

Tax-Exempt Bonds, DSRIP and the Capital Restructuring Financing Program – Why You Need to Know

NOVEMBER 18



DASNY

WE FINANCE, BUILD AND DELIVER.

Andrew M. Cuomo | Governor

Alfonso L. Carney, Jr. | Chair

Paul T. Williams, Jr. | President

Program Overview and Introductions



- Peggy Chan, DSRIP Director,
OHIP, DOH
- Debbie Paden, Esq., Managing General Counsel,
DASNY
- Ed Oswald, Esq., Partner,
Orrick, Herrington & Sutcliffe LLP

- Delivery System Reform Incentive Payment (“DSRIP”) Program
 - Federal program to assist in the transformation of the State’s health care system, lower costs, increase access to quality care and develop a sustainable health care service delivery model.

- Capital Restructuring Financing Program (“CRFP”)
 - State grant program for capital projects that will enhance the quality, financial viability and efficiency of the health care delivery system in New York State
 - The majority of the CRFP funding is intended to support projects undertaken by providers that qualify for and participate in DSRIP

Focal Point Of Webinar

- The webinar will primarily focus on the federal tax rules that apply to outstanding tax-exempt bonds.
- As participants think about these new State initiatives (as well as ongoing tax compliance), healthcare institutions need to be mindful of how any arrangements with third parties could impact their outstanding tax-exempt bonds.

Health Care Transformation and Use of Tax-Exempt Financed Property

- Use of bond financed property by a private health care partner will give rise to private business use if the business is a “user” of bond-financed property
 - For example, private business use will be generated by a lease, license, grant, association or other arrangement by and between the private health care partner and governmental/501(c)(3) entity regarding use of bond-financed property
 - Such arrangements provide the private health care partner with a “special legal entitlement” to use bond financed property

Private Payments and Use of Tax-Exempt Financed Property

Lease, license or other direct and indirect payments to governmental/501(c)(3) organization

- Disguised private payments/quid pro-quo arrangements
 - Private healthcare partner agrees to pay certain expenses of healthcare organization
 - Private health care partner agrees to build or finance other improvements for governmental/501(c)(3) organization
 - Profit sharing or revenue sharing agreement

Tax Compliance and Use of Tax-Exempt Financed Property

- Need to closely examine “any consideration” in this matter and each situation must be evaluated based on its own unique facts and circumstances
- Generally, any payments by a private healthcare partner to governmental/501(c)(3) entity will give rise to private payments

Consequences of a Failure to Follow Tax-Exempt Bond Rules

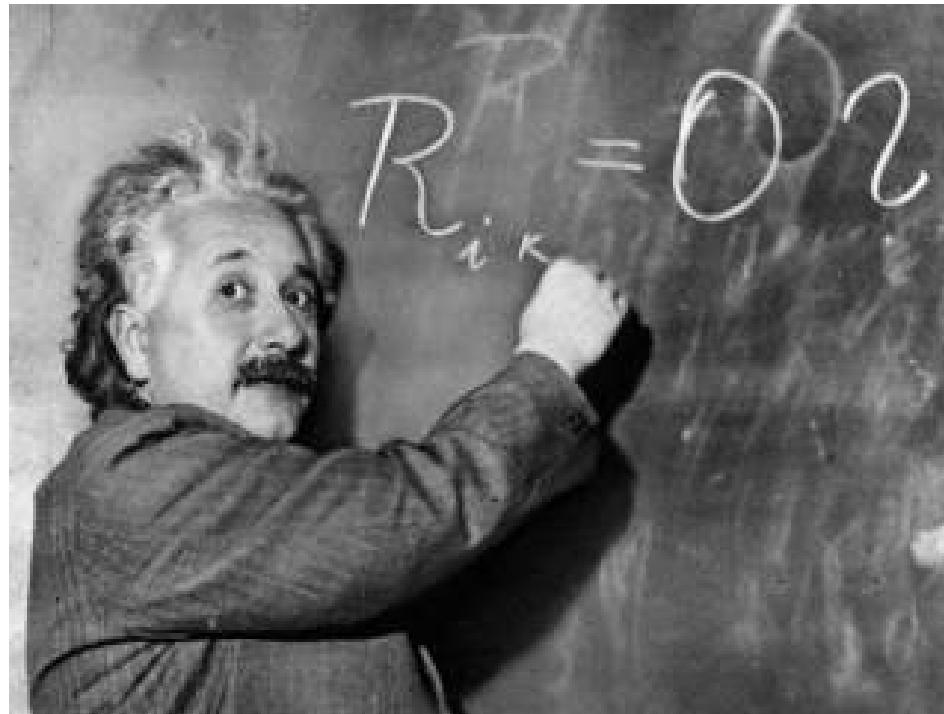
- In the case of a conduit financing, failure to follow the tax rules is a violation of covenants and representations by the borrower to the actual bond issuer regarding tax compliance
- Such a failure by the conduit borrower or the actual issuer translates into a covenant breach that the actual issuer of the bonds made to bondholders
- A violation means that the IRS can declare the interest on the bonds to be taxable

