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Effect of Tax Reform Act of 1986 Upon Tax-Exempt Bond Financing for the Health Care Industry

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Robert J. Zimmerman*

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I. INTRODUCTION

This article analyzes the effects of the Tax Reform Act of 1986 upon the use of tax-exempt bonds to finance the capital requirements of the not-for-profit, tax-exempt health care industry. Tax-exempt debt has provided an increasingly larger proportion of the capital required by the not-for-profit health care industry for its long-term and intermediate-term needs. These needs have included the financing of construction, renovation and acquisition of property, plants, and equipment. The Tax Reform Act of 1986 does not legally preclude the industry access to tax-exempt debt capital. As this article demonstrates, however, the new law raises the direct out-of-pocket costs of using this source of capital and may increase the ongoing interest expense relative to taxable securities. The article also discusses more precise requirements on the use of the proceeds of tax-exempt bonds imposed by the new law. This discussion illustrates that as a result, the use of tax-exempt debt for any activities other than the directly-related, charitable activities of the tax-exempt borrower will be effectively precluded. The article concludes that more precise and informative legal, financial, strategic, and corporate planning analyses must be utilized before a not-for-profit, tax-exempt health care organization undertakes a tax-exempt bond financing.

A. Background to the Tax-Exempt Bond Provisions of the Tax Reform Act of 1986

The Tax Reform Act of 1986 (the "Act")1 redesignated the Internal Revenue Code of 1954, as amended (the "1954 Code"), as the Internal Revenue Code of 1986 (the "1986 Code").2 Most of the provisions of the 1954 Code relating to tax-exempt bonds were significantly amended by the Act.3 The Conference Committee of

3. Title XIII, Subtitle A of the Act reorganized Part IV of Subchapter B of Chapter 1 of the 1954 Code to include in Sections 141 through 150 the provisions of the 1986 Code governing the issuance of tax-exempt bonds and the conditions under which the interest on such bonds would continue to be exempt from taxation pursuant to Section 103 of the 1986 Code. Most of the substantive provisions of Sections 103 and 103A of the 1954 Code are now included in Sections 141 through 150 of the 1986 Code. Section 1301(a) of the Act amended Section 103 of the 1954 Code to provide for the exemption from taxation on bonds which meet the qualifications of Sections 141 through 150 of the 1986 Code. Section 103A of the 1954 Code, which provided for mortgage bonds, was repealed by Section 1301(j)(1) of the Act. To the extent amended by the Act, principles of prior law are not affected by the reorganization of the 1954 Code. See Jt. Comm. on Taxa-
the House of Representatives and the Senate (the "Conference Committee") estimated that the tax-exempt bond provisions of the Act will generate an additional $622 million in federal revenue during federal fiscal years 1987 through and 1991, contrasted with revenues anticipated under the 1954 Code. Nevertheless, transitional rules or "grandfather provisions" in the Act, which exempt several specific projects from various provisions of the 1986 Code, reduce the anticipated additional revenue below the amounts that would have been expected from the substantive revisions to the 1954 Code, had the exemption provisions not been included.

The dollar volume of tax-exempt bonds used to finance the activities of nongovernmental entities increased from approximately $30.9 billion in 1981 to $71.1 billion in 1984, representing approximately two-thirds of the tax-exempt bond market in 1984, contrasted with less than one-third in 1975. During these same periods, the volume of bonds issued to finance the activities of not-for-profit, tax-exempt hospital and health care organizations ("Section 501(c)(3) organizations" with respect to both the 1954 Code and the 1986 Code) also increased substantially from less than

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7. Sections 501(a) and 501(c)(3) of the 1954 Code and the 1986 Code are identical. Section 501(a) of the 1986 Code exempts from income taxation "an organization described in subsection (c)." I.R.C. § 501(a) (1986). An organization is described in section 501(c)(3) if it is "organized and operated exclusively for religious, charitable, scientific
$5 billion in 1977 to $31.25 billion in 1985, representing approximately 15.3% of the total 1985 dollar volume.  

Both the Committee on Ways and Means of the House of Representatives (the “Ways and Means Committee”) and the Committee on Finance of the Senate (the “Finance Committee”) indicated that the revisions to the tax-exempt bond provisions of the 1954 Code were intended to reduce the volume of tax-exempt bonds issued for nongovernmental purposes and to correct perceived abuses by issuers of tax-exempt bonds. The Ways and Means Committee noted an erosion of public confidence in the “equity of the tax system” caused, in part, by the ability of high-income taxpayers to limit their tax liability by investing in tax-exempt bonds. The increasing supply of bonds issued to finance the activities of nongovernmental entities relative to demand for such bonds was perceived to increase yields on tax-exempt bonds relative to taxable securities, narrowing the traditional “spread” between taxable and tax-exempt earnings. As a result, taxpayers with high marginal federal income tax rates receive an after-tax yield higher than they would receive on taxable securities. A reduction in the volume of tax-exempt bonds would decrease the supply of tax-exempt bonds, theoretically reducing the yield on tax-exempt bonds, assuming a relatively constant demand. In addition, noting that the use of bonds proceeds to finance the activities of nongovernmental entities represents “an indirect subsidy by the federal government” of private activities, the Ways and Means Committee concluded that private use of tax-exempt bonds constituted an “inefficient allocation of new capital.”

... or educational purposes... no part of the net earnings of which inures to the benefit of any private shareholder or individual.” Id. § 501(c)(3). Not-for-profit hospitals and health care organizations are typically qualified for exemption as a consequence of meeting the requirements of section 501(c)(3).


11. Id.

12. “The efficient allocation of capital requires that the social return from a marginal unit of investment be equal across activities. When there is no difference between the private return on capital and the social return, the output of capital will be maximized only if there is no preferential treatment for investment in certain activities. If the ability
Means Committee also concluded that the costs to state and local governments of financing their governmental activities has increased because the increasing volume of tax-exempt bonds for nongovernmental purposes increases the aggregate supply of tax-exempt bonds, though it does not always increase demand.\(^\text{13}\)

The Ways and Means Committee further concluded that arbitrage\(^\text{14}\) is an “inefficient substitute for additional bond volume,” generating a greater loss in federal revenues than would result from increasing the amount of the borrowing to provide funds otherwise generated by arbitrage.\(^\text{15}\) Arbitrage was characterized as a “device for concealing the true cost of a bond-financed facility from the public” by relying on the “indirect Federal Government subsidy” represented by arbitrage earnings.\(^\text{16}\) The Ways and Means Committee suggested that the public may not approve a request for bond issuance authority sufficient to cover the actual cost of the facility that is partially “hidden” to the extent of arbitrage earnings.\(^\text{17}\) Finally, the Ways and Means Committee indicated that issuers should pay the costs of borrowing directly, rather than using arbitrage to recover issuance costs. The direct payment of such costs should “encourage issues to scrutinize more closely” issuance costs.\(^\text{18}\)

**B. The General Approach of the Act to Tax-exempt Bonds**

1. The “Supply Side”

To implement the objectives of the Ways and Means Committee, the Act amended the 1954 Code to reduce directly and indirectly the supply of tax-exempt bonds. Some of the provisions directly restrict the volume of tax-exempt bonds through the imposition of a state-wide volume cap on bonds issued to finance certain private activities\(^\text{19}\) and on bonds used for non-hospital purposes and which are issued for the benefit of Section 501(c)(3) organizations.\(^\text{20}\) Other amendments eliminate or restrict the number of permitted

\(^{13}\) Id.

\(^{14}\) Arbitrage is the investment of the proceeds of the sale of tax exempt bonds at a yield higher than the interest cost to the issuer. See infra note 231 and accompanying text.

\(^{15}\) Id.

\(^{16}\) Id.

\(^{17}\) Id.

\(^{18}\) Id.

\(^{19}\) I.R.C. § 146(a) (1986); see infra notes 419-22 and accompanying text.

\(^{20}\) I.R.C. § 145(b)(1) (1986); see infra note 159 and accompanying text.
advance refundings. Additional amendments were intended to reduce indirectly the volume of the tax-exempt bonds by shifting more of the cost of financing a facility or activity to the issuer, by means of arbitrage restrictions, rebate requirements, and limitations on the amount of issuance costs that may be paid out of bond proceeds.

2. The "Demand Side"

Certain provisions of the Act adversely affect taxpayers who invest in tax-exempt bonds. Although these provisions are intended to generate revenues to the federal government, they also may reduce indirectly the volume of tax-exempt bonds by reducing demand. The reduction in demand for tax-exempt bonds may increase further federal revenues as potential issuers of tax-exempt bonds shift to taxable debt to finance their projects. The income on certain types of tax-exempt bonds, not including bonds issued to benefit Section 501(c)(3) organizations, are directly subject to the calculation of the alternative minimum tax. The income of corporate taxpayers attributable to tax-exempt bonds is indirectly affected as a consequence of the calculation of the corporate alternative minimum tax. Banks cannot deduct their costs of carrying a substantial portion of tax-exempt bonds. In addition, tax-exempt income will affect the loss deduction available to property and casualty insurance companies.

C. Effective Dates and Transitional Rules

In general, the provisions of the Act affecting tax-exempt bonds apply to bonds issued after August 15, 1986. The provisions of the Act affecting tax-exempt bonds, however, will not affect bonds issued to finance certain facilities that benefit from a general transitional or "grandfather" rule. In order to qualify for this general transitional exception, the bonds must have been described in an

21. I.R.C. § 149(d)(1), (3)(A)(i) (1986). An advance refunding occurs when bond proceeds are used to refinance an existing bond issue prior to the date the existing bonds are redeemable or due at maturity. See infra note 299 and accompanying text.
22. I.R.C. §§ 103(b)(2), 148(a) (1986); see infra note 231 and accompanying text.
23. I.R.C. § 148(f) (1986); see infra note 281 and accompanying text.
24. I.R.C. § 147(g)(1) (1986) see infra note 139 and accompanying text.
25. I.R.C. §§ 57(a)(5)(A), (C)(ii) (1986); see infra note 373 and accompanying text.
27. I.R.C. § 265(b)(1) (1986); see infra note 399 and accompanying text.
inducement resolution\textsuperscript{30} or other similar preliminary approval adopted by the issuer, or must have been approved by voter referendum prior to September 26, 1985.\textsuperscript{31} In addition, the facility to be financed with the proceeds of bonds under the transitional rule must meet one of several alternative conditions. The original use of the facility must commence with the borrower and the construction, reconstruction, or rehabilitation of the facility must have commenced prior to September 26, 1985 and be completed on or after September 26, 1985.\textsuperscript{32} Another option is to have entered a binding contract to incur significant expenditures (defined as ten percent or more of the reasonably anticipated construction cost,\textsuperscript{33} with respect to the facility) entered into before September 26, 1985 and some expenditures incurred on or after September 26, 1985.\textsuperscript{34} In the alternative, the facility must have been acquired by September 26, 1985 pursuant to a binding contract entered into before that date.\textsuperscript{35}

Despite the exemption afforded by the general transition rule, certain provisions of the 1986 Code will apply. These provisions include the limitations on the maturity of the bonds,\textsuperscript{36} the public approval requirement,\textsuperscript{37} the limitations on issuance costs that may be paid out of bond proceeds,\textsuperscript{38} the arbitrage requirements\textsuperscript{39} and the restrictions on changes in use of the financed facility.\textsuperscript{40}

\section*{II. Limitations Upon The Use of Proceeds Of The Sale of Bonds}

Proceeds of tax-exempt bonds typically are used for a variety of

\begin{itemize}
\item \textsuperscript{30} An inducement resolution is an action taken by the governing body, such as a city council, board of trustees or county commissioners, of a governmental unit in the nature of preliminary approval of a project which is intended to encourage or "induce" the implementation of the proposed subject.
\item \textsuperscript{32} Id. § 1312(a)(1)(A)(i), 100 Stat. 2085, 2659.
\item \textsuperscript{33} Id. § 1312(a)(2), 100 Stat. 2085, 2659.
\item \textsuperscript{34} Id. § 1312(a)(1)(A)(ii), 100 Stat. 2085, 2659.
\item \textsuperscript{35} Id. § 1312(a)(1)(A)(iii), 100 Stat. 2085, 2659.
\item \textsuperscript{36} Id. § 1312(b)(1)(E), 100 Stat. 2085, 2659 (codified at I.R.C. § 147(b) (1986)); see infra note 347 and accompanying text.
\item \textsuperscript{38} Tax Reform Act of 1986, Pub. L. No. 99-514, § 147(g)(11), 100 Stat. 2085, 2660 (codified at I.R.C. § 147(g)(1) (1986)); see infra note 139 and accompanying text.
\item \textsuperscript{40} Tax Reform Act of 1986, Pub. L. No. 99-514, § 1312(b) (1) (J), 100 Stat. 2085, 2660 (codified at I.R.C. § 150(b) (1986)); see infra note 149 and accompanying text.
\end{itemize}
purposes. The traditional tax-exempt bond is issued by a state or local governmental unit to finance government projects and activities for use by the general public, including the construction of public schools, sewers, roads, bridges, and governmental office facilities. Proceeds of governmental bonds also are used to finance the construction of facilities that are owned by the governmental unit but may be used by private enterprise and by the general public, including airports, ports, docks, mass transit facilities, and water distribution facilities. Finally, proceeds of governmental bonds may be used to finance the construction of facilities owned exclusively by private enterprise, including not-for-profit private hospitals and schools, low income residential rental housing, and smaller commercial and industrial projects. The proceeds of governmental bonds also may be used to finance private housing through mortgage bonds. Proceeds used for such private enterprises reflect the governmental policy of encouraging the development of facilities that benefit society.

