Recent IRS Regulations Involving Mixed-Use Projects Financed With Tax-Exempt Bonds Very Beneficial to 501(c)(3) Health-Care Organizations

BY ROBERT L. CAPIZZI

On Oct. 27, 2015, the United States Treasury Department and the Internal Revenue Service published long-awaited final regulations that provide welcome guidance to 501(c)(3) health-care organizations that are borrowers of qualified 501(c)(3) bonds. The final regulations provide guidance on the allocation of tax-exempt bond proceeds and equity to specific uses within a mixed-use health-care project. Additionally, the final regulations adopt rules to accommodate partnerships between 501(c)(3) health-care organizations and private entities. The final regulations also clarify the rules for “anticipatory remedial actions” that permit bonds to be redeemed prior to an action that would cause the private activity restrictions applicable to all exempt bonds to be violated. Generally, all of these provisions of the final regulations will be of significant benefit to 501(c)(3) health-care organizations that are borrowers of tax-exempt qualified 501(c)(3) bonds.

Background

Federal income tax law restricts the private ownership and private business use of property financed with tax-exempt qualified 501(c)(3) bonds. To constitute qualified 501(c)(3) bonds, all property that is financed or refinanced with proceeds of the bonds must be owned by a 501(c)(3) organization or a state or local governmental unit. Additionally, no more than 5 percent of the proceeds of qualified 501(c)(3) bonds may be used for any private business use. Private business use generally refers to use by nongovernmental and non-501(c)(3) users and private entities, or to use by a 501(c)(3) organization operating an unrelated trade or business. If there is private use of bond-financed property in excess of the 5 percent allowance, qualified 501(c)(3) bonds may lose their tax-exempt status and become taxable private activity bonds.

Compliance with the private ownership, private use and unrelated trade or business use restrictions applicable to qualified 501(c)(3) bonds has become increasingly difficult for 501(c)(3) health-care borrowers over the years. The detailed tax-exempt bond reporting requirements contained in Schedule K to Form 990 have resulted in additional compliance difficulties for 501(c)(3) borrowers. On Schedule K, there are numerous questions regarding private use and unrelated business use of proceeds of the bonds, including questions that require the 501(c)(3) borrower to identify the percentage of bond-financed property used in a private use and unrelated trade or business use. The final regulations should be quite helpful to 501(c)(3) health-care or-

1 See 80 Fed. Reg. 65637.
2 “Qualified 501(c)(3) bonds” are defined in Section 145 of the Internal Revenue Code (IRC).
3 This article focuses on the application of the final regulations to qualified 501(c)(3) bonds issued for the benefit of 501(c)(3) health-care organizations. However, the final regulations also apply to tax-exempt bonds issued to finance health-care facilities and other types of facilities owned by state or local governments.
4 I.R.C. § 145.
5 Section 141(b)(6) of the IRC defines the term “private business use” which is applicable to qualified 501(c)(3) bonds. For purposes of simplicity, references in this article to “private use” are intended to mean “private business use” as defined in Section 141(b)(6) of the IRC.

Robert L. Capizzi is a partner in the law firm of Chapman and Cutler LLP in Chicago, Illinois. Mr. Capizzi focuses his practice primarily on the federal tax aspects of tax-exempt health-care finance. The views expressed in this article are those of the author and may not represent the views of his firm. He can be reached at capizzi@chapman.com.
financed in whole or in part with proceeds of the project. Including land, buildings, equipment or other property, the project is defined as a project that is financed both with proceeds of tax-exempt bonds and with "qualified equity." The "same plan of financing" requirement of the final regulations must be made before the placed in service date of the project is placed in service, and in no event later than 18 months after the date of the expenditure. The final regulations provide specific rules for applying this commonly used "equity carve out" approach.

