unit Defined

The Conference Report defines housing unit for purposes of IRC 145(d). The definition would apply to both low income housing projects and residential care facilities for the elderly. The property must be comprised of housing units which contain separate and complete facilities for living, sleeping, eating, cooking and sanitation. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes and trailer parks for use on a transient basis are not residential rental property. Most residential care facilities would be considered housing units under this definition. Although they provide communal meals, they usually have cooking facilities in the apartments.

4. Why are 501(c)(3) Bonds So Attractive

A. In General

The requirements contained in IRC 145 for a "qualified 501(c)(3) bond" have been fully discussed. But, the statutory scheme is not over. There are some penalty provisions for change in use and there are more requirements contained in other sections. Before discussing the additional requirements, it is important to discuss the requirements of IRC 141 through IRC 150 that do not apply to qualified 501(c)(3) bonds. Knowledge of the provisions that do not apply, provide insight into why IRC 145 bonds are so attractive to the exempt organization and to the investor.

If the Tax Reform Act of 1986 gutted the tax exempt bond area, IRC 501(c)(3) organizations only got minor degree burns. There are three major advantages (and a number of minor advantages) that qualified 501(c)(3) bonds have over other qualified private activity bonds. These advantages make participation in tax exempt bond financing through a IRC 501(c)(3) organization most attractive.

B. Alternative Minimum Tax

The first big difference is the alternative minimum tax. The intent of the alternative minimum tax is to make everyone pay their fair share. A number of deductible items are added back in to income. The 1986 Tax Reform Act made tax exempt bond interest a tax preference item subject to the alternative minimum tax. That means that for certain high income taxpayers, the very people who would gain the most by buying municipal bonds, the interest may be taxable. But, the alternative minimum tax does not apply to interest on qualified 501(c)(3) bonds and governmental bonds. These are the only bonds that are truly tax free for the high income taxpayer.

C. State Volume Cap

The next difference is contained in IRC 146, the State Volume Cap. Each state is only allowed to issue bonds the aggregate value of which does not exceed the state volume cap. For years after 1987, the volume cap is the greater of $50 times the state population or $150,000,000. This only applies to qualified private activity bonds. There is no cap on governmental bonds. The cap does not apply to nonqualified private activity bonds because there is no exclusion for the interest they earn the investor. The bond issuing authorities in the state determine which bonds should be issued to make up the ceiling. The competition may be intense. Finally, qualified 501(c)(3) bonds are not subject to this ceiling, a big advantage.

D. Arbitrage

IRC 148 contains the arbitrage rules. These rules apply penalties if the proceeds from tax-exempt bonds are used to invest in higher yield investments. Arbitrage is an abuse area and Congress cracked down. The arbitrage profits have to be rebated to the government and failure to do so will result in loss of the tax exempt status of the bonds. However, qualified 501(c)(3) bonds are treated more liberally than other qualified private activity bonds. If the IRC 501(c)(3) organization fails to rebate the arbitrage it can pay a penalty of half the amount without losing the tax exempt status of the bonds.

Arbitrage income may be subject to the tax on unrelated business income because of the debt-financed income rules of IRC 514. This issue is currently being studied in the National Office.

E. IRC 147 - Additional Rules

IRC 147 contains additional rules for all qualified bonds. Some apply to 501(c)(3) organizations, but most do not. The following is brief discussion of the provisions that do not apply.

1. IRC 147(a)

IRC 147(a) provides that a private activity bond will not be qualified if it is held by a person who is a substantial user of the bond financed facility.

2. IRC 147(c)

IRC 147(c) provides that a private activity bond will not be a qualified bond if 25% or more of the bond proceeds are used to buy land.

3. IRC 147(d)

IRC 147(d) provides that a private activity bond will not be a qualified bond unless it is used to purchase new or substantially rehabilitated facilities.

F. Legislative Limitation

In addition, Congress has specifically provided in the Tax Reform Act of 1986 that any legislation affecting private activity bonds will not affect qualified

501(c)(3) bonds unless the legislation specifically provides that it will affect qualified 501(c)(3) bonds.

5. More Requirements for 501(c)(3) Bonds

This section discusses the remaining restrictions and penalties affecting qualified 501(c)(3) bonds, including the remaining provisions of IRC 147.

A. IRC 147 Restrictions Affecting Qualified Bonds

The penalty for failure to comply with the provisions of IRC 147 is loss of the interest exclusion.