A. General Rules Under the 1954 Code

Under the 1954 Code, whether or not the interest on bonds was entitled to tax-exempt status depended in part upon how the proceeds of the sale of bonds issued by state and local governments were used. As a general proposition, if the proceeds were used to finance the activities and functions of a governmental unit, and the issuer adhered to certain technical restrictions, then interest on the bonds was exempt from federal income taxation. The same status was afforded to bonds issued to finance the charitable activities and purposes of Section 501(c)(3) organizations. Governmental units and Section 501(c)(3) organizations, to the extent of the latter's activities which were not unrelated trade or business activities as defined in Section 513 of the 1954 Code, were defined as "exempt persons," a characterization that provided the legal basis for

41. See infra notes 42-73 and accompanying text.
42. I.R.C. § 103(a)(1), (b) (1954).
43. Id.
44. Unrelated trade or business as defined in the 1954 and 1986 Codes is "any trade or business the conduct of which is not substantially related...to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501." See I.R.C. § 513(a) (1986); I.R.C. § 513(a) (1954). In addition, in the case of a hospital, unrelated trade or business exists if the hospital provides certain enumerated services (data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center and personnel services) to other hospitals with 100 or more inpatient beds. I.R.C. § 513(e) (1986).
the tax-exempt status of interest received on the bonds.\textsuperscript{45} 

If more than a specified percentage of bond proceeds was used by or loaned to "non-exempt" persons, then interest received on the bonds was not entitled to tax-exemption.\textsuperscript{46} If use of lending in excess of such limits occurred, then the bonds were "industrial development bonds"\textsuperscript{47} or "consumer loan bonds," respectively.\textsuperscript{48} Interest on industrial development bonds or consumer loan bonds was exempt from federal income taxation only if the use or lending of bond proceeds by or to non-exempt persons, respectively, was specifically allowed under other provisions of the 1954 Code.\textsuperscript{49}

1. Industrial Development Bonds

The 1954 Code mandated the satisfaction of two standards before the use of bond proceeds could be considered an industrial development bond. These two standards are referred to as the "trade or business use test"\textsuperscript{50} and the "security interest test."\textsuperscript{51}

\textit{a. Trade or Business Use Test}

The trade or business use test required that more than 25 percent of the proceeds of the bonds\textsuperscript{52} must have been "used directly or indirectly in any trade or business carried on by any person who is not an exempt person."\textsuperscript{53} Exempt persons included only govern-

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{45}] I.R.C. § 103(b)(3) (1954).
\item[\textsuperscript{46}] No more than twenty-five percent of the proceeds could be used by non-exempt persons. Treas. Reg. § 1.103-7(b)(3)(iii) (1987). No more than five percent of the proceeds could be loaned to non-exempt persons. I.R.C. § 103(o) (1954); see infra notes 53, 67, 70-71 and accompanying text.
\item[\textsuperscript{47}] I.R.C. § 103(b) (1954).
\item[\textsuperscript{48}] Id. § 103(o) .
\item[\textsuperscript{49}] Even though a bond satisfied the definition of an industrial development bond or consumer loan bond, tax exempt status was available if the use of proceeds was specifically permitted under other sections of the 1954 Code, which uses were described as "exempt activities," such as low income residential rental facilities, sports facilities, convention and trade show activities, airports, docks, mass commuting facilities, sewage and solid waste disposal facilities, facilities for the local furnishing of electric energy or gas, pollution control facilities, facilities for the furnishing of water, hydroelectric generating facilities, mass commuting vehicles or local district heating and cooling facilities. Id. at § 103(b)(4). A category of bonds known as "small issue bonds," the principal amount of which was limited to $1,000,000 or, at the option of the issuer, $10,000,000, which were used typically to finance relatively small commercial, retail, office, manufacturing and industrial facilities, also was entitled to tax exempt status. Id. § 103(b)(6).
\item[\textsuperscript{50}] Id. § 103(b)(2)(A).
\item[\textsuperscript{51}] Id. § 103(b)(2)(B).
\item[\textsuperscript{52}] Treas. Reg. § 1.103-7(b)(3)(iii) (1987).
\item[\textsuperscript{53}] The 1954 Code required that all or a "major portion" be used by other than an exempt person. I.R.C. § 103(b)(2)(A) (1954). Treasury regulations defined "major por-
\end{itemize}
\end{footnotesize}
mental units and Section 501(c)(3) organizations. While the trade or business use test was relatively simple to apply to bond proceeds used for governmental purposes, application of the test was more complicated when bonds were issued to finance the activities of Section 501(c)(3) organizations. If at least seventy-five percent of the bond proceeds were used to finance activities related to the charitable purposes of the borrowing Section 501(c)(3) organization, then the trade or business use test was not satisfied, even if twenty-five percent or less of the proceeds were used by a non-exempt person. If any part of a facility owned by a section 501(c)(3) organization financed with tax-exempt bonds was used in an unrelated trade or business activity of the Section 501(c)(3) organization it was considered as being used in a trade or business by a non-exempt person.

Trade or business use by a non-exempt person may have been the consequence of facilities financed by a governmental unit or on behalf of a Section 501(c)(3) organization managed or otherwise

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55. For example, if City A issued bonds and used the proceeds to construct a general maintenance facility and leased more than twenty-five percent of the facility so constructed to a private construction contractor, the trade or business use test would have been satisfied because the construction contractor was not an exempt person. If, however, City A used the bond proceeds to construct a series of neighborhood health clinics and leased more than twenty-five percent of the total facility space constructed to hospitals (assuming they were Section 501(c)(3) organizations) to operate drug rehabilitation centers for use by the general public, and assuming the hospitals did not extend use to private physicians for their private patients, the trade or business use test would not have been satisfied because the hospitals were exempt persons. The result would have been different if the same amount of space were leased by City A or subleased by the hospitals to private physicians for their use as private office space because the physicians were not exempt persons.
56. For example, if a hospital (assuming it was a Section 501(c)(3) organization) used bond proceeds to construct an addition for replacement inpatient acute care beds and a new physicians office building, and if twenty-five percent or less of total facilities financed were attributable to the physicians office building, then the trade or business use test would not have been satisfied. If more than twenty-five percent of the proceeds were attributable to the physicians office building, then the test would have been satisfied. If the facilities financed included the inpatient bed component described above and an off-campus ambulatory surgical facility to be owned and operated by a Section 501(c)(3) organization or a classroom facility owned and operated by a Section 501(c)(3) organization, then the percentage of use by such affiliates would not have caused the trade or business use test to be satisfied because such affiliates were exempt persons.
57. For example, if the facilities financed included a laboratory that was used to provide services to physicians and other hospitals (to the extent such use would constitute an unrelated trade or business activity by application of Section 513(e) of the 1954 Code), and if the space and equipment so financed exceeded twenty-five percent of proceeds, the trade or business use test would have been satisfied.
used by or leased to nonexempt persons. Facilities owned by a governmental unit or a Section 501(c)(3) organization that were managed by a private person pursuant to a management contract were not considered used in the manager's trade or business. Thus, the trade or business use test was not satisfied if the management contract did not exceed a five-year term, including renewal options. If the temporal term of the contract exceeded two years, the exempt owner must have had the option to cancel the contract without penalty at the end of any two-year period. The manager's compensation must have been based upon a periodic flat fee reasonable in relation to the services performed; with respect to newly-operational facilities, compensation could have been based upon a percentage of gross revenues attributable to the facilities for a period generally not exceeding one year. The exempt owner of the facilities managed and the management company could not be under common control.

If the non-exempt person "used" the facility owned by the exempt person in an arrangement other than management, to avoid satisfaction of the trade or business use test, different rules applied. The contract term could not exceed two years. The compensation to the non-exempt user must have been reasonable and based upon a percentage of the fees charged for services rendered by the nonexempt user, but not upon a percentage of net income or profits of the exempt owner. Furthermore, the contract must have been cancelable by the exempt owner without penalty upon ninety days notice. In the alternative, if the compensation to the non-exempt user was based upon a periodic flat fee and the contract term could not exceed five years. In addition, the compensation must have been reasonable in relation to the services performed and the exempt owner must have had the right to cancel the contract without penalty at the end of any two-year period. In either case, common control was prohibited.

58. Rev. Pro. 82-14, 1982-1 C.B. 459; Rev. Pro. 82-15, 1982-1 C.B. 460.
59. Rev. Pro. 82-14, 1982-1 C.B. 459.
60. Id.
61. Id. at 460.
63. Id.
64. Id.
65. Id. at 460-61.
66. Id. at 461.
b. Security Interest Test

In addition to the trade or business use test, the use of bond proceeds also had to satisfy the security interest test to be considered an industrial development bond. To satisfy the security interest test, payment of principal or interest on the bonds to the extent of more than twenty-five percent of the proceeds of the bonds must have been secured by an interest in property used in a trade or business or secured or derived by or from payments in respect of such property. As a general proposition, if the bonds were directly secured by the facilities used in a trade or business, such as by a mortgage or a direct or indirect pledge of revenues attributable to the facility, the security interest test was satisfied. The security interest test also would have been satisfied, by alternative means. If the facilities financed with bond proceeds were leased to a non-exempt person and if either the lease payments provided direct security for the bonds, for example, by an assignment of rents, or were a source, but not necessarily the sole source, of payment on the bonds, the test was satisfied assuming the major portion requirement was satisfied.

2. Consumer Loan Bonds

If all or a “significant portion” of bond proceeds were reasonably expected to be used directly or indirectly to make or finance loans to non-exempt persons, then, with certain exceptions, the bonds were “consumer loan bonds” and thus not entitled to tax-exempt status. Exceptions to the rule were granted for the lending of proceeds of qualified student loan bonds, industrial development bonds (including exempt facility bonds and small issue industrial development bonds), qualified mortgage bonds and qual-

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67. The 1954 Code required that payment of principal or interest on the bonds must have been in whole or “major part” secured by property used in a trade or business. I.R.C. § 103(b) (2)(B) (1954). Treasury regulations defined “major portion” as more than twenty-five percent of the proceeds. Treas. Reg. § 1.103-7(b)(3)(iii) (1987).

68. Id. § 1.103-7(b)(4).

69. The term “significant portion” was not defined in the 1954 Code. Section 103(o) of the 1954 Code was added by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494. The Report of the Committee on Finance of the Senate indicated that five percent would be considered “significant” and, as a consequence, Section 103(o) has been so applied. See S. Fin. Comm. Rep., supra note 1.

70. A consumer loan was defined as “any obligation which is issued as part of an issue all or a significant portion of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans . . . . to persons who are not exempt persons (within the meaning of subsection [103](b)(3)).” I.R.C. § 103(o)(2)(A) (1954).
ified veterans' mortgage bonds.\textsuperscript{71} By definition, loans to Section 501(c)(3) organizations (to the extent of the Section 501(c)(3) organization's activities which were not unrelated trade or business activities) were not considered consumer loan transactions because Section 501(c)(3) organizations were exempt persons under the 1954 Code.\textsuperscript{72}

A transaction would have been an obvious lending transaction if proceeds would have fallen within the parameters of Section 103(o) if the transaction was the economic equivalent of the extensions of credit or making of a loan even if, on its face, the transaction did not purport to be a loan. For example, a hospital leasing space to private physicians in a hospital-owned office building would have been considered to have extended credit if the rent charged was less than the space's fair rental value. It would also have been an extension of credit if the lease constituted a capitalized lease or included the elements of a capitalized lease, for example, purchase options for less than fair value. If space in the leased building constituted more than five percent of the facilities financed with bond proceeds, then a consumer loan bond transaction arose. Essentially, a loan arose if, as a consequence of a transaction (such as a lease or an installment contract), ownership for tax purposes was transferred to a non-exempt person.\textsuperscript{73}

\section*{B. General Rules Under the 1986 Code}

The Act has preserved the trade or business use test, the security interest test, and the concept of a consumer loan bond. The nomenclature applied both to the tests and the type of bond, however, has been changed, the percentage thresholds have been substantially revised, and new concepts have been added.\textsuperscript{74}

Under the new Act, interest on bonds used to finance operations of state and local governmental units remains exempt from federal income taxation.\textsuperscript{75} Such bonds must continue to comply with arbitrage restrictions, as expanded by the Act,\textsuperscript{76} registration requirements,\textsuperscript{77} and prohibitions against federal guarantees.\textsuperscript{78} Additionally, the bonds must now satisfy the information reporting

\begin{itemize}
\item \textsuperscript{71} Id. § 103(o)(2)(B).
\item \textsuperscript{72} Id. § 103(b)(3)(B).
\item \textsuperscript{73} Conf. Comm. Rep. supra note 4, at II-690-692.
\item \textsuperscript{74} See infra notes 75-110 and accompanying text.
\item \textsuperscript{75} I.R.C. § 103(a) (1986).
\item \textsuperscript{76} Id. § 148; see infra note 231 and accompanying text.
\item \textsuperscript{77} I.R.C. § 149(a) (1986); see infra note 417 and accompanying text.
\item \textsuperscript{78} I.R.C. § 149(b) (1986); see infra note 412 and accompanying text.
\end{itemize}
requirements.\textsuperscript{79} The Act creates a category of bonds described as private activity bonds.\textsuperscript{80} A private activity bond is any bond that satisfies both the “private business use test” and the “private security or payment test,” or that satisfies the “private loan financing test.”\textsuperscript{81} Interest on private activity bonds is taxable unless such bonds are issued pursuant to an exception in the 1896 Code that would characterize such bonds as “qualified bonds.”\textsuperscript{82} The interest on a qualified bond will be exempt from federal income taxation if the use of bond proceeds will permit characterization of such bond as a “qualified bond.”\textsuperscript{83}

1. Private Business Tests

a. Private Business Use Test

Satisfaction of the private business use test requires that an amount exceeding ten percent of the proceeds be used for private business.\textsuperscript{84} The ten percent threshold is a significant reduction from the twenty-five percent threshold under the 1954 Code.\textsuperscript{85} To calculate the percentage attributable to private use, the costs of insurance and amounts deposited to a reserve fund\textsuperscript{86} are allocated between the governmental use portion and the private use portion.\textsuperscript{87}

Private business use is defined in the new Act as “use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit.” This definition is similar to the trade or business use concept under the 1954 Code.\textsuperscript{88} Ownership, actual use, or use deemed to arise pursuant to management contracts and leases or similar arrangements, other than ownership or use by a governmental unit, will be considered private business use.\textsuperscript{89} For

\textsuperscript{79} I.R.C. § 149(e) (1986); see infra note 418 and accompanying text.
\textsuperscript{81} I.R.C. § 141(a) (1986); see infra notes 84-110 and accompanying text.
\textsuperscript{82} See id. § 103(b) (1986). A bond is a “qualified bond” if it is a private activity bond and is described in one of the categories of bonds listed in Section 141(d) of the 1986 Code and meets other requirements of the 1986 Code applicable to the specific category. See id. at 141(d).
\textsuperscript{83} Id. § 103(b)(1), 141(d).
\textsuperscript{84} Id. § 141(b)(1).
\textsuperscript{85} See supra note 53 and accompanying text.
\textsuperscript{86} See infra notes 139, 257 and accompanying text.
\textsuperscript{87} CONF. COMM. REP., supra note 4, at II-687 n.8.
\textsuperscript{89} I.R.C. § 141(b)(6)(A) (1986); Treas. Reg. § 1.103-7(b) (3) (i) (1987).
purposes of the private business use test, any use by a Section 501(c)(3) organization is a private use. As under the 1954 Code, use by a member of the general public is not a private use. Any use of proceeds other than private business use is deemed to be "governmental use."

Private business use will not necessarily result from a management contract if the terms of the contract satisfy the conditions set forth by the Treasury Department. The Act directs the Treasury Department to modify its advance ruling guidelines pertaining to management contracts, set out in Revenue Procedure 82-14. Under the modified guidelines, private business use will not result if the term of the management contract, including renewal options, does not exceed five years and the exempt owner has the option to cancel such contract at the end of any three-year period. The contract manager cannot be compensated on the basis of net profits of the owner and at least fifty percent of the manager's annual compensation must be based upon a periodic fixed fee. Earlier guidelines required that the cancellation option be exercisable at the end of any two-year period and that all compensation be determined on a fixed fee basis, with a one-year exception for newly operational facilities.

b. Private Security or Payment Test

The Act retains but modifies the security interest test from the 1954 Code. Satisfaction of the private security or payment test requires that the payment of the principal or interest on more than ten percent of the proceeds of the bonds be directly or indirectly "secured by any interest in (i) property used or to be used for a private business use, or (ii) payments in respect of such property," or "derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use or to be used for a purpose other than a governmental unit." I.R.C. § 141(b)(6)(B) (1986).

