

A horizontal collage of four images: a balance scale, a keyboard, a gavel, and an open book.

JONES DAY
COMMENTARY

HEALTH CARE

NEW TAX-EXEMPT BOND REFUNDING REGULATIONS REQUIRE SUBSTANTIALLY MODIFIED RECORDKEEPING

On December 19, 2005, the United States Treasury published new regulations¹ (the “Refunding Regulations”) that will change the recordkeeping and document retention policies for any hospital or other health-care provider that has outstanding tax-exempt debt. In short, such a provider should keep records of all arrangements resulting in private-business use of the bond-financed facilities as long as any tax-exempt debt issued on its behalf remains outstanding. Borrowers that do not retain records documenting the cost, location, and use of bond-financed property will find it difficult, if not impossible, to refinance their tax-exempt debt on a tax-exempt basis after February 17, 2006, since the Refunding Regulations generally

require that private-business use of bond-financed property during a look-back period (described hereafter) must be combined with the private-business use after the refunding to determine whether average private-business use during the relevant measurement period exceeds the private-use limit (generally 5 percent).²

Typically, a borrower of tax-exempt bond proceeds is asked by bond counsel to make certain certifications regarding the use of bond-financed property. Whether private use during the look-back period is determined by means of (a) bond counsel due diligence, (b) borrower certifications, or (c) some combination of the

1. Treas. Reg. § 1.141-13.

2. Unless otherwise specified, all references herein to “bonds” or “tax-exempt bonds” are references to qualified 501(c)(3) bonds; all references to “prior bonds” are references to the refunded bonds; all references to “private use” are references to “private-business use”; all references to “costs of issuance” are references to those costs of issuance that are treated as a private-business use of bond proceeds; and the limit on private-business use of bond proceeds means 5 percent.

foregoing, it will be the borrower's responsibility to document the use of the bond-financed assets (hereafter, "Asset Use"). In order for a borrower to determine the amount of private-business use in connection with a refunding issue, it will need to review all contracts, leases, and other arrangements relating to the private-business use of bond-financed property going back a significant period of time. This task is made all the more difficult by the fact that the Treasury Department can presume that a contract resulted in private use if the borrower cannot produce the actual contract.

In order to determine Asset Use, hospitals and other health-care providers should develop specific policies and procedures governing (i) documentation of the identity, cost, location, and disposition of property financed with each issue of tax-exempt bonds (including appropriate property tagging and maintaining property lists), (ii) the use of bond-financed property, including policies governing contracts for the sale, lease, management, or other use of bond-financed property (such as approvals required prior to entering into contracts to perform research or to sell bond-financed assets), (iii) document retention, and (iv) annual or other periodic computations of private-business use.

This article highlights the need for developing policies and procedures that will enable a borrower of qualified 501(c)(3) bonds to accurately track the existence and use of bond-financed property for purposes of the Refunding Regulations. Individual borrowers are encouraged to discuss their specific circumstances with bond counsel.

BACKGROUND

In 1997, the United States Treasury published regulations³ governing the permitted uses of tax-exempt bond proceeds (the "1997 Regulations"). Generally, if a nongovernmental or non-501(c)(3) organization uses more than 5 percent of the proceeds of 501(c)(3) tax-exempt bonds, those bonds become taxable. The amount of private-business use of property financed by an issue of tax-exempt bonds is equal to the average private-business use of that property during

a defined measurement period. Generally, the *measurement period* begins on the issue date of the tax-exempt bonds that financed that property⁴ and ends on the latest maturity date of the issue financing that property.⁵

However, the 1997 Regulations do not address how the private-use test is applied to tax-exempt bonds that are issued to refund prior tax-exempt bonds. Simply put, the question was whether the computation of average private use included private use during the period the property was financed by the prior bonds (*i.e.*, "tacking"), or whether private use was determined on a separate basis as of the issue date of the refunding bonds (*i.e.*, a "fresh start"). The 1997 Regulations specifically reserved the question of whether the determination of private-business use for a refunding issue required tacking private use from the prior bonds rather than permitting a fresh start.

THE ANSWER IN THE REFUNDING REGULATIONS

In general, in determining private-business use for a refunding-bond issue, the Refunding Regulations adopt a modified tacking approach (designed to limit the look-back period). However, under certain circumstances, private use can be computed on a fresh-start basis, at the borrower's election. In either case, *solely* for purposes of applying the private-business-use test to a refunding issue, use of proceeds of the prior issue (or any earlier issue in a series of refundings) to pay costs of issuance is not treated as private-business use.