1. IRC 147(b)

IRC 147(b) provides that a private activity bond will not be a qualified bond if the average maturity of the bonds issued exceeds 120% of the average reasonably expected economic life of the facility. This provision would have application when an exempt organization is purchasing an existing facility.

2. IRC 147(e)

IRC 147(e) is very specific. A private activity bond will not be a qualified bond if any portion of the proceeds is to be used to provide any airplane, skybox or other private luxury box, health club facility, facility primarily used for gambling, or a store the principal business of which is the sale of alcoholic beverages for consumption off premises. The legislative history modifies this provision so that a qualified 501(c)(3) bond can be for health facilities if the facilities are related to the purpose of the 501(c)(3) organization.

3. IRC 147(f)

IRC 147(f) requires that there be public approval of the qualified private activity bond either by elected representatives after a public hearing or by referendum.

4. IRC 147(g)

IRC 147(g) provides that the bonds will not be qualified if the cost of financing exceeds 2% of the proceeds. Bond issuance costs include underwriter's

spread, bond counsel, underwriter's counsel, issuer's counsel, borrower's counsel, financial advisor on the bonds, rating agency, and trustees fees. The 2% has to be taken out of the 5% private use permitted for qualified 501(c)(3) bonds. But taxable bonds can be issued in conjunction with tax-exempt bonds to pay issuance costs.

B. IRC 149 Restrictions Affecting Qualified 501(c)(3) Bonds

1. IRC 149(a)

IRC 149(a) requires that the bonds must be in registered form. (See Part Two of this article, at section 2.N, for a discussion of the registration process.)

2. IRC 149(b)

IRC 149(b) requires that the bonds can not be federally guaranteed but, FHA, VHA and a few others are excluded.

3. IRC 149(e)

IRC 149(e) imposes reporting requirements. Depending on the type of bond, there are three applicable forms. The issuer (the governmental issuing authority) of private activity bonds files Form 8038 which is due no later than the 15th day of the second calendar month following the calendar quarter in which the bonds were issued. Issuers of governmental bonds file Form 8038-G, which is due in the same time period. Form 8038-GC is a consolidated information return for issues having an issue price of less than $100,000. It is filed annually by February 15 of the calendar year following the calendar year in which the small issues were issued. If the reporting requirements are not satisfied, the bonds are not tax exempt.

C. The Penalties of IRC 150

IRC 150 contains special rules and may take away the benefits bestowed by the prior sections.

1. IRC 150(b)(2)

IRC 150(b)(2) provides that the deduction of interest will be lost if a residential rental bond described in 142(a)(7) no longer meets the requirements of IRC 142(d) [low income housing].

2. IRC 150(b)(3)

IRC 150(b)(3) provides penalties if the IRC 501(c)(3) organization permits its bond financed facility to be used in a trade or business by any one other than a IRC 501(c)(3) organization or a governmental unit. The IRC 501(c)(3) organization will be treated as receiving unrelated business taxable income. The amount of gross income attributable to that portion will be its fair market rental value. No deduction from unrelated trade or business income will be permitted for interest paid on the bonds. So the organization could have no real income and have deemed unrelated business income with no deduction. And the bond interest would be taxable to the bond holders if the 5% private use rule is violated.

3. IRC 150(b)(5)

IRC 150(b)(5) provides that if tax exempt financing was provided for a facility but that facility is sold to any organization other than a 501(c)(3) organization or governmental unit, the interest will no longer be deductible.

6. Quasi-governmental Organizations

Most of the rules described above apply to qualified private activity bonds, not to governmental bonds. As previously discussed, governmental bonds are the government issuing bonds for a governmental purpose backed by the credit of the governmental unit. There are two ways a 501(c)(3) organization can be government-like so that its bonds can be treated the same as governmental bonds.

A. Constituted Authorities

The organization can be a constituted authority within the meaning of Rev. Rul. 57-187, 1957-1 C.B. 65, or it can be a 63-20 Corporation within the meaning of Rev. Rul. 63-20, 1963-1 C.B. 24, which controls obligations issued on behalf of a political subdivision.

1. Rev. Rul. 57-187

To satisfy Rev. Rul. 57-187 the organization has to have the following characteristics.

(a) It has to have specific statutory authorization.

(b) It has to have a public purpose.

(c) It has to have a governing board controlled by apolitical subdivision.

(d) It has to have the power to acquire, lease, sell property and issue bonds payable solely out of the project.

(e) There can be no inurement.

(f) On dissolution the property has to go to the subdivision.