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92. Private business use is defined as the "use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit." I.R.C. § 141(b)(6)(B) (1986).
93. See supra note 61 and accompanying text.
94. Tax Reform Act of 1986, Pub. L. No 99-514, § 1301(e), 100 Stat. 2085, 2655. Although the Act does not mandate similar changes in the "other use" guidelines described in Revenue Procedure 82-15, the Conference Committee expressed an intention that such guidelines be similarly revised.
95. Id.
96. Id.
97. Rev. Pro. 82-14, 1982-1 C.B. 459.
business use." The source of the payment obligation may arise from the legal documents, such as the bond resolution or indenture, or any underlying arrangement.

The Act modifies the earlier security interest test in several respects, broadening the scope of economic and financial transactions that provide security for the bonds. Both direct and indirect payments made by a private user are considered. Formal security arrangements are unnecessary. Special fees, charges, or taxes imposed by the governmental unit with respect to the property would satisfy the test. In addition, payments need not be made directly to the governmental issuer. Any payment with respect to the use of the property, if such payment provides a direct or indirect source of payment on the bonds, is sufficient.

c. Related Use Restriction

The 1954 Code did not require that the private use portion of bond proceeds used for governmental purposes be related to the governmental operation or activity financed with the bonds. The Act imposes a requirement that not more than five percent of the proceeds of a bond issue be unrelated to the governmental purpose for which the bonds were issued or disproportionate to a related governmental use.

2. Private Loan Financing Test

The Act retains but modifies the 1954 Codes consumer loan bond test, redesignating consumer loan bonds as private loan bonds. Private loan bonds are private activity bonds. The "significant portion" threshold included in the 1954 Code has been altered. A private loan financing results if the lesser of five percent of the proceeds or $5,000,000 are used to make or finance loans to persons other than governmental units. The applications of the test under the 1954 Code also carry forward to the 1986 Code.

103. Id. § 141 (b)(2)(B).
104. Id.
106. Id. § 141(b)(3) (1986).
107. Id. § 141(c).
108. Id. § 141(a)(2).
109. Id. § 141(c)(1).
110. See GENERAL EXPLANATION, supra note 3, at 1166-67.
III. QUALIFIED 501(c)(3) BONDS

A. General Discussion of Treatment Afforded to Bonds Issued to Benefit Section 501(c)(3) Organizations

Under the 1954 Code, bonds issued for the benefit of Section 501(c)(3) organizations generally were treated in a manner similar to bonds issued by governmental units to finance governmental activities.111 If twenty-five percent or less of the proceeds of bonds issued under the 1954 Code to finance the activities of Section 501(c)(3) organizations were used in the unrelated trade or business activities of the borrowing Section 501(c)(3) organization or were used to benefit a person other than a Section 501(c)(3) organization or governmental unit, then the bonds were not industrial development bonds.112

To a substantial extent, the favorable treatment afforded to Section 501(c)(3) organizations is continued in the 1986 Code; bonds issued to benefit Section 501(c)(3) organizations are not subject to a substantial number of the tax-exempt bond restrictions of the 1986 Code. Nevertheless, some of the restrictions contained in the 1954 Code that did not apply to bonds issued to benefit Section 501(c)(3) organizations, including the public approval113 and rebate requirements,114 now apply under the 1986 Code. Moreover, all of the restrictions in the 1954 Code that applied to bonds issued to benefit Section 501(c)(3) organizations continue to apply, such as the arbitrage restrictions, as expanded,115 the prohibition against federal guarantees,116 the registration requirements,117 and information reporting requirements.118 Certain provisions of the 1986 Code that are applicable to private activity bonds do not apply to bonds issued to benefit Section 501(c)(3) organizations, such as the prohibition against advance refunding,119 the volume cap,120 the substantial user requirement,121 the limitations on the use of proceeds to acquire land and existing property,122 and certain arbi-

113. Id. § 147(f); see infra note 364 and accompanying text.
114. I.R.C. § 148(f) (1986); see infra note 281 and accompanying text.
115. I.R.C. § 148 (1986); see infra note 231 and accompanying text.
116. I.R.C. § 149(b) (1986); see infra note 412 and accompanying text.
117. I.R.C. § 149(d)(2) (1986); see infra note 417 and accompanying text.
118. I.R.C. § 149(a) (1986); see infra note 418 and accompanying text.
119. I.R.C. § 149(d)(2) (1986); see infra note 301 and accompanying text.
120. I.R.C. § 146(g)(2) (1986); see infra note 419 and accompanying text.
121. I.R.C. § 147(h)(2) (1986); see id. § 147(a).
122. Id. § 147(h)(2) (1986); see infra note 425 and accompanying text.
trage limitations pertaining to limitations on investments at a materially higher yield.\textsuperscript{123}

In addition, if any portion of the proceeds of bonds issued to finance governmental operations are used by or loaned to Section 501(c)(3) organizations, the entire bond issue is considered private business use of bond proceeds or private loan financing, unless the issuer elects to treat such portion as a "qualified 501(c)(3) bond."\textsuperscript{124} That portion must independently satisfy all requirements for the issuance of bonds to benefit Section 501(c)(3) organizations. To the extent these requirements are satisfied, the portion used to benefit Section 501(c)(3) organizations will not require any volume cap allocation, to the extent otherwise required. The issuer need not comply with other provisions of the 1986 Code which otherwise apply to the private use or private loan financing portions of governmental function bonds to the extent qualified 501(c)(3) bonds are exempted from such provisions.\textsuperscript{125}

\section*{B. Characteristics of a Qualified 501(c)(3) Bond}

A "qualified 501(c)(3) bond" is a private activity bond. It results from either the consequence of the private business use of the proceeds of the bond or a loan of bond proceeds to a private person.\textsuperscript{126}

\subsection*{1. Requirement of Ownership of Property Financed}

All property financed with the net proceeds of qualified 501(c)(3) bonds must be owned by either a Section 501(c)(3) organization or a governmental unit.\textsuperscript{127} In the event ownership of property financed with the proceeds of a qualified 501(c)(3) bond subsequently is transferred to a person other than another Section 501(c)(3) organization or a governmental unit, the transferee will not be permitted to deduct interest incurred in connection with the acquisition accruing during the transferee's period of ownership of the property so financed.\textsuperscript{128} The transferee is presumably denied

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{123} I.R.C. §148(d)(3)(F) (1986); see infra note 263 and accompanying text.
\item \textsuperscript{124} I.R.C. §141(b)(9) (1986); see infra note 126 and accompanying text.
\item \textsuperscript{125} I.R.C. §141(b)(9) (1986).
\item \textsuperscript{126} Id. §141(d)(1)(G), 145(a) (1986); see generally General Explanation, supra note 3, at 1183-88.
\item \textsuperscript{127} I.R.C. §145(a)(1) (1986) ("[T]he term qualified 501(c)(3) bond means any private activity bond issued as part of an issue if . . . all property which 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 . . . . ").
\item \textsuperscript{128} See General Explanation, supra note 3, at 1184.
\end{itemize}
\end{footnotesize}
interest deductions on any indebtedness incurred to finance the acquisition, whether the indebtedness represents an assumption of the bond indebtedness or a loan from other sources. In the latter situation, the deduction denied would arguably be limited to the extent of interest accruing on the qualified 501(c)(3) bonds if the qualified 501(c)(3) bonds remain outstanding. As a consequence, transfer to a taxpaying entity may have the effect of decreasing the value of the property to the purchaser to the extent of the denial of the interest deduction, particularly if the qualified 501(c)(3) bonds are not to be repaid in conjunction with the transfer.

Under the 1954 Code, changes in ownership of facilities owned by a Section 501(c)(3) organization and financed with the proceeds of bonds issued to benefit the Section 501(c)(3) organization ordinarily did not affect the taxexemption on the bonds if the events at the time of the transfer were unforeseen and unexpected at the time of the issuance of the bonds. If the transferee was not a Section 501(c)(3) organization or a governmental unit, then one would expect that use for private purposes could violate the trade or business use constraints. A series of private letter rulings have indicated, however, that a legitimate, non-prearranged sale, transfer or other private use of a facility as a consequence of unforeseen intervening circumstances, including changed economic conditions, will not cause the interest on the bonds to become taxable as industrial development bonds. Other than the loss of interest deductions discussed above, the Act does not change the rules under the 1954 Code regarding change in ownership.

2. Special Rules Regarding Use of Proceeds

a. Five Percent Private Business Use Limit

In order to qualify as a qualified 501(c)(3) bond, the proceeds of the bond cannot be used in a private business use, applying the ten percent use test generally applicable to private activity bonds, but modified, as described below, with respect to qualified 501(c)(3) bonds, and cannot be loaned in a transaction that would satisfy the private loan financing test. A private loan financing results
when more than the lesser of five percent of bond proceeds or $5,000,000 is used to finance loans to persons other than governmental units or other Section 501(c)(3) organizations, to the extent the loan to the other Section 501(c)(3) organization independently would satisfy all the requirements of a qualified 501(c)(3) bond.134 Under the modified private business use test, not more than five percent of the net proceeds135 of the bonds may be used for any private business use. Furthermore, they can neither be secured by or paid from property used in private business, nor used in the unrelated trade or business activities of a Section 501(c)(3) organization, including the borrowing Section 501(c)(3) organization.136 Use by another Section 501(c)(3) organization of a portion of the proceeds is a private use, but would not necessarily have an adverse effect if the use of proceeds by the other Section 501(c)(3) organization independently satisfies all the requirements of a qualified 501(c)(3) bond.137 Moreover, any unrelated trade or business activity of the Section 501(c)(3) organization, determined by applying Section 513(a) of the 1986 Code, will be considered private business use of bond proceeds.138

b. Limitations on Costs of Issuance

The costs of issuing the bonds that are paid with the proceeds of the bonds cannot exceed two percent of the aggregate face amount of the issue.139 Bond issuance costs include underwriters' spread, whether paid directly or through a discounted purchase by the underwriters' and attorneys' fees, including bond counsel, underwriters' counsel (which also may be paid through the discount),

135. Net proceeds are the proceeds of the bonds less proceeds deposited in a reasonably required reserve or replacement fund. Id. at 150(a)(3). See infra note 215 and accompanying text. For other private activity bonds, the percentage of minimum use is measured against total proceeds rather than net proceeds. Id. § 141(b)(1). This is different from the ten percent provision applicable to other private activity bonds in section 141(b) of the 1986 Code.
137. Id. § 141(b)(9).
138. Id. § 145(a)(2)(A).
139. Id. § 147(g)(1). Issuers may consider the issuance of a series of taxable bonds simultaneously with the tax exempt bonds for the purpose of paying issuance costs exceeding the two percent limitation. To the extent the proceeds of the taxable issue are used solely to pay the excess issuance costs, then the two issues may be excluded from the common plan of financing rules. See General Explanation, supra note 3, at 1158. If the common plan of financing rules were to apply, then the two issues would be deemed as one issue for various purposes, including use of proceeds, yield calculation, arbitrage and rebate. Treas. Reg. § 1.103-13(b)(10) (1987).
issuer’s counsel and borrower’s counsel. They also include financial advisor fees paid in conjunction with the borrowing, rating agency fees, and trustee fees. Bond insurance premiums paid when bonds are issued will not be considered a cost of issuance but rather interest, provided the present value of such premium is less than the present value of interest reasonably expected to be saved as a consequence of insuring the bonds. Letter of credit fees will be treated similarly. Such fees, however, must represent an assumption of the credit risk by the insurer or issuer of the letter of credit. To the extent any payments to the insurer or issuer of the letter of credit do not represent such risk assumption fees but rather fees or costs such as commitment fees, initial administrative or set-up fees or any other “shifting” of issuance costs, then the total fee payment will be considered as a cost of issuance and counted against the two percent limit.

c. Effect of Limits

The requirements that at least ninety-five percent of net proceeds be used for the exempt purposes of the Section 501(c)(3) organization, and that the costs of issuance paid from bond proceeds, subject to the two percent limit discussed above, be applied against the five percent balance are a substantial constriction of the requirement under the 1954 Code that at least seventy-five percent of the proceeds be used for the exempt purpose of the borrowing. The use of proceeds for private business use or the existence of security provided by private business property, when combined with the use of proceeds by the Section 501(c)(3) organization for its unrelated trade or business activities and the payment of costs of issuance by the Section 501(c)(3) organization, significantly increases the risk of non-compliance.

140. Id. § 1.103-13(c)(5)(iv); CONF. COMM. REP., supra note 4, at II-729-30.
141. Treas. Reg. § 1.103-13(c)(5)(iv) (1987); CONF. COMM. REP., supra note 4, at II-729-30 (also includes paying and authenticating agents’ fees; accountant fees in connection with the borrowing, including costs of verifications for advance refundings; printing costs and costs associated with the public approval process; and costs of engineering and feasibility studies related to the financing, but not such fees incurred with respect to the underlying project).
142. Treas. Reg. § 1.103-13(c)(8) (1987); CONF. COMM. REP., supra note 4, at II-730.
143. Id.
144. Id. at II-747. (subject to the two percent limit).
145. See id.
146. See supra notes 133-45 and accompanying text.
147. The effect of the five percent use can be illustrated as follows: assume the issuance of bonds in the aggregate amount of $30,000,000, of which the maximum permitted
C. Effects of Change in Use of Financed Property

If a Section 501(c)(3) organization finances property it owns with the proceeds of a qualified 501(c)(3) bond and the use of the property (but not the ownership) thereafter changes, adverse consequences may ensue. \(^{148}\) If the subsequent user is not a Section 501(c)(3) organization or a governmental unit, then the Section 501(c)(3) organization that continues to own the property will be deemed to be engaged in an unrelated trade or business activity with respect to the property so used. \(^{149}\) Moreover, the amount of gross income attributable to the Section 501(c)(3) organization owner with respect to the property for any period will be deemed to be at least the fair rental value of the property for that period. \(^{150}\) In addition, interest accruing during the period of such use and allocable to the facilities so used will not be deductible. \(^{151}\) If the subsequent user is also a Section 501(c)(3) organization and the property is not used in an unrelated trade or business activity, these consequences do not follow.

The most significant effect of this treatment is the possible loss of the Section 501(c)(3) status of the Section 501(c)(3) organization owner if the actual or imputed amount of unrelated trade or business income is substantial. The Act, however, changed neither Section 501 nor 513 of the 1954 Code to reflect any possible effects of such "imputed" unrelated trade or business use deemed to arise as a consequence of change in use. \(^{152}\) Another adverse consequence will be the realization of current gross income attributable to the property transferred without the benefit of deducting interest use of proceeds to fund a reasonably required reserve fund pursuant to Section 148(d)(2) of the 1986 Code or $3,000,000 is deposited to a debt service reserve fund, resulting in net proceeds of $27,000,000. Of this amount, 95 percent or $25,650,000 must be used by the Section 501(c)(3) organization directly for the exempt purposes of the borrowing, leaving a balance of $1,350,000. If the maximum permitted costs of issuance to be paid from proceeds is assumed, then $600,000 will be applied to such use, leaving a small balance of $750,000 which may be used in a private business use or to finance an unrelated trade or business activity of the borrowing organization or in a private loan financing transaction.

\(^{148}\) See infra notes 149-54 and accompanying text.

