

IRS Clamping Down on Private Business Use of Tax Exempt Bond-Financed Space

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Tax Exempt Bond Overview – Focus on Private Business Use (PBU)

- I) Benefits of Tax Exempt Bonds**
- II) History of “Conduit Financings”**
- III) Internal Revenue Code**
 - “Qualified 501(c)(3) Bond” v. “Governmental Bond”

Tax Exempt Bond Overview – con't

IV) Income Tax Regulations

- Definition of PBU
- Measurement of PBU, Measurement Period
- Allocation of, and Accounting for, PBU
- Management Contracts, Research Agreements
 - safe harbors

V) Record Retention

- “After The Bonds Are Issued: Then What?”

Tax Exempt Bond Overview – con't

VI) Recent & Proposed IRS Initiatives

- 2007 “Compliance Project” ~ 200 questionnaires
- 2008 Tax Exempt Bonds Work Plan
- Swap Initiatives

VII) Consequences of Failure to Qualify

Tax Exempt Bond Overview – con't

VIII) Audit Activity of IRS

- Random Audits
- Targeted Audits
- Voluntary Compliance Agreement Program (VCAP)

Profile of *University of Pittsburgh*

◆ 5-Campus System

- Oakland-Pittsburgh, Johnstown, Greensburg, Bradford, Titusville

◆ State-Related

- Commonwealth of PA appoints 1/3 of voting Trustees
- Revenue contribution FY2007 = 12%

◆ Student Quality – Fall 2007 Freshman

- SAT average (Oakland) - 1248
- Class Rank Top 10% (Oakland) – 48%
- University-wide FTE Enrollment – 30,787

Sponsored Research Statistics

- ◆ **FY2007 Receipts = \$620MM**
- ◆ **Research Funding Base Increased 264% Over 12-Year Period**
- ◆ **Ranked #7 Among Educational Institutions in Country for NIH Funding**
- ◆ **Revenue Contribution FY2007 = 39%**

Capital Structure Overview

- ◆ Total Debt = \$747MM
- ◆ 90% LTD / 10% STD
- ◆ 99% Fixed Rate* / 1% Variable Rate
 - * synthetic: via swap overlay
- ◆ Ratings:
 - AA Stable (S&P)
 - Aa2 Stable (Moody's)

Challenges to Ensuring Private Business Use (PBU) Compliance

- ◆ **Each of Pitt's Bond Issues Finance:**
 - Upwards of 150-300 individual capital projects
 - Spread across 100 campus buildings
- ◆ **Bond Refundings Complicate the Tracking Mechanism**
- ◆ **Employing a Rationale and More Formal Approach to PBU Measurement**
- ◆ **Future Change in Use**

Management of PBU

◆ Team Approach

- Facilities Management, Financial Information, Finance, Tax, Legal
- Team meetings held *in advance* of debt offering:
 - Capital budgets – and related sources of funding
 - Individual capital project details
- End Results
 - Including qualified capital projects only
 - All projects scrutinized regarding *potential* PBU
 - Ability to size bond issue with great degree of certainty
 - Due diligence performed on the front-end

Management of PBU - continued

◆ Recent PBU Assessments at Pitt

- Biomedical Science Tower 3 – mixed-use research building
 - Result: equity contribution of 60% (total cost \$205MM)
- Greensburg campus – dining hall addition & renovation
 - Result: exclusion given non-qualified management agreement

◆ Senior Management Involvement

- Department of Property Management (lease agreements)
- Office of Research (sponsored research agreements)
- Office of the Executive Vice Chancellor (management and service agreements)
- Provost Office

Post-Bond Issuance Compliance - Initiatives

- ◆ Annual Query Letters to Targeted Population
- ◆ Standard Forms Available on Pitt Web-Site (*i.e., sponsored research agreement*)
- ◆ Formal Documentation Surrounding Our Debt Compliance Practices