2. Rev. Rul. 63-20

Rev. Rul. 63-20 requires the following characteristics.

(a) The organization has activities that are public in nature.

(b) The organization is not organized for profit.

(c) There is no inurement.

(d) The state or political subdivision has a beneficial interest in the Corporation while indebtedness is outstanding and must get full legal title upon retirement.

(e) Corporation must be approved by the State or political subdivision and approve the bonds.

If the provisions of either of these two revenue rulings are met, the bonds are totally outside the statutory scheme for qualified 501(c)(3) bonds except for the minor provisions applicable to government bonds.

PART FIVE

APPENDIX

News Release
Department of the Treasury
Internal Revenue Service
Public Affairs Division
Washington, DC 20224

For release: 4/3/90
Media Contact: Tel. (202) 566-4024
Copies: Tel. (202) 566-4054
IR-90-60

Washington -- The Internal Revenue Service today warned against several potentially abusive transactions in which charitable organizations purchase or sell health care facilities financed with tax exempt bonds.

Transactions of this type may result in impermissible private benefit or private inurement and the loss of an organization's tax exempt status. If so, the interest paid on the bonds issued by the organization may be taxable. In some circumstances the charitable organization may not be considered the true owner of the health care facility for tax purposes and the interest on the bonds used to finance the facility may be taxable. Because of these concerns the IRS said examiners will closely scrutinize these types of transactions.

The first transaction involves a charitable organization acquiring a nursing home or hospital with proceeds of tax exempt bonds. For example, a developer may acquire a nursing home and resell it at a substantial profit to a new or existing charity over which the developer exercises control or influence. The developer may also enter into an agreement with the charitable organization to rehabilitate, manage or operate the nursing home for an excessive fee.

A second transaction involves a charitable organization leasing or selling health care or similar facilities that it financed with proceeds of tax exempt bonds. The facilities are leased or sold to partnerships or other entities in which the physicians or medical staff of the charitable organization have a financial interest.

A third transaction involves a private health care corporation selling an unprofitable facility to a charitable organization. For example, a private corporation may set up a new charitable organization to issue tax exempt bonds and use the proceeds along with purchase money debt to purchase the facility from the private corporation at an inflated price.

News Release
Department of the Treasury
Internal Revenue Service
Public Affairs Division
Washington, DC 20224

For Release: 8/21/90
Media Contact: Tel. (202) 566-4024
Copies: Tel. (202) 566-4054
IR-90-107

Washington -- The Internal Revenue Service today issued new instructions to its examiners to help them detect potentially abusive transactions in which charitable organizations buy or sell health care facilities financed with tax exempt bonds.

The IRS emphasis on examining such transactions was announced earlier in a news release dated April 3, 1990.

The instructions issued today for exempt organizations examiners concern processing applications for recognition of exemption from federal tax under Internal Revenue Code section 501(c)(3) that are submitted by nursing homes, old age homes, extended care facilities, hospitals and other health care organizations.

The instructions explain how examiners are to handle cases with evidence of possible abuse. They describe abusive situations the IRS intends to curtail and specify information that should be provided by applying organizations that have or intend to have facilities financed by tax exempt bonds.

The IRS said that abusive transactions can have adverse consequences both for charitable organizations and for investors in tax exempt bonds. Impermissible private benefit can result in the loss of the organization's tax exempt status. If that happens, the interest paid on bonds issued by the organization may be taxable to the bondholder.

The new instructions are included in Internal Revenue Manual sections 7668.(17) and 7(10)7(11).

IRM 7600 Processing Determination Letter Applications

7668.(17)3 (8-14-90)
Disposition of Cases

(1) If the organization intends to finance health care projects with tax exempt financing (7668.(17)2:(1)(a) and (1)(b) are affirmative) but it cannot describe the health care project specifically, it is not experienced in the health care field, and does not intend to manage the project directly (7668.(17)2:(1)(c)-(1)(e) answered negatively), the case should be forwarded to National Office for handling in accordance with IRM 7664.31:(20).

(2) If the organization does not provide all the documentation asked for above or if the district is uncomfortable with the facts, the National Office contact should be telephoned to determine whether the case should be forwarded to National Office. These cases will also be forwarded citing IRM 7664.31:(20) on Form 3778.

(3) If the organization is providing or intending to provide health care but it does not intend to finance through tax exempt bonds, the district may issue a favorable determination letter with the following caveat assuming that the organization otherwise qualifies for exemption.

