PRIVATE BUSINESS USE FOR QUALIFIED 501(C)(3) BONDS

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PRIVATE BUSINESS USE GENERAL RULE

- Borrowers may lose their tax exemption if they have more than 5% of Private Business Use
- Private Business Use means:

  (a) any use (directly or indirectly)

  (b) of the facilities financed by proceeds of the tax-exempt financings

  (c) in a trade or business

  (d) carried on by a “nonqualified user”

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GENERAL RULE - DEFINITIONS

Direct Use: Leasing to nongovernmental person

Indirect Use: Leasing to governmental person who leases to nongovernmental person

Trade or Business: Activity carried on by a person other than a natural person

Nonqualified User: user other than state or local governmental unit, or in some circumstances a 501(c)(3) but not the federal government and its agencies

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EXAMPLES OF POTENTIAL PRIVATE USE OF BOND-FINANCED PROPERTY

- Bookstore Agreements
- Cafeteria Contracts
- Gift Shops
- Leases of Property
- Research Agreements
- Food Courts
- Coffee Shops
- Concessions
- Parking Agreements
- Hosting Private Events
- Summer Use of Facilities
- Use by other 501(c)(3) Organizations
- Naming Rights for Buildings
- Costs of Issuance during Bond Issuance

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GENERAL PUBLIC USE EXCEPTION

- Use as a member of the general public is not private business use.
- Use needs to be reasonably available for use on the same basis by natural persons not engaged in a trade or business.
- Term of arrangement, including renewals, is 200 days or less.

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TEMPORARY USE EXCEPTION

LENGTH OF USE (INCLUDING ALL RENEWAL OPTIONS)	TERMS OF USE
100 days or less	Generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business (e.g., prisons).
50 days or less	The arrangement is a negotiated arm's-length arrangement, and compensation under the arrangement is at fair market value.
Initial development period of an improvement that carries out an essential government function	The issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and to transfer it to a qualified user, and such transfer occurs.

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INCIDENTAL USE EXCEPTION

- Incidental uses of a financed facility are disregarded to the extent that those uses don't exceed 2.5% of the proceeds of the issue
- Incidental uses include pay telephones, vending machines, advertising displays, and nonpossessory use of property
- Nonpossessory use means use where person has no possession or control of space that is separated from other areas of the facility by walls, partitions or other physical barriers

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LEASE ARRANGEMENTS

- Borrower must be Owner of financed property
- Lease Arrangements may change “ownership” of financed Property
- For tax purposes, when a Lessee leases a facility under a term of at least 80% of the economic life of the facility, the Lessee is treated as the “owner” for tax purposes.
- To determine if something is a lease look at (1) the degree of control over the facilities exercised by a nonqualified user and (2) whether a nonqualified user bears risk of loss of the facilities.

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NAMING RIGHTS

- Naming Rights are considered a "special legal entitlement" which may create private business use.
- May use an Individual's name for a bond financed facility since an individual is not a trade or business.

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MANAGEMENT CONTRACTS

- A management contract is a management, service or incentive payment contract between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a tax-exempt bond financed facility
- For Colleges, these are commonly food vendor, bookstore and facilities management contracts
- Incidental contracts such as janitorial, office equipment repair, hospital billing or similar services are not considered management contracts

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MANAGEMENT CONTRACTS

- Generally a Management Contract is considered private business use based on a “facts and circumstances test”
- The IRS created a Safe Harbor under Rev. Proc. 97-13
- New Rules: IRS Notice 2014-67

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REV. PROC. 97-13

- Sets forth standards for a safe harbor test that if satisfied will treat the entire contract as not being subject to Private Business Use
- If the safe harbor test is not met, the facts and circumstances test is used to make the Private Business Use Determination
- Compensation must be reasonable, and not based, in whole or in part on a share of “net profits” from the operation of the facility

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REV PROC. 97-13

Permitted compensation structures:

1. % of Gross Revenues (or adjusted gross revenues) OR % of expenses (but not both)
2. Capitation Fee
3. Per-Unit Fee

Compensation does not include reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties