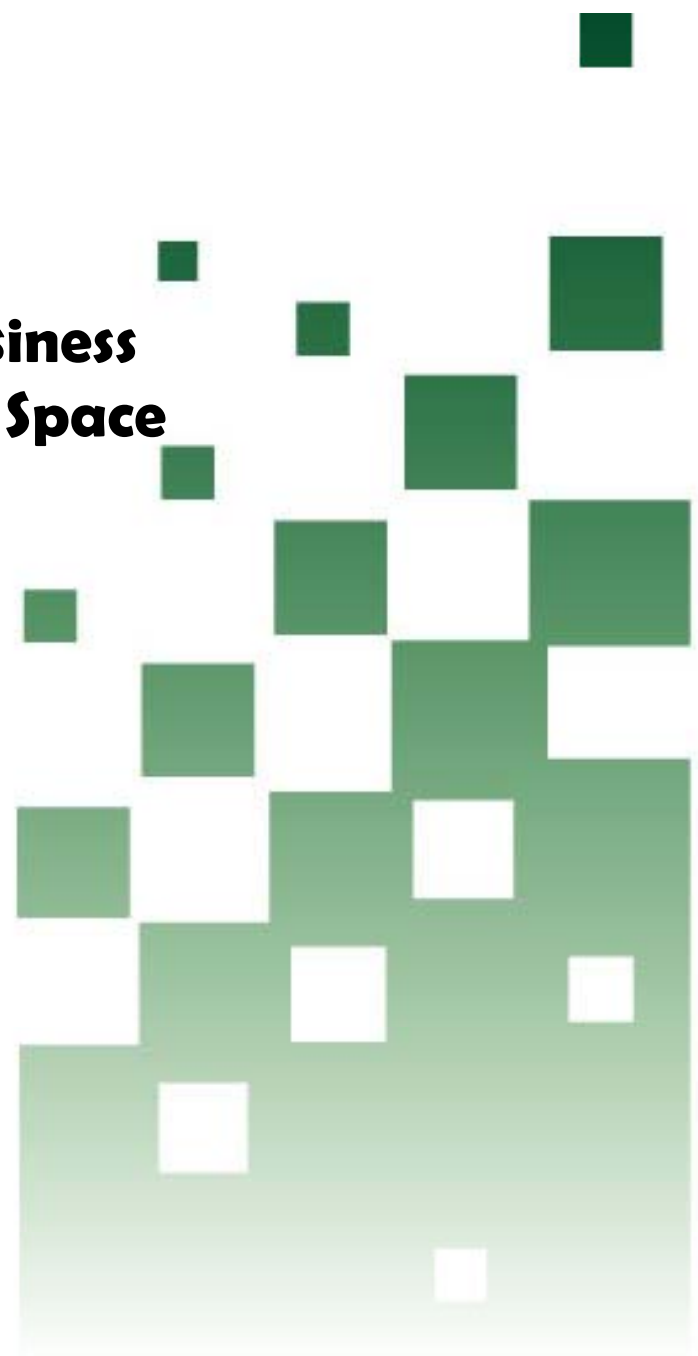
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Appendix

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Tax Exempt Bond Overview – Focus on Private Business Use

- I) “Benefits” of tax-exempt bonds include lower interest rate, a longer maturity date on the bonds and the ability to usually finance a larger portion of the project, i.e., less “equity.” “Costs” of tax-exempt bonds include limitations on the use of the property that was financed with such bonds and the resulting additional record retention that will enable the borrower to show that the use was in fact qualified.

- II) History of “Conduit Financings.” What is a “conduit financing?”

- III) The Code.
 - A) Section 103 of the Code provides generally that gross income does not include interest on a “State or local bond.” Such exclusion from gross income, however, does not apply to a “private activity bond” unless such bond is a “qualified bond” under Section 141 of the Code. A “private activity bond” is defined as a bond that meets the “private business use test” (i.e., more than 10% of the proceeds of the issue are to be “used” for any “private business use”) and the “private security or payment test” (i.e., more than 10% of the proceeds of the issue are, directly or indirectly, secured by any interest in property used in any private business use, or derived from payments in respect to property used for any “private business use”). Use by a Section 501(c) (3) organization is “private business use.”