"You have indicated that you will not finance your activities with tax exempt bonds or certificates of participation. Therefore, this determination letter is based on the understanding that you will not raise funds through such financing. If in the future you wish to raise Funds by either of these methods, you should request a ruling from the Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington D.C. 20224, Attn: E:EO:R, according to Revenue Procedure 90-4, 1990-2 I.R.B. 10."

(4) If the organization answered all the questions in IRM 7668.(17)2 affirmatively and provided all the documentation requested, the district may issue a favorable determination letter containing the following caveat:

"This determination is based on the understanding that you will own and operate your health care facility directly without the use of a management company. Bond authorities should not rely on the validity of this letter if your operation is not self-managed."

(5) If the case involves an organization's notification to IRS of an amendment, or change in sources of support, purposes, character or method of operation, rather than an initial application, technical advice procedures will have to be followed before submission to National Office. A field examination may also be warranted in order to properly develop the facts.

7669 (9-26-79)

Adverse Rulings and Determination Letters

7669.1 (12-12-89)
General

(1) Proposed adverse rulings and determination letters must be individually composed and must contain the following:

(a) The material facts upon which the determination is made;

(b) Applicable statute, regulations, and other governing precedent;

(c) The Service's conclusion and a clear explanation of the underlying reasoning;

(d) A refusal to recognize status under any related paragraph of IRC 501(c);

(e) The organization's right to protest the proposed action by submitting a statement of the facts, law, and arguments in support of its claim of exemption (Publication 892 EO Appeal Procedures for Unagreed Issues must also be attached to proposed determination letters);

(f) The right of the organization to a conference;

(g) A statement that the determination will become final if the organization does not submit a written protest within the allotted time.

(h) In cases under IRC 501(c)(3), a statement that if the determination is the final disposition by the Service, appropriate State officials will be advised of the action in accordance with

(p) complete description of the relationship between all the parties involved in the health care project

(q) trust indenture and all other bond documents

(r) bond closing book containing documents relating to the bond issuance.

(3) Specialists are encouraged to telephone the designated National Office contact person when developing this type of case to determine whether it should be forwarded for National Office handling.

(4) The questions in (1) above can be modified to fit other types of organizations (i.e. low income housing, etc.) to develop the bond financing issues that arise.

7668.(17)3 (8-14-90)
Disposition of Cases

(1) If the organization intends to finance health care projects with tax exempt financing (7668.(17)2:(1)(a) and (1)(b) are affirmative) but it cannot describe the health care project specifically, it is not experienced in the health care field, and does not intend to manage the project directly (7668.(17)2:(1)(c)-(1)(e) answered negatively), the case should be forwarded to National Office for handling in accordance with IRM 7664.31:(20).

(2) If the organization does not provide all the documentation asked for above or if the district is uncomfortable with the facts, the National Office contact should be telephoned to determine whether the case should be forwarded to National Office. These cases will also be forwarded citing IRM 7664.31:(20) on Form 3778.

(3) If the organization is providing or intending to provide health care but it does not intend to finance through tax exempt bonds, the district may issue a favorable determination letter with the following caveat assuming that the organization otherwise qualifies for exemption.

"You have indicated that you will not finance your activities with tax exempt bonds or certificates of participation. Therefore, this determination letter is based on the understanding that you will not raise funds through such financing. If in the future you wish to raise Funds by either of these methods, you should request a ruling from the Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington D.C. 20224, Attn: E:EO:R, according to Revenue Procedure 90-4, 1990-2 I.R.B. 10."

(4) If the organization answered all the questions in IRM 7668.(17)2 affirmatively and provided all the documentation requested, the district may issue a favorable determination letter containing the following caveat:

"This determination is based on the understanding that you will own and operate your health care facility directly without the use of a management company. Bond authorities should not rely on the validity of this letter if your operation is not self-managed."

(5) If the case involves an organization's notification to IRS of an amendment, or change in sources of support, purposes, character or method of operation, rather than an initial application, technical advice procedures will have to be followed before submission to National Office. A field examination may also be warranted in order to properly develop the facts.

IRM 7(10)00 Examination Procedures

7(10)7(11).1 (8-14-90)
Background

(1) News Release IR-90-60, dated April 3, 1990, warns about several potentially abusive transactions in which charitable organizations purchase or sell health care facilities financed with purportedly tax exempt bonds. It points out that such transactions may result in impermissible private benefit or private inurement and the loss of an organization's tax exempt status. It further provides that because of the Service's concerns, examiners will be closely scrutinizing these types of transactions.