In general, the Refunding Regulations require that the amount of private-business use be computed over a "combined measurement period." Generally, the combined measurement period begins on the first day of the measurement period (as described above) for the prior issue (or the earliest issue date in the case of a series of refundings) and ends on the last day of the measurement period for the refunding issue.

As an alternative to the combined measurement approach, the Refunding Regulations permit a borrower to measure private-business use on a fresh-start basis, but only if

3. Treas. Reg. § 1.141.

4. Or the date the property was placed in service, if later.

5. Or the last date of that property's useful life, if earlier.

private-business use of the prior issue does not exceed the private-use limit (generally, 5 percent) during a truncated measurement period beginning on the first day of the measurement period for the prior issue (or the earliest issue date in the case of a series of refundings) and ending on the issue date of the refunding issue. Whether a prior issue exceeds the private-use limit during this truncated measurement period is determined based on the actual use of proceeds, without regard to the borrower's reasonable expectations on the issue date of the prior issue. In other words, a borrower is generally permitted to use a fresh-start method for computing private-business use beginning with the issue date of the refunding bonds, so long as the private use that occurred during the period the prior issue (or issues) was outstanding did not exceed the private-use limit (generally 5 percent for post-1986 bonds).

EFFECTIVE DATES AND COMPUTATION START DATES

The Treasury Department understood the difficulty a borrower would have in establishing the amount of private-business use during a measurement period that began some time ago (in some cases of multiple refundings, as long as 30 years or more). Tacking bond-financed assets and computing private-business use become more complicated over time, due to changes in use, dispositions, and additional issues of refunding bonds. Initially, however, the Refunding Regulations limit the look-back period by establishing specific start dates for application of the Refunding Regulations and for measuring private-business use of prior bonds.

The Refunding Regulations apply only to refunding bonds that (a) are sold on or after February 17, 2006, and (b) are subject to the 1997 Regulations. Refunding bonds are subject to the 1997 Regulations only if (i) the refunding bonds refund prior bonds that are subject to the 1997 Regulations (*i.e.*, the refunded bonds were originally issued on or after May 16, 1997) ("post-1997 bonds"), or (ii) the refunding bonds refund prior bonds that are not subject to the 1997 Regulations

("pre-1997 bonds")⁶ and either (A) the weighted average maturity of the refunding bonds is longer than the weighted average maturity of the refunded bonds, (B) the issuer chooses to apply the 1997 Regulations to the refunding bonds, or (C) a principal purpose of the refunding bonds is to finance new capital expenditures.

Where the Refunding Regulations apply to pre-1997 bonds (*e.g.*, due to extending the weighted average maturity or electing into the 1997 Regulations), the combined measurement period is treated as beginning on the earlier of (i) December 19, 2005, and (ii) the first date the prior bonds became subject to the 1997 Regulations. In other words, the look-back period for pre-1997 bonds (for which private-business use is computed and tracked) begins on December 19, 2005, or such earlier date that the prior bonds became subject to the 1997 Regulations. With regard to post-1997 bonds, the combined measurement period generally begins on the date of issuance of those prior bonds.

Therefore, in order to make the findings and certifications necessary to refund a tax-exempt bond, a borrower will likely need to review the use of bond-financed property back to at least December 19, 2005, and possibly as far back as May 16, 1997, depending on the date the prior bonds were issued.

THE PRACTICAL EFFECT OF THE REFUNDING REGULATIONS

So what does this mean for a 501(c)(3) organization? Borrowers that do not retain records documenting the cost, location, and use of bond-financed property will find it difficult, if not impossible, to refinance their tax-exempt debt on a tax-exempt basis. In light of the Refunding Regulations, all hospitals and other health-care providers should develop specific policies and procedures related to (i) tracking the identity, cost, location, and disposition of property financed with each issue of tax-exempt bonds (including appropriate property tagging and property lists), (ii) the use of bond-financed property, including policies governing contracts

6. The refunding bonds must also be subject to Section 1301 of the 1986 Tax Act (*i.e.*, subject to the 1986 Code).

for the sale, lease, management, or other use of bond-financed property (such as research contracts), (iii) document retention, and (iv) annual or other periodic computations of private-business use.

Hospitals, elder care, and other health-care providers should contact bond counsel for answers to their questions on exactly how to accomplish this task.

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