Tax Exempt Bond Overview – Focus on Private Business Use

- B) Section 141 of the Code provides that a “qualified bond” includes a “qualified 501(c) (3) bond.”
- C) “Qualified 501(c) (3) bond” compared to “governmental bond.”
- D) Section 145 of the Code provides that a “qualified 501(c) (3) bond” means any private activity bond issued as part of an issue if (1) all of the property that is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and (2) such bond would not be a private activity bond if 501(c)(3) organizations were treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses and by applying a 5% “bad use” limitation. Thus, under Section 145 of the Code, **all** of the property financed with proceeds of the bonds must be owned by the 501(c) (3) or a governmental unit and no more than 5% of the proceeds may be used for a “non-qualified” purpose. Non-qualified uses would include uses by a for-profit entity pursuant to leases, subleases or “non-qualified” management or service contracts or uses by a 501(c) (3) organization that is not in furtherance of its exempt purposes.

Bond Overview – Focus on Private Business Use

IV) The Regulations.

Section 1.141-1 through 1.141-15 of the Income Tax Regulations apply to “governmental bonds” as well as to “qualified Section 501(c) (3) bonds.”

A) Section 1.141-2 provides that bonds are “private activity” bonds if the “trade or business test” and the “security interest test” are both met. Use “reasonable expectations.”

B) Section 1.141-3 provides a definition of “private business use.” Must consider “direct” and “indirect” uses. Multiple uses, e.g., ownership, leases, sub-leases, can occur for the same property at the same time and any one of which could result in “bad” use for the entire property.

C) Types of private business use arrangements- general definition.

(1) Ownership.

(2) Leases.

(3) Non-Qualified Management/Service Contracts.

(4) Output Contracts.

(5) Non-Qualified Research Agreements.

(6) “Other actual or beneficial use.” Arrangements that convey “special legal entitlements” similar to (1) through (5) and in situations where the property is not available to the general public, arrangements that convey a special “economic benefit.”

Tax Exempt Bond Overview – Focus on Private Business Use

D) Exceptions.

(1) General Public Use

(2) Agents. Independent contractors vs. employees. An employee of a Section 501(c) (3) organization is not considered to be in a separate trade or business from his/her employer. Thus, employment contracts are generally not a concern.

(3) Various exceptions relating to short-term uses where ownership stays with the 501(c) (3) organization, e.g., leases of parking spaces to entities engaged in a trade or business.

E) Management Contracts / Revenue Procedure 97-13: safe harbors

F) Research Agreements / Revenue Procedure 2007-47 (supersedes 97-14): safe harbors

V) Record Retention

A) Notice 2006-63. In Notice 2006-63 the Internal Revenue Service requested comments concerning developing record retention standards.

B) “After the Bonds are Issued: Then What?” Report by the Advisory Committee on Tax Exempt and Government Entities. This report was intended to assist issuers and conduit borrowers to develop policies, procedures and systems in order to ensure that the interest on tax-exempt bonds remains excludable from the gross income of the bondholders.

B) http://www.irs.gov/pub/irs-tege/bonds_act_0607.pdf

Tax Exempt Bond Overview – Focus on Private Business Use

VI) Recent and Proposed Internal Revenue Service Initiatives

A) Tax Exempt Bond Group and the Exempt Organization Compliance Area initiated a “Compliance Project” in 2007 to determine post-issuance tax compliance. Approximately 200 questionnaires were sent out to 501(c)(3) organizations. Although compliance was “voluntary,” the Internal Revenue Service informally indicated that it would audit 501(c)(3) organizations that did not comply.