\(^{149}\) I.R.C. § 150(b)(3) (1986). Section 1311(c) of the Act provides that the new use and ownership rules were effective August 15, 1986, but only with respect to bonds issued after that date. Section 1313(b)(3)(F) of the Act provides that the rules regarding transfers of ownership or use apply to advance refunding bonds issued on and after August 16, 1986 to the extent the advance refunding bonds are issued pursuant to the transition rule of Section 1313(b) of the Act.

\(^{150}\) Id. § 150(b)(3)(A).

\(^{151}\) Id. § 150(b)(3)(B). The non-deductibility of interest may also apply to debt incurred by the new user for purposes of the use. See General Explanation, supra note 3, at 1219.

expense allocable to the facility. The provisions of the 1986 Code that include unrelated debt-financed income as unrelated business taxable income, however, should not apply because the property so transferred is not considered debt-financed property to the extent the income from the property is already taken into account when computing the gross income from an unrelated trade or business.\footnote{153} In addition, the interest received on the qualified 501(c)(3) bonds may become taxable if the portion of the property so used in a private business use (other than by a Section 501(c)(3) organization in other than its unrelated trade or business activities) exceeds five percent of net proceeds of the qualified 501(c)(3) bonds.\footnote{154} The rules permitting continued tax-exemption on the bonds if change in ownership results from unforeseen intervening circumstances, however, also should apply to change in use.

\section*{D. $150,000,000 Aggregate Limit for Qualified 501(c)(3) Bonds Other than Qualified Hospital Bonds}

When qualified 501(c)(3) bonds, excluding "qualified hospital bonds,"\footnote{155} are issued, the proceeds are "allocated" to those Section 501(c)(3) organizations that are considered "test-period beneficiaries" with respect to the issue.\footnote{156} Test-period beneficiaries include the Section 501(c)(3) organization on whose behalf the qualified 501(c)(3) bonds are issued, "principal users,"\footnote{157} and their respective related parties.\footnote{158} The amount of the qualified 501(c)(3) bonds (other than qualified hospital bonds), plus previously issued and outstanding qualified 501(c)(3) bonds, and certain other outstanding tax-exempt bonds issued prior to August 16, 1986 allocated to any test-period beneficiary cannot exceed $150,000,000.\footnote{159}

\begin{footnotes}
\footnote{154} Id. § 145(a)(2).
\footnote{155} A qualified hospital bond is a "bond issued as part of an issue ninety-five percent or more of the net proceeds of which are to be used with respect to a hospital." Id. § 145(c). \textit{See infra} note 201 and accompanying text.
\footnote{156} \textit{See infra} note 168 and accompanying text.
\footnote{157} \textit{See infra} note 173 and accompanying text.
\footnote{158} \textit{See infra} note 186 and accompanying text.
\footnote{159} I.R.C. § 145(b)(1) (1986). Only qualified 501(c)(3) bonds that cause the $150,000,000 limit would be taxable; the $150,000,000 limit does not affect the tax exemption of interest on bonds issued prior to August 16, 1986. \textit{See General Explanation, supra} note 3, at 1187. For purposes of determining compliance with the $150,000,000 limit, premiums and discounts will be ignored to determine "the true principal amount of the issue." Id. at 1193 n.135.
\end{footnotes}
1. Outstanding Non-Hospital Bonds

   a. Other Qualified 501(c)(3) Bonds

   The amount of previously issued qualified 501(c)(3) bonds, other than qualified hospital bonds, that are outstanding on the date of issuance of the new qualified 501(c)(3) bonds and are allocated to a test-period beneficiary, are included in the $150,000,000 aggregate limit.\textsuperscript{160} Outstanding qualified 501(c)(3) bonds that are to be redeemed immediately or within 90 days of the date of the issue with the proceeds of the new issue are excluded from the calculation.\textsuperscript{161}

   b. Tax-exempt Bonds Issued Prior to Effective Date of Act

   Tax-exempt bonds issued prior to August 16, 1986 are included in the $150,000,000 aggregate limit if both: (1) more than twenty-five percent of the proceeds of such bonds were used by a Section 501(c)(3) organization, other than in its unrelated trade or business activities; and (2) more than twenty-five percent of the principal or interest on the bonds are secured by property of a Section 501(c)(3) organization.\textsuperscript{162} Only those portions of the outstanding bonds that were not used for hospital purposes are included in the calculation.\textsuperscript{163} There is, however, a ten percent non-hospital use “safe harbor”: if ninety percent or more of the proceeds of such bonds were used with respect to a hospital, then none of the bonds are counted against the limit.\textsuperscript{164} Small issue industrial development bonds and exempt facility bonds issued under the 1954 Code for the benefit of the Section 501(c)(3) organization do not count against the $150,000,000 aggregate limit.\textsuperscript{165}

2. Allocation of Outstanding Bonds

   Outstanding bonds must be allocated to a Section 501(c)(3) organization that is a test-period beneficiary when the qualified

\textsuperscript{160} I.R.C. §§ 145(b)(2)(A), (B)(i) (1986).

\textsuperscript{161} Id. § 145(b)(2)(A)(ii). Bonds are considered to have been advance refunded if a subsequent issue of bonds (the “refunding bonds”) is issued to provide funds to provide for repayment of the earlier bonds (the “refunded bonds”), but the proceeds of the refunding bonds will not be so used until at least ninety days after the date of issuance of the refunding bonds. Id. § 149(d)(5). If the proceeds of the refunding bonds are used within the ninety-day period following issuance to redeem or pay the refunded bonds in a current refunding, then the refunded bonds will not be considered outstanding for the purposes of the $150,000,000 aggregate limit.

\textsuperscript{162} Id. § 145(b)(2)(B)(ii).

\textsuperscript{163} Id. § 145(b)(2)(C)(i).

\textsuperscript{164} Id. § 145(b)(2)(C)(ii).

\textsuperscript{165} Id. § 145(b)(2)(B)(ii)(II) (1986). Exempt facility bonds were described in Section 103(b)(4) of the 1954 Code. See supra note 51 and accompanying text.
501(c)(3) bonds are issued to determine compliance with the $150,000,000 aggregate limit. In addition, two or more organizations under common management or control are deemed to be one organization for purposes of determining compliance with the limit.

a. Test-Period Beneficiary

A test-period beneficiary is any Section 501(c)(3) organization that is an owner or a principal user of facilities financed with the proceeds of non-hospital bonds at any time during a three-year period commencing on the later to occur of the date the facilities financed with the bonds were placed in service or the date on which the bonds were issued. If a test-period beneficiary is a

167. Id. § 145(b)(3); see supra note 118 and accompanying text.
168. I.R.C. §§ 144(a)(10)(D), 145(b)(4) (1986). Test-period beneficiaries of bonds outstanding on August 16, 1986 were issued more than three years prior to August 16, 1986 include only the owners and principal users on August 16, 1986. See GENERAL EXPLANATION, supra note 3, at 1187. The concept of a test-period beneficiary was included in Section 103(b)(15) of the 1954 Code in the context of applying a $40,000,000 aggregate on the amount of small issue industrial development bonds allocated to certain persons in a manner substantially similar to the $150,000,000 aggregate on qualified 501(c)(3) bonds. The $150,000,000 aggregate will be administered in a manner similar to the $40,000,000 aggregate. See id. at 1186.

Under Proposed Treasury Regulation Section 1.103-10 (i)(3)(i), once a person is characterized as a test-period beneficiary because such person is a principal user of the facility financed or is related to the principal user during the three-year test period, such person will be a test-period beneficiary until the issue is no longer outstanding, even if such person ceases to be a principal user or a related party to a principal user. See id. at 1187. Double allocation is avoided pursuant to Proposed Treasury Regulation Section 1.103-10(i)(4)(iv): if a person is a test-period beneficiary because such person is an owner, and such person leases a portion of the facility to a related person who is also a principal user, the owner is allocated its portions pursuant to its principal owner status only. The owner does not obtain an allocation as a consequence of the lease to its related party.

Proposed Treasury Regulation Section 1.103-10(i)(4)(vi) provides that if all or a portion of the bond issue in question or a prior issue of bonds is redeemed (other than through a refunding) within 180 days after the date the person becomes a test-period beneficiary, then the portion so redeemed will not be allocated to the test-period beneficiary or its related parties.

If regulations similar to the Proposed Treasury Regulations under Section 103(b)(15) of the 1954 Code are promulgated with respect to the test-period beneficiary rules of Section 145(b) of the 1986 Code, then the one hundred and eighty day window probably will be reduced to ninety days to reflect the advance refunding rules of Section 148(d) of the 1986 Code. If a test-period beneficiary transfers substantially all of its assets to another person or a series of related persons, the transferee is treated under Proposed Treasury Regulation Section 1.103-10(i)(5) as a test-period beneficiary with respect to the issues and shall be allocated the portions which were allocated to the transferor. If the asset transfer occurs during the three-year test period, the interest on the bonds used to finance the facility becomes taxable retroactive to the date of issuance. See GENERAL EXPLANATION, supra note 3, at 1187.
principal user but not an owner of the facilities financed, then the portion or percentage of the bonds allocated to the test-period beneficiary will be the same as the percentage of the facility used by the test-period beneficiary.\textsuperscript{169} If the test-period beneficiary is the owner of the facility financed, then the percentage allocated will be the same as the percentage of the facility owned by the test-period beneficiary.\textsuperscript{170} The portion allocated to a related person is the same portion allocated to the test-period beneficiary to which such person is related.\textsuperscript{171}

The Act provides a general transition rule applicable to bonds issued to refund bonds which were issued prior to August 16, 1986 or after August 15, 1986 pursuant to certain other transitional rules.\textsuperscript{172} The $150,000,000 limit will not apply to the refunding bonds in two situations. The first requires the satisfaction of three elements: (1) the net proceeds of the refunding bonds must be used to redeem the refunded bonds within ninety days of issuance of the refunding bonds; (2) the principal amount of the refunding bonds can not exceed the outstanding principal amount of the refunded bonds; and (3) the average maturity of the refunding bonds does not exceed 120 percent of the average reasonably expected economic life of the facilities financed.\textsuperscript{173} The other alternative is possible where the final maturity of the refunding bond is not later than seventeen years after the refunded bond was issued.\textsuperscript{174} In addition, the $150,000,000 limit does not apply to the first advance refunding occurring after March 14, 1986 of a bond issued before January 1, 1986.\textsuperscript{175}

\textit{b. Principal User}

Neither the 1954 Code nor the 1986 Code define a "principal


\textsuperscript{170} Id. § 144(a)(10)(C)(ii).


\textsuperscript{172} See infra notes 173-75 and accompanying text.

\textsuperscript{173} I.R.C. § 147(b) (1986); see infra note 347 and accompanying text.


\textsuperscript{175} Id. § 1313(c)(2), 100 Stat. 2085, 2663. House Concurrent Resolution 395 ("HCR 395") adopted by the House of Representatives on September 25, 1986 provided for certain technical revisions to the Act. The Senate Amendment No. 3467 to HCR 395 was adopted by the Senate on October 16, 1986 and provided for an amendment to Section 1313(c)(2) of the Act which would have the effect of applying the $150,000,000 limitation to a second advance refunding. The House of Representatives did not adopt the Senate version of HCR 395. Any technical corrections bill amending the Act may incorporate the Senate provisions regarding the $150,000,000 limitation. See General Explanation, supra note 3, at 1186.
user." Under proposed Treasury Regulation Section 1.103-10(h), a principal user is defined to include a principal owner, principal lessee or "other" principal user, and a person related to such principal user through the application of the related person rules of Section 103(b)(6)(C) of the 1954 Code. A principal owner is defined as a person holding a ten percent ownership interest in the facility financed determined by applying federal income tax indicia of ownership. If there is no ten percent owner, then the person, or persons in the case of "multiple equal owners," holding the largest ownership interest is deemed to be a principal owner.

A principal lessee is a person who leases more than ten percent of the facility financed pursuant to a lease with a term of more than one year, taking into consideration renewal options and any reasonable expectation that the option may or may not be exercised. The portion leased may be determined by reference to its fair rental value as a percentage of the facility's aggregate rental value. In addition, because a principal user need not have a direct relationship with the owner in order to be considered a principal user, a sublessee subleasing ten percent of a facility is deemed to be a principal user, as would the sublessor/lessee. An "other" principal user is a person who enjoys a use of the facility (other than a short-term use) in a degree comparable to the enjoyment of a principal owner or a principal lessee, taking into account all the relevant facts and circumstances, such as the person's participation in control over use of the facility or its remote or proximate geo-

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176. The concept of a principal user was included in Sections 103 (b)(6) and 103(b)(15) of the 1954 Code in the context of rules applicable to small issue industrial development bonds. In order to issue small issue industrial development bonds, the aggregate face amount of such bonds could not have exceeded $1,000,000 (or $10,000,000 if an election was made under Section 103(b)(6)(D) of the 1954 Code, the issuance of bonds for the "principal user" of the facilities to be financed (but only with respect to such principal user's facilities situated in the same municipality or county) were aggregated with the amount of the new bonds to determine compliance with the $1,000,000 limit. Similar rules applied to the $10,000,000 election, but the principal user's capital expenditures within a six-year period were also included. Proposed Treasury Regulation 1.103-10(h) defines a principal user and describes the operation of the principal user concept. It is reasonable to assume that the proposed definitions and rules or substantially similar definitions and rules, once adopted in final form, would apply to qualified 501(c)(3) bonds.

178. Id. § 1.103-10(h)(1)(i).
179. Id. § 1.103-10(h)(1)(ii).
180. Id.
Once a principal user ceases owning, leasing or using the facility, that person is still considered a principal user. As a consequence, the principal user remains a test-period beneficiary until the expiration of the test period. In addition, if a person is considered a principal user because he is a related party, and he ceases being a related party, he remains a test-period beneficiary.

c. Related Parties

The test-period beneficiary rules of Section 145(b) of the 1986 Code do not directly include related parties. The absence of an express inclusion of related parties in the context of qualified 501(c)(3) bonds may be insignificant because of the “aggregation rule” of Section 145(b)(3) of the 1986 Code, which requires that two or more organizations “under common management or control” be treated as one organization. Moreover, the Ways and Means Committee Report states that related party rules will be pertinent in determining whether common management or control exists. In addition, if Treasury Regulations promulgated under Section 145(b) of the 1986 Code are substantially similar to the proposed Treasury Regulations under Sections 103(b)(6) and 103(b)(15) of the 1954 Code, then persons who are related to the principal user also would be deemed to be principal users.