Implications Regarding a Failure to Follow Tax-Exempt Bond Rules

- A taxable determination by the IRS could result in a large financial settlement by the conduit borrower or actual issuer to the IRS **OR**
- If no settlement between conduit borrower/actual issuer and IRS in the event of a taxable determination, the bondholders who purchased the bonds expecting a tax-exempt rate of return will litigate if the interest is now includable in their gross income
- Such an event will blemish conduit borrower/actual issuer reputation in the capital markets and, therefore, increase the cost (\$) of future borrowing given perceived additional tax risk by investors
- Such an event will negatively effect conduit borrower/actual issuer ability to access capital markets which would jeopardize capital funding in the future

Tax-Exempt Bonds = What?

“The hardest thing to understand in the world is the income tax.” **Albert Einstein**



Why Are We Here?

- Federal Fiscal Interest/U.S. Treasury Department - Tax-exempt bond interest represents forgone federal tax revenue
- Exclusion of interest from federal income tax permits State and local governments to borrow at a lower interest cost
- *e.g.* 30-year bond illustration
 - Taxable debt coupon 6%
 - Tax-exempt coupon 5.25%
- Trade off – facilities/improvements financed with tax-exempt bonds subject to various restrictions in IRS regulations

Role of the Internal Revenue Service

- IRS audits of tax-exempt bonds now very common
- Audits can be random or targeted
- Based on information released by the IRS in 2012, there are approximately 400 (+) examinations per year
- Generally, issuers of tax-exempt bonds have no right to judicial review in the event the IRS makes an adverse determination

Source of Financing is Important

- Tax-exempt bonds
- Taxable bonds with federal subsidy (Build America Bonds)
- Taxable bonds
- Other funding sources for facilities
 - State funding/appropriations/Federal funds
 - Grants funded with tax-exempt bond proceeds
- In analyzing use of facilities by third parties, the source of financing is a critical focus

Tax Covenants in Tax-Exempt Bond Financings

- When bonds are issued, there are a range of representations and covenants made by the issuer/bond-beneficiary regarding the federal tax law and applicable limits:
 - private activity;
 - private payments;
 - private loans; and
 - other various tax rules

Tax Covenants in Tax-Exempt Bond Financings

- Tax representations and covenants regarding health care facilities may be contained in:
 - Indenture
 - Loan Agreement
 - Tax Certificate
 - Lease Purchase Agreement
 - Lease and Agreement

Tax Covenants (continued)

Question: How long do the IRS tax restrictions apply?

Answer:

- For as long as the bonds are outstanding
- Tax-exempt bonds are commonly refunded and the IRS restrictions will also apply to any refunding bonds

Types of Bonds Issued for Health Care Facilities

- Federal tax rules are applied to each “issue” of bonds and the use of the facilities financed with the proceeds of such issue
- Health care facilities are generally financed with two different types of tax-exempt bonds
 - Governmental bonds, or
 - 501(c)(3) bonds

Health Care Facilities – May Include

- Hospitals
- Residential health care facilities
- Diagnostic and treatment centers
- Entities licensed pursuant to NYS Public Health law
- Entities licensed pursuant to NYS Mental Hygiene law
- Assisted living programs
- Primary care providers

Governmental Bonds – Basic Tests

- No more than 10% of the proceeds of the bonds can be used for a private business use, and
- No more than 10% of the bond issue can be paid or secured (directly or indirectly) by any interest in property used for a private trade or business or derived from payments in respect of property used or to be used for a private business use

* depending on facts and circumstances the 10% limit can be reduced to 5% (see closing documents)

Governmental Bonds – Basic Tests

- No more than the lesser of 5% or \$5 million of the proceeds of a governmental bond issue may be loaned to a private party
- The 10% private use limit is generally reduced to the lesser of 5%/10% or \$15 million in large bond financings

Governmental Bonds (continued)

\$800 million bond issue

	\$ 800 million	\$ 800 million	\$800 million
	10%	5%	—
MAX PBU	\$80 million	\$40 million	\$15 million

- Need to be mindful of this “lesser of” concept
- Need to consider all private use within the bond issue
 - Situations in which there are only 1 beneficiary
 - Pool bond issue involving many beneficiaries

501(c)(3) Bonds – Basic Tests

- No more than 5% of the net proceeds of the bond issue can be used for a “private business use” or an “unrelated trade or business use.” Accordingly, at least 95% of the net proceeds of the bond issue must be used in a manner related to the exempt purposes of the Section 501(c)(3) organization for this purpose, or
- No more than 5% of the net proceeds of the bond issue can be paid or secured (directly or indirectly), by any interest in property used for a private trade or business or derived from payments in respect of property used or to be used for a private business use.