The final regulations provide allocation rules for "eligible mixed-use projects." An eligible mixed-use project is defined as a project that is financed both with proceeds of tax-exempt bonds and with "qualified equity" pursuant to the "same plan of financing." The project must be wholly owned by one or more 501(c)(3) organizations or a partnership in which at least one 501(c)(3) organization is a partner. The final regulations define "project" as one or more facilities or capital projects, including land, buildings, equipment or other property, financed in whole or in part with proceeds of the bonds. This definition of "project" is more favorable and flexible than the definition contained in the proposed regulations, which focused on the functional relationship of the facilities, and should provide significant tax planning opportunities. Qualified equity is defined as proceeds of taxable bonds and funds that are not derived from proceeds of a borrowing that are spent within certain time periods on the same eligible mixed-use project as the proceeds of the tax-exempt bonds, but does not include equity interests in real property or tangible personal property and does not include funds used to redeem or repay bonds.

The "same plan of financing" requirement may be problematic in certain financings. Qualified equity must be contributed to a project as part of the "same plan of financing" as the tax-exempt bonds and must pay for capital expenditures of the project on a date that is no earlier than the date on which the expenditures would be eligible for reimbursement by proceeds of the tax-exempt bonds. This requirement appears to mean that tax-exempt bonds generally are entitled to "qualified equity" benefits only to the extent the bonds are issued, and also describe in the tax documents that the project was financed with both tax-exempt bond proceeds and qualified equity. Upon completion of the project, it will be important to complete a final allocation of bond proceeds and qualified equity. Existing regulations require allocations of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project is placed in service, and in no event later than 60 days after the fifth anniversary of the issue date. Under this rule, the 501(c)(3) borrower should allocate qualified equity that was part of the "same plan of financing to all private use of the project.

The final regulations do not require any special elections or record retention requirements to make use of the qualified equity rules. However, 501(c)(3) borrowers should identify the "project" in the tax documents executed when the bonds are issued, and also describe in the tax documents that the project was financed with both tax-exempt bond proceeds and qualified equity. Upon completion of the project, it will be important to complete a final allocation of bond proceeds and qualified equity. Existing regulations require allocations of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project is placed in service, and in no event later than 60 days after the fifth anniversary of the issue date. Under this rule, the 501(c)(3) borrower should allocate qualified equity that was part of the "same plan of financing to all private use of the project.

Example 1 of the final regulations illustrates the application of the undivided portion allocation method. In that example, City A issues $70x of bonds and finances the construction of a 10-story office building costing $100x with proceeds of the bonds and $30x of qualified equity. To the extent that the private use of the project does not exceed 30 percent in any particular year, the qualified equity is allocated to the private use. If private use of the project were, for example, 44 percent in a year, the qualified equity would be allocated to 30 percent ($30x) private use and proceeds of the bonds would be allocated to the excess (that is, 14 percent or $14x), resulting in private use of the bonds in that year of 20 percent ($14x/$70x). Conversely, if private use of the project were 20 percent, qualified equity would be allocated to 20 percent. The remaining qualified equity (that is, 10 percent or $10x) would be allocated to the governmental use in excess of the 70 percent to which the proceeds of the bonds would be allocated.

Applying the "floating" use concept to this example, three floors of the 10-story office building could be used by private entities, and the three floors used by such entities could change from year to year. The ability to

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6 Treas. Reg. § 1.141-6(b).
7 Treas. Reg. § 1.141-6(a)(3).
9 Treas. Reg. § 1.141-6(b).
10 Treas. Reg. § 1.141-6(b).
11 The "private use measurement period" is defined in Treas. Reg. § 1.141-3(g).
12 Treas. Reg. § 1.148-6(d).
13 Although this example does not involve the issuance of qualified 501(c)(3) bonds, the analysis and conclusions in the example would be the same for qualified 501(c)(3) bonds.
“float” the private use to different floors or locations over the years should be very beneficial to 501(c)(3) health-care organizations in complying with the private use restrictions.