The 1986 Code retains the 1954 Code's definition of a related party. A person is considered related to another person if the relationship between such persons would result in a disallowance of losses under Sections 267 or 707(b) of the 1986 Code. Although “disallowance of losses” is not apparently relevant in the context of a Section 501(c)(3) organization, Section 267 provides that a person is related to a Section 501(c)(3) organization if the Section 501(c)(3) organization “is controlled directly or indirectly by such person.” In addition, the requisite control is “any control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and

182. *Id.* § 1.103-10(h)(2)(iv).
183. *Id.* § 1.103-10(h)(1)(iv).
184. *Id.* § 1.103-10(i)(3).
185. *Id.*
187. WAYS & MEANS COMM. REP., supra note 6, at 539-40.
190. *Id.* § 267(b)(9).
regardless of the method by which the control is exercised or exercised." Furthermore, a person is considered related to another person if the relationship would result in a disallowance of losses under Section 707(b) of the 1986 Code with respect to partnerships. If a person possesses more than fifty percent of the capital interest or profit interest in a partnership, then partnership losses are disallowed. Finally, a person is considered related to another person if such persons are members of the same controlled group of stock corporations under Section 1563(a) of the 1986 Code. Generally, a controlled group exists if more than fifty percent of the voting stock or more than fifty percent of the total value of all shares is owned by one or more of the corporations in a chain of corporations or a parent organization possesses such fifty percent or more interest.

d. Organizations Under Common Management and Control

Organizations under common management or control are considered to be one organization for purposes of determining compliance with the $150,000,000 aggregate limit for qualified 501(c)(3) bonds. The 1986 Code does not provide direct guidance or standards addressing the degree of commonality or the concepts of management and control. Some guidance is provided by the Ways and Means Committee Report, which indicates that the small issue industrial development bond related person rules of the 1954 Code will apply. A Section 501(c)(3) organization may be treated as related to another person if the two have "significant common purposes and substantial common membership" or direct or indirect substantial common direction. In addition, a Section 501(c)(3) organization may be treated as related to another organization if the Section 501(c)(3) organization owns more than fifty percent of the capital interest or profit of the other organization.

191. Treas. Reg. § 1.267(b)-1(a) (3)(1987). Treasury Regulation 1.267(b) - 1(a)(3) was addressed by the United States Tax Court in Nationwide Corp. v. U.S., in which the Tax Court indicated that control over an exempt organization may arise through interlocking directors and officers. 72-1 T.C. 9430 (S.D. Ohio), aff'd. 73-1 T.C. 9269 (6th Cir. 1972).
193. Id. § 707(b)(1).
194. Id. § 144(a)(3)(B).
195. Id. § 1563(a) (1) (as modified by I.R.C. § 144(a)(3)(B) (1986)).
196. Id. § 145(b)(3).
197. Ways & Means Comm. Rep., supra note 6, at 539. See supra notes 185-95, and accompanying text.
199. Id.
Common control generally has been assumed to exist if one corporation has the right, typically granted by organizational documents such as articles of incorporation or by-laws, to select a sufficient number of the members, directors, or trustees of a second corporation who, in turn, determine the policies, activities, and business of the second corporation. Common management poses a significant interpretive problem, particularly as a consequence of the management by contract of otherwise independent organizations. The common control rule will pose significant concern for multi-institutional health care systems that possess characteristics of central common control and have financed or have planned to finance on a tax-exempt basis alternative delivery systems or long-term care facilities. The concern will be more acute for systems under church control or sponsorship.

3. Qualified Hospital Bonds

Qualified hospital bonds are excluded from the $150,000,000 aggregate limit. A qualified hospital bond is defined as a “bond issued as part of an issue ninety-five percent or more of the net proceeds of which are to be used with respect to a hospital.” The remaining five percent of the net proceeds need not be used “with respect to a hospital.” If less than ninety-five percent of net proceeds are used toward hospital purposes, then the portion not so used will be included in the $150,000,000 aggregate limit; the balance used for “hospital purposes” will not. Neither the 1986 Code nor the Conference Committee Report defines “use with respect to a hospital.” The Conference Committee Report indicates that hospital use arises “to the extent of . . . the use of the facilities for in-patient hospital services.” This suggests an intention that in-patient acute care services constitute a hospital, to the exclusion of outpatient services or ancillary services, to the extent not used to service the inpatient component.

The Ways and Means Committee Report defines a hospital as a facility accredited by the Joint Commission on Accreditation of Healthcare Organizations; if not so accredited, then it is accredited or approved by a qualified governmental unit with jurisdiction over the institution, if the Secretary of Health and Human Services has

201. Id. § 145(c).
202. See CONF. COMM. REP., supra note 4, at II-727.
203. Id. But see WAYS & MEANS COMM. REP., supra note 6, at 541 (rest or nursing homes, day care centers, medical school facilities, research laboratories and ambulatory care facilities are not considered hospitals).
determined that local approval is essentially equivalent to such accreditation. Although the Ways and Means Committee Report does not indicate what constitutes a qualified governmental unit, a state licensing agency or its equivalent would probably qualify. The facility must be used primarily to provide diagnostic and therapeutic services for medical diagnosis, treatment and care of the injured, disabled or sick persons as hospital in-patients, under the supervision of physicians. The Conference Committee Report indicates that the concept of "sick persons" include those who are mentally ill. Consequently, general acute care, rehabilitation, and psychiatric hospitals would qualify. The institution must require that each patient be under a physician's care and supervision. Finally, the institution must provide twenty-four hour nursing services to be rendered or supervised by either a registered professional nurse or a licensed practical nurse on duty at all times.

Certain applications of the rule may be clearer than others. For example, discrete units within an acute care hospital facility that are used for long-term nursing care, including skilled nursing or intermediate care units, may not be considered hospital uses. A similar conclusion may apply to discrete ambulatory surgical treatment centers and non-surgical ambulatory care and treatment facilities located within an acute care hospital facility or in separate buildings, including those both on and off "campus."

But numerous ambiguities will arise that will require clarification by regulation, ruling, or both. For example, in most states, a licensed hospital is required to maintain an emergency care service, in which non-emergency ambulatory services are typically provided. Because of this requirement, one should assume that the emergency care facility, at least to the extent it is available to provide emergency care, constitutes hospital use of such facilities. Use for non-emergency care should not disqualify the facility to the extent such use does not constitute a primary use of the facility. Regulations should address allocation of facility use, issues, particularly with respect to tertiary care facilities. Such regula-

205. See General Explanation, supra note 3, at 1188.
207. See General Explanation, supra note 3, at 1188.
tions should recognize state and local laws, the availability of health care facilities within a service area, and technological and socio-political changes in the nature of a "hospital." Appropriate allocation will be difficult. Predominant use should be the determinative factor, which would necessarily permit use of bond proceeds for non-acute inpatient care to the extent of incidental use.

4. Option to Issue Other Types of Bonds

If a Section 501(c)(3) organization wishes to avoid application of the $150,000,000 aggregate limit, it may elect not to issue qualified 501(c)(3) bonds but rather another category of bonds appropriate for the intended use of proceeds.210 The other categories essentially are limited to exempt facility bonds211 or qualified redevelopment bonds.212

Within the category of exempt facility bonds, the most likely to be utilized by a Section 501(c)(3) organization would be exempt facility bonds for qualified residential rental projects. Bonds for multifamily residential rental projects were entitled to tax-exemption under the 1954 Code.213 Treasury Regulations required that the rental units be used "other than on a transient basis."214 Consequently, hotels, motels, dormitories, fraternity and sorority homes, rooming houses, hospitals, nursing homes, sanitariums, rest homes, and trailer courts were not considered residential rental projects.215

The Conference Committee Report indicates that "retirement homes" do not "qualify" as residential rental property.216 If the Conference Committee Report represents a general intention to disqualify retirement homes despite the basis of their use and occupancy, then the most logical use of exempt facility bonds for qualified residential rental projects by Section 501(c)(3) organizations will be precluded. Many retirement homes are not occupied on a "transient basis," as are hotels, dormitories and nursing homes. Thus, the intention of the conferees may have been to direct the Treasury Department to disqualify retirement homes, whether or not their use can be considered "transient." On the other hand, the conferees may have intended that "retirement homes" be consid-

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212. See generally id. § 144(c).
215. Id.
ered the equivalent of “rest homes,” which are “transient use” facilities. Other types of retirement facilities, such as congregate care facilities and life care centers, should not be considered “transient use” facilities. Treasury Regulations are required to clarify the ambiguity and obvious inconsistency.

E. Limitation on Cost Recovery of Bond Financed Property

With certain transitional exceptions, property that has been financed with the proceeds of tax-exempt bonds is treated less favorably than property that has not been so financed to the extent cost recovery or depreciation deductions are relevant. Transactions in which a Section 501(c)(3) organization transfers property that has been financed by qualified 501(c)(3) bonds to a tax paying entity will be affected by the cost recovery rules.

Tax-exempt bond financed property is defined as any property to the extent such property has been financed directly or indirectly by a tax-exempt bond. Qualified residential rental projects financed with tax-exempt bonds pursuant to Section 142(a)(7) of the 1986 Code are excluded from this definition.

The 1986 Code provides for an accelerated cost recovery system for most property. Property that is considered “tax-exempt bond financed property,” however, is depreciated on the basis of the “alternative depreciation system.”

The only distinction with respect to the accelerated cost recovery system and the alternative depreciation system.

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218. I.R.C. § 168(g)(5)(A), (c) (1986).
219. Id.
220. Id. § 168.
221. Id. § 168(g)(1)(C). Under the accelerated cost recovery system, property generally may be depreciated on the basis of a 200 percent declining balance method, switching to a straight line method when the deduction would be greater; property identified as “15 year” and “20 year” property uses an initial 150 percent declining balance method. Id. § 168(b)(1),(2). The straight line method applies to nonresidential real property, residential rental property and property with respect to which the taxpayer irrevocably elects to apply the straight line method. Id. § 168(b)(3), (5). Under the alternative depreciation system, property is depreciated using the straight line method. Id. § 168(g)(2)(A). The “applicable convention,” or the method by which property is deemed placed in service or disposed, is the same under both the accelerated cost recovery system and the alternative depreciation system. Id. §§ 168(d), (g)(2)(B). Under the accelerated cost recovery system, property is depreciated over a recovery period based upon the property’s class life, with exceptions for certain specified types of property. Id. §§ 168(c), (e). These class lives and recovery periods are as follows:
to qualified technological equipment is the depreciation method.\textsuperscript{222}

If the property consists of nonresidential real property, the depreciation method is the same.\textsuperscript{223}

The alternative depreciation system of the 1986 Code applies to tax-exempt bond financed property placed in service after December 31, 1986.\textsuperscript{224} A transitional rule provides that the rules under the 1986 Code are inapplicable in several situations.\textsuperscript{225} The rules are inapplicable if the original use of a facility commences with the taxpayer and work on the project was begun prior to March 2, 1986, and completed on or after that date.\textsuperscript{226} They also are inapplicable if, prior to March 2, 1986, a binding contract to incur significant expenditures\textsuperscript{227} was entered into with respect to the project.\textsuperscript{228} Furthermore, if the facility was acquired on or after March 2, 1986, pursuant to a binding contract entered into prior to that date, the 1986 Code is inapplicable.\textsuperscript{229} In all circumstances, an in-

\begin{table}
\centering
\begin{tabular}{|c|c|c|}
\hline
Class Life & Property Class & Recovery Period
\hline
4 or less & 3-year property & 3 years
More than 4, less than 10 & 5-year property & 5 years
10 or more, less than 16 & 7-year property & 7 years
16 or more, less than 20 & 10-year property & 10 years
20 or more, less than 25 & 15-year property & 15 years
25 or more & Residential Rental Property & 27.5 years
Nonresidential Rental Property & 31.5 years
\hline
\end{tabular}
\end{table}

Notwithstanding the above categories, qualified technological equipment (which includes computer or peripheral equipment high technology or computer-based equipment used for diagnostic or therapeutic purposes in a laboratory, medical or hospital setting) and property used in connection with research and experimentation are deemed to be five-year property depreciated over a five-year period. \textit{Id.} \textsection 168(i)(2)(A)(i)(ii), (B), (e)(3)(B). Property which does not have a class life and is not otherwise classified is deemed seven-year property. \textit{Id.} \textsection 168(g)(3)(C).

As a general proposition, under the alternative depreciation system, the recovery period will be the class life ADR midpoint and not the recovery period under Section 168(c); personal property with no class life is depreciated over twelve years; and all rental property is depreciated over forty years. \textit{Id.} \textsection 168(g)(2)(C).

\textsuperscript{222} \textit{Id.} \textsection 168(g)(3)(C) (qualified technological equipment is depreciated over five years).

\textsuperscript{223} The recovery periods differ by 8.5 years. \textit{See supra} note 222.


\textsuperscript{225} \textit{Id.} \textsection 203(c)(2)(A)(i), 100 Stat. 2085, 2145; \textit{see infra} notes 226-30 and accompanying text.

\textsuperscript{226} \textit{Id.} \textsection 203(c)(2)(A), 100 Stat. 2085, 2145 (work is construction, reconstruction and rehabilitation).

\textsuperscript{227} \textit{See id.} \textsection 203(c)(2)(D), 100 Stat. 2085, 2145 (defined as expenditures greater than ten percent of the reasonably expected project cost).

\textsuperscript{228} \textit{Id.} \textsection 203(c)(2)(A)(III), 100 Stat. 2085, 2145.

\textsuperscript{229} \textit{Id.}
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ducement resolution or other preliminary approval must have been adopted prior to March 2, 1986.\footnote{Id. § 203 (c)(2)(A)(ii), 100 Stat. 2085, 2145.}

IV. ARBITRAGE BONDS

The 1986 Code defines an arbitrage bond as "any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly (1) to acquire higher yielding investments or to replace funds which were used directly or indirectly to acquire higher yielding investments."\footnote{I.R.C. § 148(a) (1986).} A "higher yielding investment" is any "investment property" producing a yield which is "materially higher than the yield on the bonds."\footnote{Id. § 148(b)(1).} "Investment property" includes securities, obligations, annuity contracts and investment-type property, excluding tax-exempt bonds.\footnote{Id. § 148(b)(2).} Because tax-exempt bonds are expressly excluded from the definition of investment property, the yield on tax-exempt bonds in which proceeds are invested can exceed the yield on the bonds without violating arbitrage restrictions.

Under the 1954 Code, the reasonable expectations of the issuer on the date of issuance of the bonds with respect to the use of proceeds established whether the bonds were arbitrage bonds.\footnote{I.R.C. § 103(c)(2)(A) (1954); Treas. Reg. § 1.103-13(a)(2)(i) (1987).} Subsequent events did not affect the reasonable expectation certification made upon issuance.\footnote{Id. § 1.103-13(a)(2)(ii)(F).} The Act does not eliminate the prospective examination of the use of proceeds and the reasonable expectation test. The Act, however, will treat bonds as arbitrage bonds if the issuer intentionally uses any portion of bond proceeds to earn impermissible arbitrage, despite the reasonable expecta-

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\footnote{Id. § 203 (c)(2)(A)(ii), 100 Stat. 2085, 2145.}
\footnote{I.R.C. § 148(a) (1986).}
\footnote{Id. § 148(b)(1).}
\footnote{Id. § 148(b)(2). On February 24, 1987, the Internal Revenue Service issued its Advance Notice 87-22 (the "Advance Notice") defining investment property not subject to the arbitrage restrictions. The Internal Revenue Service indicated that proposed regulations are anticipated to be substantially similar to the contents of the Advance Notice. The Advance Notice indicates that investment property will not include tax exempt bonds, one day certificates of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series ("SLGs") program (see infra note 333 and accompanying text), stock of certain qualified regulated investment companies which invest all of their assets in tax exempt bonds and meet the requirements of Section 852(a) of the 1986 Code and certain temporary investments in demand deposit SLGs and tax exempt bonds. Prepayment of items intended to be financed with the proceeds of payment of items intended to be financed with the proceeds of the bonds may be treated as investment-type property in order to discourage prepayment as a manner to avoid arbitrage restrictions. \textit{See General Explanation, supra} note 3, at 1202. n.154.}
\footnote{Id. § 1.103-13(a)(2)(ii)(F).}
tions on the date of issuance.\textsuperscript{236} Such intentional acts will cause the interest on the bonds to be taxable retroactive to the date of issuance.\textsuperscript{237}

\section{A. Determination of Yield and Permissible Arbitrage}

1. Bond Yield

The 1954 Code defined yield as "that yield which when used in computing the present worth of all payments of principal and interest to be paid on the [bonds] produces an amount equal to the purchase price."\textsuperscript{238} Costs of issuance, including administrative costs and purchase price, were disregarded in calculating the yield.\textsuperscript{239} Administrative costs included the cost of issuing, carrying, or repaying the issue; the underwriter's spread; and the cost of purchasing, carrying and selling or redeeming acquired purpose obligations.\textsuperscript{240}

Pursuant to the "State of Washington" rule, administrative costs and purchase price have been included in calculating yield, under the theory that issuance costs are costs of money and, therefore, should be considered as an element of "interest" paid by the borrower against which earnings must be measured.\textsuperscript{241} As a consequence of the application of the "State of Washington" rule, the purchase price was determined after deducting from the initial offering price the costs of issuance. The effect of the deduction was to allow the issuer the opportunity to recover its costs of issuance through earning a yield on investment of bond proceeds higher than the stated interest cost on the bonds. The Act, by requiring that yield be determined on the basis of its issue price within the meaning of Sections 1273 and 1274 of the 1986 Code,\textsuperscript{242} eliminates the "State of Washington" rule.