501(c)(3) Bonds – Basic Tests

- Cost of issuance of the bonds paid with bond proceeds are treated as a private business use
- The tax rules limit the use of bond proceeds to pay costs of issuance to 2% of the proceeds of the issue. So, the 5% private business use cushion is often reduced to 3%.
- All bond financed property must be owned by a 501(c)(3) organization or State or local government

501(c)(3) Bonds – Basic Tests

Unrelated Trade or Business Use

- Use of bond financed property by a 501(c)(3) organization in an “unrelated trade or business activity”
- For tax-exempt bonds – the focus is “activity”
- Unrelated trade or business use involving bond financed property will generally constitute “private use” even if it does not give rise to a liability for unrelated business income tax

Private Business Use - Generally

- What is private business use?
 - “special legal entitlement” by third party/entity to use bond-financed property
- What is a special legal entitlement?
 - Ownership; actual or other beneficial use; lease; license; management contracts; certain service contracts; output – type contracts

Private Business Use – Governmental Bonds

- Generally, special legal entitlement to use bond financed property by other than a governmental unit or the general public
 - Section 501(c)(3) organization
 - partnership
 - corporation
 - management company
 - other non-governmental entity

Private Business Use – 501(c)(3) Bonds

- Generally, special legal entitlement to use bond financed property by other than a Section 501(c)(3) entity in connection with its charitable mission
 - partnership
 - corporation
 - management company
 - other 501(c)(3) entity
 - unrelated trade or business activity by 501(c)(3) entity

Private Business Use

- Need to be mindful that the private business use rules apply to both “direct” and “indirect” use of bond financed facilities –
 - Direct use: lease of space to cafeteria operator
 - Indirect use: cafeteria space is served by HVAC system, campus chiller and campus steam units

Examples of Potential Private use of Bond-Financed Property

- Lab Services
- Cafeteria Contracts
- Gift Shops
- Physician Groups
- Leased Property
- Research Agreements
- 501(c)(3) pharmacies open to the general public
- Food Courts
- Coffee Shops
- Concessions
- Parking Agreements
- Central Utility Plants
- Use by other 501(c)(3) organizations
- Any activity which is treated as an “unrelated trade or business”
- Telecommunication installation

Private Business Use Overview

Contracts that may give rise to private business use include:

- Management Contracts
 - Physician/Medical Service Provider Contracts
 - Concession Contracts
 - Cafeteria Contracts
- Sponsored Research Contracts
 - Federal
 - Business Sponsored

Private Business Use Overview

Contracts that will give rise to private business use include:

- Leases
 - Cafeteria Contracts
 - Pharmacies
 - Physician Office Spaces
 - Gift Shops

Private Business Use Overview (Continued)

- Many so-called “management contracts” are in fact leases (even though it might be called something else)
- If someone is paying you rent (\$) or splitting profits (\$) from an operation in bond financed space they are not treated as a manager under the tax rules
- Healthcare institution ←

\$\$ Private party

Why do Some Management Contracts Give Rise to Private Business Use?

- They represent a transfer of control or economic benefit of the bond financed property from the owner to a private party
- They provide a “special legal entitlement” to use bond financed property

Management Contract Guidelines – Rev. Proc. 97-13

- Safe harbor contractual requirements that if met, the contract does not cause private business use
- Rev. Proc. 97-13 recently modified by IRS Notice 2014-67

Management Contract Guidelines – Rev. Proc. 97-13

- Types of Compensation Arrangements addressed:
 - fixed fee
 - capitation fee
 - per-unit fee
 - percentage of revenue or variable rate
 - various combinations thereof

Management Contract Guidelines – Rev. Proc. 97-13

- Duration of Contract
 - Long-term agreements are required to have larger portion of fixed compensation paid to manager
 - Short-term agreements may have a higher degree of variable fees paid to manager

Private Business Use Exceptions

Incidental Contracts or Arrangements

- Janitorial Services
- Equipment Repair
- Billing activities or similar services
- Landscaping

Private Business Use Exceptions

Short-Term Use Exception (50 Day Rule)

- Term of use under the contract (including renewal options) is not more than 50 days;
- The contract is negotiated at arm's length and compensation is at fair market value; and
- The property is not financed for a principal purpose of providing that property for use by that entity or organization

Note for short-term use exception to apply to 501(c)(3) bonds, the leasing activity must be a related activity to the 501(c)(3) organization

Notice 2014-67

- Brand new guidance
- Need to consult bond counsel
- The analysis will be highly factual
- Healthcare organizations may participate in the Medicare Shared Savings Program under the Affordable Care Act
- The Notice provides interim guidance regarding private business use as a result of governmental/ 501(c)(3) entities participating in the Shared Savings Program through an “accountable care organization” (ACO)