**Treatment of Partnerships**

Generally, federal income tax law treats partnerships in two different manners for various tax purposes. A partnership may be treated as a separate entity from its partners, with each partner owning an interest in the partnership (the “entity approach”) or a partnership may be treated as an aggregate of its partners, with each partner treated as directly owning a portion of the partnership assets (the “aggregate approach”). Under the entity approach, a partnership would be treated as a private entity for purposes of the private activity bond tests. The final regulations adopt the more favorable aggregate approach for purposes of the ownership requirement and private use limitations that apply to qualified 501(c)(3) bonds. Additionally, the final regulations provide a rule for measuring private use of tax-exempt bond financed property resulting from use of such property by a partnership that includes a private entity. The amount of such private use is the private partner’s greatest percentage share of any of the specified partnership items (income, gain, loss, deduction or credit) attributable to the time that the partnership uses the tax-exempt bond-financed property.

The adoption of the aggregate approach in the final regulations will be of great benefit to health-care organizations that are considering partnership structures with private entities involving the use of bond-financed property. In particular, the aggregate approach will facilitate the establishment of joint ventures between 501(c)(3) organizations and private entities under the provisions of the Affordable Care Act. As an example, assume the formation of a partnership with one 501(c)(3) partner and one private partner and the partnership uses 40 percent of a bond-financed hospital. The greatest percentage share of any of the specified partnership items attributable to the private partner is 50 percent. The amount of private use of the bond-financed hospital that would arise from the partnership would be 20 percent, determined by multiplying the use of 40 percent of the hospital by the partnership by the greatest percentage share of the private partner of 50 percent.

**Anticipatory Remedial Actions**

Generally, under existing regulations, a 501(c)(3) health-care borrower may cure certain deliberate actions that cause the private activity bond tests to be met by redeeming or defeasing the nonqualified bonds within 90 days of the deliberate action. The final regulations expressly permit an already common industry practice of redeeming or defeasing bonds in anticipation of a deliberate action. The final regulations state that a 501(c)(3) borrower may redeem or defease bonds at any time in advance of a deliberate action, so long as the 501(c)(3) borrower declares its intent to redeem or defease the bonds that could potentially become the nonqualified bonds and the intent identifies the tax-exempt bond financed property with respect to which the remedial action is being taken and describes the deliberate action that potentially may result in the private use.

**Effective Dates**

The final regulations generally apply to bonds sold on or after Jan. 25, 2016. The new rule in the final regulations regarding anticipatory remedial actions generally applies to any deliberate action occurring on or after Jan. 25, 2016. Most provisions of the final regulations can be permissibly applied to certain bonds sold before Jan. 25, 2016, but generally only if the provisions are applied in whole (not in part). This restriction may in certain circumstances limit the retroactive application of the final regulations. However, if certain requirements of the final regulations are satisfied, 501(c)(3) health-care borrowers may be able to allocate the private amount of use of an outstanding qualified 501(c)(3) bond issue (e.g., an outstanding bond issue in which the project was partly financed with equity).

**Conclusion**

The final regulations provide extremely useful guidance for exempt health-care organizations concerning the allocation of tax-exempt bond proceeds and equity to specific uses within a mixed-use health-care project. They help address an issue that arises frequently in health care—partnerships between 501(c)(3) health-care organizations and private entities—by explaining how mixed uses can be accomplished without violating private activity restrictions applicable to all exempt bonds. They also clarify the rules for “anticipatory remedial actions” that allow an exempt health-care organization to redeem bonds before it engages in conduct that would cause those private activity restrictions to be violated.

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14 Treas. Reg. § 1.141-1(e). This new provision of the final regulations provides a similar favorable result as adopted by the Internal Revenue Service in Rev. Rul. 98-15, 1998-1 C.B. 718. In Rev. Rul. 98-15, the IRS held that a 501(c)(3) hospital could enter into a “whole hospital” joint venture with a for-profit hospital without jeopardizing its 501(c)(3) exempt status if certain requirements were satisfied.

15 Treas. Reg. § 1.141-3(g).

16 See Treas. Reg. § 1.141-12(d).

18 Treas. Reg. § 1.141-12(d)(3).