The 1986 Code retains the old rule that treated premiums paid to insure bonds as interest paid.\textsuperscript{243} The rule includes other credit

\begin{itemize}
\item \textsuperscript{236} I.R.C. § 148(a) (1986).
\item \textsuperscript{237} CONF. COMM. REP., supra note 4, at II-746.
\item \textsuperscript{238} Treas. Reg. § 1.103-13(c)(ii) (1987).
\item \textsuperscript{239} Id. § 1.103-13(d)(i).
\item \textsuperscript{240} Id. § 1.103-13(c)(5)(iv) (provided that the present value of the premiums was less than the present value of the interest reasonably expected to be saved as a consequence of insuring the bonds).
\item \textsuperscript{241} See State of Washington v. Commissioner, 692 F.2d 128 (D.C. Cir. 1982).
\item \textsuperscript{242} I.R.C. § 148(h) (1986). The issue price is the "initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such debt instrument was sold." Id. § 1273(b)(1).
\item \textsuperscript{243} Treas. Reg. § 1.103-13(c)(8) (1987) (provided that the present value of the pre-
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enhancement devices, such as letters of credit and surety bonds. This benefit, however, is limited to instances in which the procurement of credit enhancement is a consequence of an arms-length transaction and the fee is a "reasonable charge for the credit risk." This suggests that regulations may require competitive bidding. Moreover, the fee cannot include an indirect payment of costs of issuance, but must be limited to amounts relative to the risk associated with the credit. If the fee includes any element other than the risk-shifting cost, none of the fee is treated as interest.

2. "Materially Higher" Yield

The yield on the investment under the 1954 Code was considered "materially higher" than the yield on the bonds if the "positive" spread between the two exceeded one-eighth of the one percent. An issuer, however, could have elected to waive the benefit of certain temporary periods, which increased the permissible spread to one-half of one percent. The new Act repeals the temporary period election. Although the Act does not define "materially higher," the Conference Committee Report indicates that the maximum permitted spread will continue to be one-eighth of one percent.

Different rules applied to the spread between the yield on "acquired program obligations" and the yield on the bonds. "Acquired program obligations" consisted of obligations which carry out the purpose of a governmental program. The permissible spread on acquired program obligations has been one and one half percent. The acquired program obligation exception will be preserved.

Treasury Regulations also provided a formula to calculate whether the yield on the investments of a refunding issue was

miums was less than the present value of the interest reasonably expected to be saved as a consequence of insuring the bonds).

245. Id.
246. Id.
247. Id.
249. See infra note 265 and accompanying text.
254. Id. § 1.103-13(b)(viii) (1.5%)
higher than the yield on the refunding bonds.\textsuperscript{256} The refunding bond rules may be modified pursuant to other sections of the 1986 Code pertaining to advance refunding.

\subsection*{B. Exceptions}

\subsubsection*{1. The Minor Portion and a Reasonably Required Reserve or Replacement Fund}

The Act retains a limited exception for a reasonably required reserve or replacement fund.\textsuperscript{257} A reasonably required reserve or replacement fund may be a debt service reserve fund, which is typically funded in an amount equal to maximum annual debt service on a bond issue, or a depreciation fund, which is funded to the extent depreciation expense exceeds principal payments on a bond issue, or both.\textsuperscript{258} The amount of proceeds that may be invested in a reserve or replacement fund at a materially higher yield is limited to ten percent of the proceeds or such higher amount permitted to the issuer by the Secretary of the Treasury on a case-by-case basis.\textsuperscript{259} The issuer cannot use more than ten percent of the proceeds and restrict the yield on the excess to the yield on the bonds.\textsuperscript{260}

\textsuperscript{256} Treas. Reg. § 1.103-13(b)(5)(iii) (1987).

\textsuperscript{257} The 1954 Code included two exceptions to the arbitrage rules based upon the amount of bonds. Investment of less than a "major portion" of the proceeds in materially higher yielding investments was permitted. I.R.C. § 103 (c)(4)(B) (1954); Treas. Reg. § 1.103-13 (a)(1). Major portion was defined as any amount exceeding 15% of the original face amount of the issue. Id. § 1.103-13(b)(1)(ii). In addition, proceeds could have been invested in a reasonably required reserve or replacement fund without regard to the arbitrage restrictions, provided amounts so invested, when aggregated with other amounts invested at a materially higher yield, could not have exceeded the "major portion." I.R.C. § 103(c)(4)(B) (1954); Treas. Reg. § 1.103-13 (a)(1), 14(d)(3) (1954). Therefore, if the issue qualified for a reasonably required reserve fund (which has frequently been referred to as a "debt service reserve fund"), the aggregate amount of proceeds which may have been invested at a materially higher yield in such fund and in other appropriate funds could not have exceeded a "minor portion" or 15% of original proceeds. Id. § 1.103-14(d)(3).

\textsuperscript{258} See id. § 1.103-14(d)(3)(10).

\textsuperscript{259} I.R.C. § 148(d)(1) (1986). The Conference Committee Report indicates possible circumstances in which the Secretary of The Treasury may permit the use of more than ten percent of the proceeds to fund a reserve fund. The situation includes the issuance of additional bonds pursuant to an existing master indenture which requires that all bonds issued pursuant to the master indenture must be parity bonds and must share in a debt service reserve fund which must be funded at an amount equal to the maximum annual debt service requirement, which may exceed the ten percent limit. The indenture must have been adopted prior to August 16, 1986 and not be amended after August 31, 1986 (which assumes that amendments affecting parity concerns are permitted under the terms of the indenture or do not affect the tax-exempt status of bonds issued under the indenture and which remain outstanding). Conf. Comm. Rep., supra note 4, at II-749.

\textsuperscript{260} I.R.C. § 148(d)(2) (1986).
Any excess over the ten percent limit which may be required to market the issue must be contributed by the issuer or, in the case of qualified 501(c)(3) bonds, by the borrowing Section 501(c)(3) organization.

A limited minor portion also is preserved. In addition to proceeds that may be used for a reserve fund, the Act permits the lesser of five percent of proceeds or $100,000 to be invested in higher yielding investments.261

Private activity bonds other than qualified 501(c)(3) bonds are subject to an additional limitation on investments of funds in a reasonably requires reserve fund.262 With respect to such bonds, at no time during a defined bond year may amounts invested in “nonpurpose investments” at a materially higher yield exceed one hundred and fifty percent of the debt service for that year.263 This limitation does not apply to amounts invested during a permitted temporary period.264

2. Temporary Periods

Proceeds may be invested in higher yielding investments for a reasonable temporary period until the proceeds are needed for the purposes for which the bonds were issued.265 Three issues require examination: construction financing,266 debt servicing,267 and loan pools.268

a. Construction

With respect to an issue to finance construction, eighty-five percent of the spendable proceeds must be expended within three years from the date of issuance.269 In addition, a substantial binding obligation to commence or acquire the project must be incurred within six months of issuance, with an extension up to one

261. Id. § 148(e).
262. Id. § 148(d).
263. Id. § 148(d)(3)(A). A “nonpurpose investment” is investment property (securities, obligations, annuity contracts and investment-type property) which is acquired with original proceeds of the sale of the bonds or amounts received as debt service on the bonds and which is not required to carry out the governmental purposes of the issue. Id. § 148(f)(6)(A).
264. Id. § 148(d)(3)(C).
265. Id. § 148(c)(1). The temporary period rules under the 1954 Code have been essentially preserved.
266. See infra notes 269-71 and accompanying text.
267. See infra notes 272-73 and accompanying text.
268. See infra notes 274-78 and accompanying text.
year if valid business reasons exist for the delay.\textsuperscript{270} A binding obligation is considered substantial if it represents the lesser of $100,000 or two and one-half percent of the project financed with bond proceeds.\textsuperscript{271}

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\textbf{b. Debt Service Fund}

A debt service fund typically is used to provide a depository of payments of principal and interest on a loan prior to payment of principal and interest to the bondholders.\textsuperscript{272} The temporary period for investment of amounts deposited to a debt service fund is thirteen months.\textsuperscript{273}

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\textbf{c. Loan Pools}

The loan pool is a popular financing technique in the health care industry. In such a transaction, an issuer sells bonds and deposits the proceeds into various funds, including a construction or similar fund. Out of these proceeds, the issuer makes a number of loans to individual borrowers. Repayments of the loans are used either to pay debt service on the bonds or are "recycled" into new loans. The Act includes new temporary period rules for loan pools.\textsuperscript{274} For example, the temporary period for original proceeds to fund a pool is six months.\textsuperscript{275} In addition, the loan pool limits are not intended to extend temporary periods otherwise allowed.\textsuperscript{276} If loan pool proceeds are used to fund construction, the aggregate temporary period may not exceed three years, of which six months is allocated to the pool and thirty months to the borrower.\textsuperscript{277} The temporary period for the investment of the proceeds of a loan repayment to the pool prior to relending is three months.\textsuperscript{278}

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\textbf{C. Rebate Requirement}

The new Act extends the 1954 Code's rebate rules\textsuperscript{279} to most categories of tax-exempt bonds, including qualified 501(c)(3)

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\begin{itemize}
  \item \textsuperscript{270} \textit{Id.} § 1.103-14(b)(3)(i).
  \item \textsuperscript{271} \textit{Id.} § 1.103-14(b)(3)(v).
  \item \textsuperscript{272} \textit{Id.} § 1.103-13(b)(12).
  \item \textsuperscript{273} \textit{Id.} § 1.103-14(b)(10).
  \item \textsuperscript{274} These new rules supercede Treasury Regulation § 1.103-14(b)(11) which permits a temporary period of three years from the date of deposit of the principal portion of loan repayments prior to relending such amounts.
  \item \textsuperscript{275} I.R.C. § 148(c)(2)(A) (1986).
  \item \textsuperscript{276} \textit{Conf. Comm. Rep.}, supra note 4, at II-748.
  \item \textsuperscript{277} \textit{Id.}
  \item \textsuperscript{278} I.R.C. § 148(c)(2)(C) (1986).
  \item \textsuperscript{279} I.R.C. § 103(c)(6) (1954).
\end{itemize}
bonds. With certain exceptions, the permissible arbitrage earnings on investments must be paid or “rebated” to the federal government in installments at least once every five years. At least ninety percent of the rebatable earnings during the five year period must be paid and the final installment, in an amount equal to one hundred percent of all rebatable earnings during the term of the issue, including the ten percent withheld and earnings thereon, must be paid within sixty days of final maturity or earlier redemption. Rebatable earnings include all permissible arbitrage earnings during temporary periods, excluding a six-month construction period, and earnings attributable to the reasonably required reserve fund and minor portions, less, at the option of the issuer, gross earnings attributable to investments of amounts on deposit in a debt service fund.

As a general rule, arbitrage earnings attributable to investment of gross proceeds are not rebatable if such proceeds are expended for the purpose of the borrowing within six months of the date of the issue. Gross proceeds deposited into a debt service fund are not required to be expended within the six-month period. With respect to qualified 501(c)(3) bonds, the expenditure period is extended from six months to one year for the “minor” portion of the proceeds not exceeding the lesser of five percent of the proceeds or $100,000. Thus, the six-month period is permitted for all gross proceeds; an additional six months is provided for a minor portion to the extent not expended in the initial six-month period. Any excess proceeds remaining prior to the expiration of the six-month period that are used to redeem bonds are considered as having been expended for the purpose of the borrowing.

Failure to comply with the rebate rules causes a bond to be considered an arbitrage bond retroactive to its date of issuance. The

283. Id. § 148(f)(4)(ii).
286. Temp. Treas. Reg. § 1.10315AT(d)(5)(i) (1986). Redemption of bonds in an amount not exceeding the “minor” portion permitted for qualified 501(c)(3) bonds before the expiration of the additional six-month period for qualified 501(c)(3) bonds is also considered expended for purposes of the borrowing. See GENERAL EXPLANATION, supra note 3, at 1209.
Act provides an exception for qualified 501(c)(3) bonds if the failure to rebate is due to "reasonable cause and not to willful neglect." Under these circumstances, the Secretary of the Treasury may waive the loss of tax-exemption if the issuer pays the rebate, plus a fifty percent penalty on the rebate, plus interest on the rebate at the general underpayment rate of the 1986 Code. Additionally, the Secretary of the Treasury may waive completely or partially the penalty.

V. ADVANCE REFUNDINGS

Advance refundings are transactions in which the proceeds of an issue of bonds (the "refunding bonds") are deposited into an escrow account and invested. The interest earnings on and maturing principal of the escrowed investments are used to provide payment in full, when due, of interest and principal on an outstanding bond issue (the "refunded bonds"). Because the indebtedness under the refunded bonds becomes fully funded and secured by the escrow, the indebtedness is generally considered discharged pursuant to the indenture under which the refunded bonds were issued.

Another type of advance refunding is called cross-over refunding. In such a transaction, the proceeds of the refunding bonds are deposited into an escrow, and the earnings are used to pay debt service on the refunding bonds until a specified date (the "cross-over date"). On the cross-over date, the proceeds are used to redeem the refunded bonds, which are considered defeased on that date, not earlier. Generally, refunding bonds are issued before the refunded bonds are to be paid in full. As a consequence, the refunded bonds remain outstanding until paid at maturity or redeemed.