Notice 2014-67

- The IRS is aware that governmental/501(c)(3) entities may participate in ACO's in a variety of forms:
 - membership in a non-profit corporation
 - ownership in shares of a corporation
 - ownership of an interest in a partnership
 - ownership of a membership interest in an LLC

Notice 2014-67

- Participation by a user of a healthcare facility financed with tax-exempt bonds in the Shared Savings Program through an ACO that includes any private parties needs to be structured so as to not give rise to private business use
- Any 501(c)(3) organization using a facility financed with tax-exempt bonds must structure its participation in an ACO so that its participation neither jeopardizes its 501(c)(3) status nor causes it to be engaged in an unrelated trade or business

Notice 2014-67

Under the Notice, the participation of a governmental/501(c)(3) entity in the Shared Savings Program through an ACO will not give rise to private business use of bond financed property if all of the following conditions are met:

1. The terms of the governmental/501(c)(3) entities participation in the Shared Savings Program through the ACO are set forth in advance in a written agreement negotiated at arm's length.

2. The Center for Medicare and Medicaid Services has accepted the ACO into the Shared Savings Program.
3. The governmental/501(c)(3) entities share of economic benefits derived from the ACO is proportional to the benefits or contributions such entities provide to the ACO.
4. The governmental/501(c)(3) entities share of ACO losses does not exceed the share of ACO benefits to which such entity is entitled.

5. All contracts and transactions entered into by the governmental/501(c)(3) entities and the ACO and the ACO's participants, are at fair market value.
6. The governmental/501(c)(3) entities do not contribute or otherwise transfer the property financed with tax-exempt bonds to the ACO unless the ACO is an entity that is a governmental entity, or in the case of qualified 501(c)(3) bonds, either a governmental entity or a 501(c)(3) organization.

New 5 Year Contract Rules – Notice 2014-67

All of the compensation is based on:

1. a stated dollar amount;
2. periodic fixed fee;
3. a capitation fee;
4. a per-unit fee;
5. a combination of any of the above

New 5 Year Contract Rules – Notice 2014-67

- The compensation for services may also include a percentage of gross revenue, adjusted gross revenue or expenses (but not both revenues and expenses)
- The term of the contract (including all renewal options) does not exceed 5 years
- The contract need not be subject to optional termination by the governmental/501(c)(3) entity prior to the end of the term
- Brand new/consult bond counsel

Sponsored Research

- Private party or federal government contracts with healthcare institution to perform research in bond financed space
- Sponsored research will not give rise to private use if contract meets requirements of IRS Revenue Procedure 2007-47
- 2007-47 only covers “basic research” – any original investigation for the advancement of scientific knowledge not having a specific commercial objective
- 2007-47 offers 2 “safe harbor” constructs for sponsored basic research contracts

Sponsored Research

1. Corporate sponsored.

Any license of use of resulting technology by a sponsor is permitted provided sponsor pays fair market value determined at time the license or technology is available (license can be exclusive).

2. Industry/Federally sponsored

- Title to any patent or other product resulting from research is with health care institution
- Sponsors entitled to no more than non-exclusive, royalty free license to use the product
- Generally covers federal NIH--Bayh-Dole Act research

Private Payment Test

- Direct and indirect payments by private user of bond financed property are counted (\$)
- Payments in respect of bond financed property are counted (\$)
- Where there is private business use – there are almost always private payments (\$)
- Profit sharing arrangements (\$)
- Lease payments (\$)
- Informal arrangements in which payments are made (\$)
- Non-complying management contracts (Rev. Proc. 97-13) (\$)
- Non-complying research contracts (Rev. Proc. 2007-47) (\$)

Remedial Action Rules

Tax rules accommodate excess private business use (known as the remedial action rules), without adversely impacting the tax-exempt status of the bonds

- Remedial actions must be timely
- In multi-year, multi-project bond financings, determining the precise amount of tax-exempt bonds allocable to land, building(s), portions of a building and general infrastructure can be very time consuming, pain staking and expensive

Remedial Action Rules

- Forms of remediation
 - Defease “non-qualified” bonds
 - Undertake a “private use” analysis to see if within IRS limits
 - Reallocation of bond proceeds within limited time frames
 - Alternate use of disposition of proceeds in “all cash sale”
 - In exclusively cash sales, recycle sale proceeds into other tax-exempt eligible projects
 - Only works in situations in which the property is sold (not leased)

Remedial Action Rules

Each particular situation –

- Remedial action required;
- No remedial action required;
- Determination that no bonds are involved;

is unique, and will need to be closely examined by the bond issuer and bond counsel

Before Next Steps

Questions

Next Steps

If anyone has questions, please contact the following:

Department of Health

dsrip@health.ny.gov

DASNY

dpaden@dasny.org