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COMPENSATION	MAXIMUM TERM OF THE CONTRACT (INCLUDING ALL RENEWAL OPTIONS)	OTHER
At least 95% based on a periodic fixed fee	The lesser of (1) 80% of the reasonably expected useful life of the financed facilities and (2) 15 years	A one-time, single, stated dollar amount incentive award during the term of the contract when a gross revenue or expense target (but not both) is reached is permissible
At least 80% based on periodic fixed fee	The lesser of (1) 80% of the reasonably expected useful life of the financed facilities and (2) 10 years	A one-time, single, stated dollar amount incentive award during the term of the contract when a gross revenue or expense target (but not both) is reached is permissible
At least 50% based on periodic fixed fee or all is based on a capitation fee or a combination of a capitation fee and a periodic	5 years	Contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term
All compensation based on a per-unit fee or combination of a per-unit fee and a periodic fixed fee	3 years	Contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term

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IRS NOTICE 2014-67

- This Notice provides guidelines for 501(c)(3) organizations who participate in the Share Savings Program through an “accountable care organization” but also expands Rev. Proc. 97-13 for all qualified 501(c)(3) bonds
- Expands Rev. Proc. 97-13 to allow for a productivity award based on quality of services rather than increases in revenues or decreases in expenses in instances where the award is a fixed fee, stated dollar amount or tiered system based solely on level of performance achieved

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IRS NOTICE 2014-67

- Expands Rev. Proc. 97-13 to add an additional safe harbor as follows:

  a. All compensation based on a stated amount, periodic fixed fee; capitation fee; per-unit fee or a combination of the preceding and may also include a % of gross revenues, adjusted gross revenues, or expenses (but not both).

  b. Term of contract, including renewals, does not exceed 5 years

  c. Contract does not need to be terminable by the qualified user prior to the end of the term.

  d. Tiered productivity awards treated as stated amount or periodic fixed fee

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IRS Notice 2014-67

- Applicable to contracts entered into, materially modified or extended (other than pursuant to a renewal option) on or after January 22, 2015
- May be applied to contracts entered into before January 22, 2015
- Seeking public comment on this notice to issue further guidance

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CALCULATING PRIVATE BUSINESS USE

- Borrowers may lose their tax exemption if they have more than 5% of Private Business Use

Step 1: Determine Amount of Private Business Use Available

Step 2: Reduce Amount in Step 1 by Cost of Issuance Amount

Step 3: Review Private Business Use arrangements and determine what results in Private Business Use

Step 4: Calculate Amount of Private Business Use on those arrangements in Step 3

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STEP 1: DETERMINE AMOUNT OF PRIVATE BUSINESS USE AVAILABLE

-No more than 5% of the net proceeds of a bond issue may be used for private business use.

Sales Proceeds (defined in 1.148-1)
+ Investment Proceeds during Project Period
– Rebate Amount during Project Period
Proceeds
– Proceeds deposited in a reasonable required reserve fund
Net Proceeds

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STEP 1 CONTINUED

Example: College A borrows $100 million of bond proceeds from IHELA in order to build some new facilities. College A anticipates earning $12 million in investment proceeds during the Project Period, will rebate $2 million and will initially fund a Reserve Fund with $10 million.

Sale Proceeds:	$100,000,000
Investment Earnings:	$12,000,000
Rebate Amount:	$(2,000,000)
Proceeds:	$110,000,000
Reserve Fund:	$(10,000,000)
Net Proceeds:	$100,000,000
Bad Use Allowed:	x 5%
Allowable Bad Use:	$5,000,000

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STEP 2: REDUCE AMOUNT IN STEP 1 BY COST OF ISSUANCE AMOUNT

-According to Treas. Reg. Section 1.145-2(c)(2), issuance costs are included in the five percent private business use calculation as "bad use"

-Cost of Issuance is limited to 2% of PROCEEDS (note that this is not Net Proceeds number that 5% amount is calculated from)

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STEP 2 CONTINUED

From Previous Example – Assume Cost of Issuance is $2 million

Sale Proceeds:	$100,000,000	
Investment Earnings:	$12,000,000	
Rebate Amount:	$(2,000,000)	
Proceeds:	$110,000,000	→ COI limited to 2%
Reserve Fund:	$(10,000,000)	($2,200,000)
Net Proceeds:	$100,000,000	
Bad Use Allowed:	x 5%	
Allowable Bad Use:	$5,000,000	
Cost of Issuance:	($2,000,000)	
Remaining Allowable Bad Use	$3,000,000	