A) http://www.irs.gov/pub/irs-tege/tebc3web_rev_2.pdf

B) The “Internal Revenue Service 2008 Tax Exempt Bonds Work Plan” lists both 501(c)(3) bonds and hospital/healthcare bonds (obviously, an overlap) as having a high risk of noncompliance. As a result, the Internal Revenue Service will emphasize audits of 501(c)(3) organizations and hospital/healthcare bonds.

B) http://www.irs.gov/pub/irs-tege/teb_fy08_work_plan.pdf

C) Swap initiatives. The Internal Revenue Service is generally concerned about swaps, particularly whether the fixed-leg of the swap is “above-market.”

VII) Consequences of failure to qualify.

- A) Loss of tax-exclusion of interest for bondholders. If the Internal Revenue Service determines that the bonds fail to qualify under Section 103 of the Code, the Internal Revenue Service can proceed to tax the interest received by the bondholders.
- B) Under Section 150 of the Code if the property financed with proceeds of a tax-exempt bond issue is not used in a proper manner, the 501(c) (3) organization may have “unrelated trade or business” income.
- C) Penalties under Section 6700 of the Code. Section 6700 of the Code imposes a “penalty” for promoting a tax-shelter.

VIII) Audit activity of Internal Revenue Service.

A) Random audits.

- (1) The Internal Revenue Service treats the issuer of the bonds as a “taxpayer” for purposes of resolving issues relating to whether the interest is excludable from the gross income of the bondholders. In most conduit financings the issuer will delegate some, if not all, responsibilities of the audit to the conduit borrower. The Internal Revenue Service follows certain procedural steps, including issuing a “preliminary adverse determination” and issuing a “proposed adverse determination.” If the issuer and the audit function of the Internal Revenue Service cannot resolve whether the interest is in fact excludable, the issuer has a right to proceed to the Office of Appeals to resolve the dispute. If the issuer cannot convince the Internal Revenue Service that there is not a problem, the issuer has a right to enter into a “closing agreement” (i.e., a contract) whereby the Internal Revenue Service will agree not to tax the interest received by the bondholders and the issuer/conduit borrower will, typically, agree to make a payment to the Internal Revenue Service. The closing agreement is heavily negotiated and, depending on the Internal Revenue Service's perception of the merits of a particular case, can vary widely from one case to the next. The issuer is not **required** to enter into a closing agreement and the issuer or the conduit borrower could decide to do nothing. **In fact, unless the Internal Revenue Service can impose a “penalty” under Section 150 of the Code or can impose a “penalty” under Section 6700 of the Code, the Internal Revenue Service generally cannot take any direct action against the issuer or the conduit borrower if they decide not to enter into a closing agreement with respect to the exclusion of interest on the bonds.** The issuer/conduit borrower do **not** have the ability to contest in a court of law any determination made by the Internal Revenue Service concerning the exclusion of interest on the bonds but they do have the ability to contest in court of law any penalty imposed under Section 150 of the Code or Section 6700 of the Code.

Tax Exempt Bond Overview – Focus on Private Business Use

- (2) If the issuer and the Internal Revenue Service do not enter into a closing agreement, the Internal Revenue Service could decide to tax the bondholders. If the Internal Revenue Service decides to impose a tax on the bondholders, the bondholders would be afforded the same legal rights that the issuer/conduit borrower have but the bondholders also have the ability to take an adverse determination to a court of law.

- B) Targeted audits. The procedures that the Internal Revenue Service utilizes for targeted audits are essentially identical to the procedures that it utilizes for random audits.

- C) VCAP Program. The Internal Revenue Service has established the Voluntary Compliance Agreement Program (“VCAP”) under Notice 2001-60. The VCAP Program is frequently used when there has been a change of use that cannot be rectified under a “remedial action” by the issuer/conduit borrower. Under the VCAP Program, the issuer and the Internal Revenue Service typically enter into a closing agreement. The Internal Revenue Service has indicated that any payments made under the VCAP Program will be significantly less than payments made pursuant to an audit. VCAP is frequently utilized where the issuer/conduit borrower recognizes a problem and decides not to play “audit roulette.”

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