Advance refundings typically have been undertaken for three reasons. In one situation, the interest rate on the refunded bonds is higher than interest rates under current market conditions. Because the refunded bonds cannot yet be prepaid by optional redemption, however, the refunding bonds are issued and the

288. Id. § 148(f)(7)(C).
289. Id. § 148(f)(7).
290. See generally § 148.
291. Id.
292. See generally § 1.103-14(e).
293. Id.
294. Id.
proceeds deposited into escrow to provide for payment when due at maturity or upon redemption.\textsuperscript{295} Secondly, a borrower may wish to eliminate harsh or unduly burdensome covenants, or provide for more flexible operating covenants, but the refunded bonds cannot be redeemed for several years.\textsuperscript{296} Finally, a borrower may wish to restructure the indebtedness represented by the refunded bonds, typically through changing amortization of principal.\textsuperscript{297} In these latter two situations, whether the refunded bonds are to be prepaid pursuant to optional redemption or at the stated maturity of all bonds depends on the relative interest rates of the refunding bonds and the refunded bonds.\textsuperscript{298}

\textbf{A. General Treatment of Advance Refunding Under 1986 Code}

The 1986 Code defines an advance refunding bond as one issued more than ninety days before the redemption of the refunded bond with the proceeds of the refunding bond.\textsuperscript{299} With several exceptions,\textsuperscript{300} interest on advance refunding bonds is not exempt.\textsuperscript{301} With respect to the permitted advance refunding bonds, bonds issued before calendar year 1986 may be advance refunded twice; if the bonds to be refunded were issued after calendar year 1985, they may be advance refunded once.\textsuperscript{302}

As a general rule, advance refunding bonds issued prior to August 16, 1986, are taken into account to determine the number of advance refundings of an original bond issue which have occurred.\textsuperscript{303} If the original bonds were issued before 1986 and were advance refunded at least once prior to March 15, 1986, however, for purposes of the advance refunding rules, the original bonds are deemed to have been advance refunded only once.\textsuperscript{304} As a consequence, each outstanding bond issue may be advance refunded at least one more time. Moreover, in determining whether outstanding bonds issued before calendar year 1986 constitute outstanding advance refunding bonds, if the refunding bonds were issued more than 180 days before the redemption of the refunded bonds with the proceeds of the refunding bonds, then an advance refunding

\begin{itemize}
\item \textsuperscript{295} Id.
\item \textsuperscript{296} Id.
\item \textsuperscript{297} Id.
\item \textsuperscript{298} Id.
\item \textsuperscript{299} I.R.C. § 149(d)(5) (1986).
\item \textsuperscript{300} See id. § 149(3)(A).
\item \textsuperscript{301} Id. § 149(d)(1)(2).
\item \textsuperscript{302} Id. § 149(d)(3)(A).
\item \textsuperscript{303} Id. § 149(d)(6).
\item \textsuperscript{304} Id. § 149(6)(B).
\end{itemize}
issue is deemed to have occurred.\textsuperscript{305}

A transitional rule exempts certain advance refunding bonds that advance refund bonds issued prior to August 16, 1986, including bonds issued for the benefit of Section 501(c)(3) organizations under the 1954 Code.\textsuperscript{306} This exception is intended to permit advance refunding of bonds outstanding on August 16, 1986 which were issued under the 1954 Code to benefit Section 501(c)(3) organizations but which do not satisfy the requirements of the 1986 Code for qualified 501(c)(3) bonds.\textsuperscript{307} The average maturity of the advance refunding bond under the transitional rule cannot exceed one hundred and twenty percent of the average reasonably expected economic life of the facilities financed; in the alternative, the final maturity date of the refunding bonds cannot be later than seventeen years after the date on which the original bond was issued.\textsuperscript{308} In addition, certain provisions of the 1986 Code are deemed to apply to the refunding bond, including the restriction on costs of issuance paid out of bond proceeds,\textsuperscript{309} the new arbitrage rules (except certain limits on investments in excess of the bond yield described in Section 148(d)(3) of the 1986 Code),\textsuperscript{310} the advance refunding rules,\textsuperscript{311} and the restriction on change in use.\textsuperscript{312} The rules regarding public approval also apply.\textsuperscript{313}

The $150,000,000 aggregate limit on the nonhospital portion of qualified 501(c)(3) bonds does not apply to the first advance refunding of a refunded bond issued before January 1, 1986.\textsuperscript{314} The exception is disregarded, however, when subsequent bonds are issued and, at that time, the aggregate limit will apply to the advance refunding bond.\textsuperscript{315}

\textsuperscript{305} Id. § 149(d)(6)(A) (1986).


\textsuperscript{307} CONF. COMM. REP., supra note 4, at II-759.


\textsuperscript{309} Id. § 1313(3)(B), 100 Stat. 2085, 2662.

\textsuperscript{310} Id. § 1313(3)(C), 100 Stat. 2085, 2662.

\textsuperscript{311} Id. § 1313(3)(D), 100 Stat. 2085, 2662.

\textsuperscript{312} Id. § 1313(b)(3)(E) 100 Stat. 2085, 2662.

\textsuperscript{313} Id. 1313(b)(3), 100 Stat. 2085, 2662; see infra note 361 and accompanying text.

\textsuperscript{314} Tax Reform Act of 1986, Pub. L. No 99-514 § 1313(c)(2), 100 Stat. 2085, 2663. See supra note 175 and accompanying text regarding a possible amendment to the 1986 Code which would cause the $150,000,000 aggregate limit to apply to an advance refunding occurring after March 14, 1986 if such advance refunding is a second advance refunding of an original bond.

B. Current Refundings

Current refunding bonds are refunding bonds that are issued within ninety days of the redemption of the refunded bonds and the proceeds of the refunding bonds are used within the ninety-day period to pay or redeem the refunded bonds. Transitional exceptions are provided for current refunding bonds. To qualify for the transitional exception, the principal amount of the refunding bond cannot exceed the principal amount of the refunded bond outstanding on the date of issuance of the refunding bond. The refunded bond cannot be another refunding bond. It must be an original bond and have been issued prior to August 16, 1986, or after August 15, 1986 if issued pursuant to the general transitional exception described in Section 1312(a) of the Act. The average maturity of the refunding bond cannot exceed one hundred and twenty percent of the average reasonably expected economic life of the facilities financed, or the final maturity of the refunding bond cannot be later than seventeen years after the date on which the original bond was issued. Certain provisions of the 1986 Code apply to the current refunding bonds, including the restriction on costs of issuance paid with bond proceeds and the new arbitrage rules. The restrictions on change in use and the public approval requirement apply. In addition, current refunding bonds satisfying the above requirements do not count toward the $150,000,000 aggregate limit on nonhospital bonds.

C. Revisions to Advance Refunding Transactions

1. Requirement to Redeem Bonds

If the refunded bonds were issued prior to calendar year 1986, the refunded bond must be redeemed not later than the earliest date on which the bond may be redeemed either at par or at a

316. Id. § 1313 (c)(1)(D), 100 Stat. 2085, 2663.
317. Id. § 1313(a), (c), 100 Stat. 2085, 2661.
318. Id. § 1313(a)(1)(A), 100 Stat. 2085, 2661. For purposes of determining whether the amount of a refunding bond exceeds the outstanding amount of a refunded bond, premiums and discounts will be ignored to determine “the true principal amount of the issue.” See GENERAL EXPLANATION, supra note 3, at 1193 n.135. Amounts required to pay redemption premiums cannot be derived from the original proceeds of a current refunding issue. See id. § 1213 n.179.
320. Id. § 1313(a)(1)(B), 100 Stat. 2085, 2661; see infra note 348 and accompanying text.
322. Id. § 1313(a)(3), 100 Stat. 2085, 2661.
323. Id. § 1313(c)(2), 100 Stat. 2085, 2663.
premium of three percent or less if a present value debt service savings will be realized on the date of such redemption. 324 Refunded bonds issued after calendar year 1985 must be redeemed not later than the earliest date on which such bond may be redeemed, regardless of premium, if a present value debt service savings will be realized on the date of such redemption. 325 When determining whether a present value savings will be realized, administrative expenses, including costs of issuance, are disregarded. 326

2. Temporary Period

The 1986 Code provides a maximum thirty-day temporary period with respect to the proceeds of the refunding bonds, such period commencing on the date of issuance. 327 In addition, any temporary period with respect to the refunded bonds still in effect on the date of issuance of the refunding bonds ends on the date of such issuance. 328

3. Minor Portion

The portion of the proceeds of the refunded bond issue that may be invested in materially higher yielding obligations is statutorily limited. When the advance refunding bonds are issued, the proceeds of the refunded bonds invested at an unrestricted yield are the amounts on deposit in a reserve fund or pursuant to an allowable temporary period. 329 In either case, the amounts are limited to those that would be permitted under the 1986 Code, plus an amount equal to the lesser of five percent of the proceeds of the refunded bond issue or $100,000, to the extent such amount is allocable to the refunded bond. 330

326. Id. § 149(d)(3)(B)(i).
327. Id. § 149(d)(3)(A)(iv)(I). The thirty-day temporary period applies only to proceeds used to redeem bonds. Prior law temporary periods for amounts used to pay accrued interest and issuance cost will continue to apply. See GENERAL EXPLANATION supra note 3, at 1214 n.179.
328. I.R.C. § 149(d)(3)(A)(iv)(II) (1986). This section has caused considerable confusion. One of the primary concerns arose out of its application to advance refunding bonds which refused a prior issue of advance refunding bonds in situations in which the minor portion of the original bonds has already been invested at yields permitted under prior law.
329. Id. § 149(d)(3)(V)(I).
330. Id. § 149(d)(3)(A)(v). This section has caused considerable confusion. See THE BOND BUYER, Sept. 26, 1986, at 1. Treasury regulations may provide that a minor por-
4. Relationship of Advance Refunding Rules to Rebate Provision

The Conference Committee Report suggests that the Treasury Department may, by regulation, provide an exception to the requirement that rebate of arbitrage earnings be made to the federal government every five years for escrows established with the proceeds of refunding bonds.\textsuperscript{331} The conferees acknowledged that, although over the term of the escrow the yield on investments of refunding proceeds on deposit in the escrow will not exceed the yield on the refunding bonds, on a temporary basis, the yield on the investments may exceed the permissible yield due to the mechanics of the escrow.\textsuperscript{332} Under this circumstance, the conferees indicated that rebate payments may not be required until the escrow is liquidated and the refunded bonds are paid.

\textbf{D. Directed Modification to the SLGS Program}

A substantial number of advance refunding escrows have been funded with a special type of obligation issued by the Treasury Department. Such obligations are called “United States Treasury Certificates of Indebtedness, Notes and Bonds of the State and Local Government Securities” (“SLGS”).\textsuperscript{333} The interest rates on SLGS are established by reference to the permissible yield on the escrow, provided that general market conditions permit issuance of the SLGS at the permitted yield.\textsuperscript{334} As a consequence, the SLGS program enables issuers to avoid excess arbitrage earnings on advance refunding escrow deposits.\textsuperscript{335} The Treasury Department was directed to extend the SLGS program in existence on the date of the Act, while preserving the then existing program, in order to provide greater flexibility to issuers using the SLGS program. The Treasury Department issued interim regulations\textsuperscript{336} governing the

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\textsuperscript{331} CONF. COMM. REP., supra note 4, at II-751.
\textsuperscript{332} See id.
\textsuperscript{333} See 31 C.F.R. § 344.0 (1986).
\textsuperscript{334} Id. at § 344.1(c).
\textsuperscript{335} See infra notes 336-40 and accompanying text.
\textsuperscript{336} 51 Fed. Reg. 47400 (1986). The earlier rules regarding the time deposit program have been altered significantly. The notice of subscription requirement has been reduced from 20 days to 15 days. The minimum maturity has been reduced from 45 days to 30 days. Subscriptions may be amended on or before the issue date to change the principal
SLGS program in response to the requirements of the Act. The program offers time deposit securities that are similar to those offered earlier and a new demand deposit security program available for subscription on three-days notice. The demand deposit SLGS also are excluded from the definition of investment property, and are treated as tax-exempt bonds for purposes of arbitrage and rebate.

E. Prohibitions Against Abusive Transactions

The 1986 Code contains language specifically directed against "abusive transactions" in conjunction with advance refundings. If a "device" is employed to obtain a "material financial advantage" as a consequence of arbitrage, as distinguished from savings attributable to lower interest rates on the refunding bonds, then the bond is considered an arbitrage bond. An advance refunding that does not replace higher cost debt with lower cost debt is not "per se" undesirable if the intention is to obtain relief from covenants or to restructure debt. The Act does not describe such "abusive transactions" or provide criteria to determine whether advance refundings include an impermissible "device." The Report of the Senate Finance Committee provides examples and indicates that "devices" are to be identified in Treasury Regulations. The Finance Committee Report also states that the prohibition is similar to the artifice and device provisions of existing Treasury Regula-

amount to be purchased by no more than ten percent contrasted with the earlier five percent. Under earlier rules, if a subscription was cancelled, the issuer was precluded from tendering a new subscription for six months. Under the new rules, the penalty will not apply if the cancellation is necessitated by an "adversity in the financing", such as circumstances not contemplated at the time of subscription. The new demand deposit program requires a minimum three day notice of subscription. These securities bear an interest rate computed daily based on the federal funds rate less one-quarter of one percent, adjusted to produce a tax exempt equivalent rate, less administrative costs. Interest accrues and is added to principal daily. Each security rolls over daily until redeemed. 31 C.F.R. § 344 (1986).

339. Id. at 47404-05 (1986) (to be codified at 31 C.F.R. §§ 344.6-344.9 (1986)).
340. See id.
341. I.R.C. § 149(d)(4) (1986). Examples of abusive transactions included in the Finance Committee Report include inappropriate use of debt service funds and construction funds established for the refunded bonds and insurance premium rebates. Finance Committee Report, supra note 9, at II-849.
342. CONF. COMM. REP., supra note 4, at II-758.
344. FIN. COMM. REP., supra note 9, at 849.
tions, but will not require a finding that the transaction increases the burden on the market as had been previously required.

VI. MISCELLANEOUS RESTRICTIONS

A. Limitation on Maturity

1. Bond Maturity Cannot Exceed 120 Percent of Economic Life of Facility Financed

The average maturity of the bond issue cannot exceed one hundred and twenty percent of the average reasonably expected economic life of the facilities financed with the proceeds of the sale of the bonds. The average maturity of any issue is determined by taking into account the issue prices of the bonds which constitute the issue.

The reasonably expected economic life of any facility is determined as the later of the date on which the bonds are issued or the date on which the facility is placed in service or, with respect to a facility to be constructed or renovated with the proceeds, the date on which the facility (or portion renovated) is expected to be...

345. Treasury Regulation § 1.103-13(j) considered bonds issued under an “article or device” to be arbitrage bonds. Artifice or device existed in transactions which circumvented the arbitrage rules permitting the issue to “exploit” the arbitrage “to gain a material financial advantage” and increasing the burden on the market for tax exempt bonds.