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STEP 3: REVIEW PRIVATE BUSINESS USE ARRANGEMENTS

-All management contracts that satisfy Rev. Proc. 97-13 are considered safe harbor and none of those arrangements create private business use

-Consult with Counsel about what arrangements create private business use

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STEP 4: CALCULATE PRIVATE BUSINESS USE OF ARRANGEMENTS UNDER STEP 3

Under Tax Regulations, the measurement method used must be "reasonable". There are four primary methods:

(1) Square Footage

(2) Time of Use

(3) Time/Space Analysis

(4) Revenues

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STEP 4 CONTINUED

Management Contracts for <u>Bookstores</u>, and <u>other Concessions</u> most frequently done on square footage basis

- Information required to calculate private use:
  - Square footage of private use generating space
  - Total square footage of bond financed space
  - Length of contract
  - Length of bond issue (measurement period)

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STEP 4 CONTINUED

Example: College A constructs a student union for $100,000 with tax-exempt bonds which is 50,000 square feet and has a Starbucks coffee shop subject to private business use which takes up 1,000 square feet of the student union. The Bonds mature in 20 years and the Starbucks contract also is for a term of 20 years.

$$\frac{\text{1,000 square feet of Starbucks}}{\text{50,000 total square feet}} = \text{2\% of square feet is “bad use”}$$

2% x $100 million Bond Proceeds spent on Student Union = $2 million “bad use”

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STEP 4 CONTINUED

Information required to calculate private use for Private Events typically done on a space and/or time analysis

- Information required to calculate private use:
  - Hours of the event
  - Hours open to the public
  - Hours of exempt use by the organization
  - Square footage of private use generating space
  - Total square footage of bond financed space
  - Amount of bond proceeds allocable to such space
- May qualify for Temporary Use Exception if negotiated at arms length and arrangement is no longer than 50 days.

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STEP 4 CONTINUED

Information required to calculate private use for Summer Dorm Use typically done on a time analysis

- Example: A Dormitory is financed with $25 million in tax-exempt bonds and is used 340 days/year of which 80 days is used by a for-profit basketball camp organization for campers. The Dormitory has 10 floors and only one floor is used for campers during the 80 day period. Each Floor has identical square footage and cost $2.5 million of proceeds to build.

- 80 days/340 days = 23.5% x $2.5 million = $587,500 of bad use or $587,500/$25,000,000 (2.35%) of bad use.

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HOW TO AVOID PRIVATE BUSINESS USE ISSUES

(1) Upon the issuance of Tax-Exempt Bonds, have Bond Counsel review all potential private business use arrangements

(2) After the issuance of Tax-Exempt Bonds, monitor and identify private business use arrangements on bond financed facilities

(3) Have Bond Counsel review all management contracts/lease arrangements/other contracts associated with bond-financed facilities

(4) Annually prepare a Private Business Use analysis and calculation for the Schedule K on Form 990

(5) Properly Allocate the proceeds of tax-exempt bonds to the project costs

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PROJECT COST ALLOCATION

- Treasury Reg. Section 1.148-6(d)(iii) requires an issuer to account for allocation of proceeds to expenditures not later than 18 months after the later of (1) the date the expenditure is paid; or (2) the date that the project that is financed by the issue is placed in service. In any event, the allocation must be made within 60 days after the fifth anniversary of the issue date, or if earlier, 60 days after the retirement of the issue.
- Section 1.148-6(d)(1)(i) provides that the following methods may be used if applied consistently:
  - Specific Tracing
  - Gross Proceeds spent first (except for working capital expenditures which must follow gross proceeds spent last method)
  - First-in, first-out
  - Ratable Allocation Method

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PROJECT COST ALLOCATION

Using Equity Allocations to Dilute Private Use

- *High level approach:*
  - Project costs $10 million
  - $2 million of which is equity
  - 20% of the facility financed by that project is "shielded" by equity
- Private use would only become attributable to the bonds when the private use percentage of the entire facility exceeds 20%
  - i.e., if total private use attributable to the project is 25%, only 5% is allocable to the bonds

CAUTION: MUST PROPERLY ALLOCATE IN ORDER FOR THIS TO OCCUR

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Thank you

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