(2) Because of the Service's concern in this area, the following examination guidelines should be followed with respect to these cases. Specialists should also be alert to these types of transactions by organizations outside the health care field.

7(10)7(11).2 (8-14-90)
Examination Guidelines

(1) In cases involving a charitable organization's purchase or sale of health care facilities with purportedly tax exempt bonds, specialists should closely scrutinize transactions to determine whether there are any potentially abusive types of transactions between the IRC 501(c)(3) charitable organization and for-profit entities. The term "bonds" is broadly construed and may include certificates of participation, notes, loans, installment sales and other financial debt obligations. Specialists should be especially alert to possible prohibited private inurement such as through inflated valuation of the property being acquired, excessive management fee arrangements, etc. Some examples of these potentially abusive situations are as follows:

(a) A transaction involving the use of tax exempt bond proceeds by IRC 501(c)(3) organizations to acquire nursing homes or hospitals from individuals or entities directly or indirectly related to the exempt organization. For example, a developer acquires a nursing home from a financially troubled proprietary corporation. The developer is instrumental in creating an IRC 501(c)(3) organization and sells the nursing home to the IRC 501(c)(3) organization for substantially more than the developer's cost. The developer or its affiliate may also enter into agreements with the IRC 501(c)(3) organization using proceeds from the bond offering to rehabilitate, manage, or operate the nursing home. In some cases, these transactions involve a sale directly to an IRC 501(c)(3) organization without the participation of a developer as an intermediary or may involve an existing IRC 501(c)(3) organization making payments to private persons that are not negotiated at arm's length and that may be unnecessary or exceed fair market value. These transactions may result in private inurement proscribed under IRC 501(c)(3). Moreover, these transactions raise concerns as to whether the exempt organization is operated exclusively for the exempt purposes specified in IRC 501(c)(3) or for the benefit of private interests. If the "exempt organization" is not described in IRC 501(c)(3), interest on the bonds issued to finance the acquisition of

facilities acquired by the exempt organization may not be exempt from federal income tax.

(b) A transaction involving an IRC 501(c)(3) organization's sale of a tax exempt bond-financed health care facility to a for-profit entity. The for-profit entity may lease or sell the facility to a limited partnership. The limited partners include the physicians on the medical staff of the IRC 501(c)(3) organization. Accordingly, the limited partners will share in the facility's net profits. Such relationships among the parties, including the physician investors, may result in agreements between private persons and the IRC 501(c)(3) organization that are not negotiated at arm's length and that may be less than fair market value. This may result in impermissible private benefit or private inurement. Moreover, use of the bond-financed facility by private persons under these circumstances may adversely affect the tax exempt status of the interest paid on the bonds.

(2) Some factors specialists should consider in examining these cases which may be indicative of possible problems are:

(a) Whether the organization, or a subsidiary or affiliate, is experienced in the health care field. The health care field may include a variety of operations including hospitals, nursing homes, clinics, homes for the aged, home health care organizations, etc.

(b) Whether the organization does not manage the health care project directly but rather has it done through other sources such as a management company.

(c) In those situations where the organization is just proposing to start a health care operation, whether the organization has identified a specific project for which it has completed a detailed analysis with respect to such proposed operation.

(3) As applicable, the specialist should obtain and review the following information in these cases:

(a) purchase agreement

(b) settlement agreement, if the sale has been consummated

(c) filings with federal, state, or local agencies concerning tax exempt bonds

(d) appraisals

(e) assignments

(f) development agreements

(g) offering statement or private placement memoranda

(h) opinion of counsel on tax exempt status of bonds

(i) copies of project and financing feasibility studies

(j) management agreements including employment contracts

(k) underwriters agreements

(l) patient and resident contract agreements

(m) mortgage and security agreements

(n) lease agreements

(o) complete description of the project and the financing structure

(p) complete description of the relationship between all the parties involved in the health care project

(q) copies of trust indenture and all other bond documents

(r) bond closing book containing documents relating to the bond issuance.

(4) For general examination guidelines with respect to the examination of hospitals and health care organizations, see text 333 through 336 of IRM 7(10)69, Exempt Organizations Examination Guidelines Handbook.

7(10)7(11).3 (8-14-90)
National Office Assistance

If the specialist is in need of assistance relative to development of the case, whether to refer the case to the National Office, or any other pertinent case-related matter, he/she should call the National Office contact person for assistance.