346. FIN. COMM. REP., supra note 9, at 849-850.

347. I.R.C. § 147(b) (1986).

348. Id. § 147(b)(2)(A).

349. The reasonably expected economic life of facilities is determined on a case-by-case basis. The legislative history to Section 103 (b) (14) of the 1954 Code has provided issuers with certain guidelines in determining the economic life of assets financed with bond proceeds. See H.R. REP. NO. 97-760, 97th Cong., 2d Sess. 519 (1986). One indicia of economic life is the “ADR midpoint life” administrative guidelines used to determine useful lives of assets for depreciation purposes. Rev. Proc. 83-35, 1983-1 C.B. 745. Another is the guideline lives for structures under Revenue Procedure 62-21, 1962-2 C.B. 418. As a general proposition, the ADR midpoint life for equipment is provided in Revenue Procedure 83-35 and ranges from four years through ten years. Buildings are deemed to have guideline lives ranging from 40 years through 60 years. In determining economic life, Section 147(b)(3)(B) of the 1986 Code provides a special rule for the financing of land. If less than 25 percent of the proceeds of the issue is used to finance the acquisition of land, the land is disregarded. If 25 percent or more of the proceeds is used to finance the acquisition of land, then the land is assigned an economic life of 30 years. The issuer is not limited to the safe harbors; however, independent, objective substantiation of the propriety of an economic life which differs from that provided under the safe harbors must be provided. Substantiation may be provided by an independent appraisal or engineering report. Depreciation guidelines traditionally applied by the Health Care Finance Administration in determining the reimbursement of capital costs should bear substantial weight to the extent the borrower has categorized assets historically in accordance with such guidelines.
If multiple facilities are to be financed, the average life of the facilities is determined by taking into account the respective costs of the facilities or their financed portions. If the bond sale proceeds are less than the entire cost of the facilities, a pro rata portion of each asset to be financed with the proceeds should be deemed to have been so financed.

The application of the maturity limits to the tax-exempt health care industry will be accompanied by uncertainty and unanticipated consequences. For example, the economic life of a special purpose structure generally is the same as the equipment which the structure supports. This may shorten the average economic life of a multiple facility financing for a facility housing highly technological equipment. Financing of "soft assets," such as insurance programs, accounts receivable, and other items of working capital will be difficult. Insurance programs financing probably will be limited to programs providing occurrence-based coverage in which the actuarially-recommended funding is based upon claims to be made in the future for present occurrences. The insurance must be categorized as a prepaid asset for a specifically projected period of time. Accounts receivable financing will be even more difficult; the receivable generally has a short life and is based upon historical experience.

2. Exceptions

a. FHA Mortgage Loans

The maturity limit does not apply if two conditions are met. First, ninety-five percent or more of the bond proceeds must be used to finance mortgage loans under the Section 242 Mortgage Loan Program of the Federal Housing Administration ("FHA") or similar programs. In addition, the loan terms approved by the FHA plus the maximum maturity of the FHA debentures must exceed the permitted bond maturity calculated in accordance with Section 147(b) of the 1986 Code.

b. Pools for Section 501(c)(3) Organizations

The maturity rule does not apply to bonds issued for the purpose

351. Id. § 147(b)(2)(B).
of funding a pool of monies to be loaned to Section 501(c)(3) organizations.\textsuperscript{355} The maximum maturity of the bond issue, however, cannot exceed thirty years from date of issuance or, with respect to a refunding, thirty years from the date of issuance of the refunded bond.\textsuperscript{356}

Certain conditions must be satisfied before this exception applies. For example, each loan must satisfy the maturity rule.\textsuperscript{357} As a consequence, the borrowing Section 501(c)(3) organization must adhere to the rule. The exception applies to the bonds, not to the term of the loans made with bond proceeds. At least ninety-five percent of the bond proceeds must be used to make loans to two or more Section 501(c)(3) organizations or governmental units.\textsuperscript{358} Bond proceeds must be used for the acquisition of property to be used by the borrower.\textsuperscript{359} Before the bonds are issued, the governmental issuer must certify that a demand survey was conducted which showed that the demand for funds will exceed one hundred and twenty percent of lendable proceeds.\textsuperscript{360} At least ninety-five percent of the lendable proceeds must be loaned within one year of issuance.\textsuperscript{361} Unspent proceeds must be used to redeem bonds as soon as practicable, but in all events within eighteen months of issuance.\textsuperscript{362} The use of unspent proceeds for redemption purposes does not provide an exception to the ninety-five percent lending requirement.\textsuperscript{363}

\textbf{B. Public Hearing}

The bond issue must be approved both by the governmental unit that issues the bond and by a governmental unit having jurisdiction over the area in which the facility to be financed with the proceeds of the bonds is located or on whose behalf the bond is to be issued.\textsuperscript{364} Approval requires either voter referendum or approval by

\begin{itemize}
\item \textsuperscript{355} I.R.C. § 147(b)(4) (1986). See \textit{supra} notes 274-78 and accompanying text for a further discussion of loan pools.
\item \textsuperscript{356} I.R.C. § 147(b)(4) (1986).
\item \textsuperscript{357} See \textit{supra} note 347 and accompanying text.
\item \textsuperscript{358} I.R.C. § 147(b)(4)(i) (1986).
\item \textsuperscript{359} Id. § 147(b)(4)(ii).
\item \textsuperscript{360} For example, if an issue is sold with an aggregate principal of 100 million and lendable proceeds are $90 million, there must exist a documented “need” for approximately $108 million funds.
\item \textsuperscript{361} Id. § 147(b)(4)(iv).
\item \textsuperscript{362} Id.
\item \textsuperscript{363} Id. § 147(b)(4)(B)(iv).
\item \textsuperscript{364} Id. § 147(f)(2)(A). Exceptions will be created by Treasury regulation for pool financings for Section 501 (c) (3) Organizations to the extent the facilities to be financed cannot be identified when the bonds are issued. See \textbf{GENERAL EXPLANATION}, \textit{supra} note
the "applicable elected representative" of the governmental unit required to approve the issue, after a public hearing following reasonable public notice.\textsuperscript{365} The "applicable elected representative" for any governmental unit is the elected legislative body of the chief elected executive officer, elected state legal officer or the executive branch or any other elected state official designated as the "applicable elected representative" by the chief elected executive officer or by state law.\textsuperscript{366} If the governmental unit required to approve the issue does not have an "applicable elected representative," the person to give such approval shall be the individual holding the position for the next higher governmental unit from which the authority of the unit without the representative is derived.\textsuperscript{367}

If a financing plan for a facility has been approved as required, such approval applies to any bond issued pursuant to the plan within three years after the date of the initial issue, including subsequent refunding issues.\textsuperscript{368} Approval is not required for any current refunding of a bond issue which itself has been approved, unless the maturity of the bond is extended. This exception does not apply to advance refundings, which requires new approval.\textsuperscript{369}

\section*{VII. THE TAX REFORM ACT OF 1986 AND THE "DEMAND SIDE" OF A TAX-EXEMPT BOND TRANSACTION}

\subsection*{A. Alternative Minimum Tax}

\subsubsection*{1. Individual Taxpayers}

A tax equal to the amount by which an individual taxpayer's tentative minimum tax exceeds the regular tax is imposed.\textsuperscript{370} The "tentative minimum tax" is twenty-one percent of the excess of a taxpayer's "alternative minimum taxable income" over the taxpayer's "exemption amount," reduced by certain foreign tax credits.\textsuperscript{371} The "alternative minimum taxable income" is the taxpayer's taxable income, with certain adjustments, increased by the amount of "tax preference items."\textsuperscript{372}


\textsuperscript{365} Id. § 147(f)(2)(B).

\textsuperscript{366} Id. § 147(f)(2)(E)(i).

\textsuperscript{367} Id. § 147(f)(2)(E)(ii).

\textsuperscript{368} Id. § 147(f)(2)(C).

\textsuperscript{369} Id. § 147(f)(2)(D).

\textsuperscript{370} Id. § 55(a).

\textsuperscript{371} Id. § 55(b)(1).

\textsuperscript{372} Id. § 55(b)(2)(B). Tax preference items are described in Section 55 of the 1986
Interest income on tax-exempt bonds is not included as an income item when computing the regular tax. Nevertheless, interest on certain types of private activity bonds issued after August 7, 1986, reduced by any deduction not allowed when computing the regular tax, is considered a tax preference item. For purposes of determining tax preference items and the alternative minimum tax, interest received on qualified 501(c)(3) bonds is excluded. In addition, interest income on refunding bonds if the original bond was issued before August 8, 1986 is not included.

2. Corporate Taxpayers

   a. Amendments Made by Tax Reform Act of 1986

The alternative minimum tax rate for corporations is twenty percent. The treatment of certain tax-exempt income with respect to individual taxpayers also applies to corporate taxpayers. In determining the alternative minimum taxable income of a corporation, certain adjustments are made that may result in the inclusion of all tax-exempt income, including income on bonds that are not considered tax preference items. For taxable years commencing in 1987, 1988, or 1989, the alternative minimum taxable income of a corporation will be increased by fifty percent of the amount by which the corporation's "adjusted net book income" exceeds the alternative minimum taxable income of the corporation. The adjusted net book income is the corporate taxpayer's net income or loss shown on its "applicable financial statement," with certain adjustments not directly affecting tax-exempt income. A corporation's applicable financial statement includes statements required to be filed with the Securities and Exchange Commission. It also includes certified audited income statements used for credit purposes, income statements required to be provided to federal, state or local governments and agencies; and unaudited income statements used for the same purposes as the audited statements described above. For taxable years commencing after 1989,

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Code and consist of certain enumerated economic transaction, income items and expenses.

373. Id. § 57(a)(5)(A), (C)(i).
374. Id. § 57(a)(5)(C)(ii).
375. Id. § 57(a)(5)(C)(iii).
376. Id. § 55(b)(1)(A).
377. Id. § 56(C)(1) (including income on qualified § 501(c)(8) bonds).
378. Id. § 56(f)(1).
379. Id. § 56(f)(2)(A).
381. Id. § 56(f)(3)(A)(iii)-(iv).
instead of using fifty percent of the excess of adjusted net book income over alternative minimum taxable income, a corporate taxable adjustment will be based on seventy-five percent of the excess of “adjusted current earnings” over alternative minimum taxable income. In all instances, the adjustments do not apply to any “S corporation,” regulated investment company, real estate investment trust, or real estate mortgage investment conduit (“REMIC”).

b. Superfund Amendments and Reauthorization Act of 1986

In addition to the amendments to the corporate alternative minimum tax provisions made by the Tax Reform Act of 1986, an amendment was made by the Superfund Amendments and Reauthorization Act of 1986 (the “Superfund Act”). The Superfund Act imposes an “environmental tax” upon corporations equal to 0.12 percent of the excess of the corporation’s “modified alternative minimum taxable income” over $2,000,000. The “modified alternative minimum taxable income” is the corporation’s alternative minimum taxable income, as determined under Section 55(b)(2) of the 1986 Code, less certain otherwise permitted deductions. To the extent interest income on qualified 501(c)(3) bonds is included in the calculation, such interest income will be subject to this environmental tax. As a general rule, the tax applies to taxable years commencing after December 31, 1986 and before January 1, 1992.

3. Litigation Involving Taxation of Certain Social Security Benefits

For taxable years ending after January 1, 1984, recipients of social security income have been required to include tax-exempt interest in calculating adjusted gross income. Section 86 of the 1954 Code provides that the amounts by which one-half of social security income, plus all of certain specified income items, including all tax-exempt interest, exceed $25,000 in the case of a single taxpayer or $32,000 for joint taxpayers is considered income.

382. Id. § 56(g)(1). Section 56(g)(3) defines “adjusted current earnings”, a precise analysis of which is beyond the scope of this article.
383. Id. § 56(f)(4), (g)(6).
386. Id. § 59A(B).
387. Id. § 59(A)(d)(1).
388. Id. § 86.
The requirement to include tax-exempt income in the calculation of social security benefits has been recently challenged on constitutional grounds.\footnote{Goldin v. Baker, 809 F.2d 187 (2d Cir. 1987); Shapiro v. Baker, 646 F. Supp. 1127 (D.N.J. 1986).} A federal appellate court, finding a challenge based on the tenth amendment unsupported,\footnote{The tenth amendment provides that “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the states respectively, or to the people.” U.S. CONST. amend. X.} avoided addressing the constitutional issue, and held that Section 86 of the 1954 Code\footnote{I.R.C. § 86 (1954).} did not impose a direct tax on municipal bond income.\footnote{See Goldin v. Baker, 809 F.2d 187 (2d Cir. 1987); Shapiro v. Baker, 646 F. Supp. 1127 (D.N.J. 1986).} A district court has found that the doctrine of intergovernmental tax immunity was nearly extinct.\footnote{Shapiro, 646 F. Supp. at 1133. See id. at 1129-32 for a discussion of the doctrine of intergovernmental tax immunity.}

The decisions in these actions may have a bearing upon the alternative minimum taxation provisions of the Act. If the taxpayers appeal adverse decisions and prevail on the grounds of the unconstitutionality of the targeted provisions of Section 86, the constitutionality of the inclusion of certain tax-exempt income in the calculation of the alternative minimum tax could be suspect. It is questionable, however, whether a successful challenge could ensue based upon actions which have been or may be decided favorably to the taxpayers. Interest on tax-exempt bonds issued for governmental purposes is not included in the alternative minimum tax calculation; interest on private purpose bonds is included. One can argue that the doctrine of intergovernmental tax immunity does not apply to obligations issued by state and local governments for the benefit of private persons, including Section 501(c)(3) organizations.

\section*{B. Property and Casualty Insurance Companies}

The calculation of taxable income of insurance companies, other than life insurance companies, is established by Section 831 of the 1986 Code. In calculating “underwriting income,” losses incurred reduce premiums earned.\footnote{I.R.C. § 832(b)(3) (1986).} With respect to taxable years commencing after December 31, 1986, “losses incurred” for any year are reduced by an amount equal to fifteen percent of tax-exempt interest received or accrued during the taxable year.\footnote{Id. § 832(b)(5)(B)(I).}
percent "offset" does not apply to interest received on any bond acquired by the taxpayer before August 8, 1986.\(^{396}\) Therefore, any bonds acquired after August 7, 1986, regardless of when issued, and all bonds issued under the 1986 Code will be subject to the offset rules. Moreover, the offset applies not only to interest income received but also to such income accrued. The effect is to increase the taxable income of property and casualty insurance companies to the extent of the reduction in losses offsetting premium income as a consequence of the fifteen percent offset.

C. Bank Cost of Purchasing and Carrying Tax-exempt Bonds

With certain transitional and permanent exceptions,\(^{397}\) for taxable years ending after December 31, 1986, financial institutions\(^{398}\) will not be allowed to deduct any portion of interest expense allocable to tax-exempt interest.\(^{399}\) The portion of the financial institution’s total interest expense (including amounts paid on deposits) allocable to tax-exempt interest is based on the ratio of the financial institution’s average adjusted basis\(^{400}\) of tax-exempt obligations acquired after August 7, 1986, with certain exceptions, to the financial institution’s average adjusted basis for all its assets.\(^{401}\) Interest on tax-exempt bonds acquired on or before August 7, 1986 is not included in calculating the ratio.

“Qualified tax-exempt obligations” acquired after August 7, 1986, whether upon initial issuance or in a secondary market transaction, are not included in the apportionment calculation.\(^{402}\) A qualified tax-exempt obligation is not a private activity bond, other

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\(^{396}\) Id. § 832(b)(5)(i).


\(^{399}\) Id. § 265(b)(1). Under Section 265(2) of the 1954 Code, financial institutions were not permitted to deduct interest expense on indebtedness incurred to purchase and carry tax exempt bonds. However, financial institutions have deducted interest paid on deposits which have been invested in tax exempt bonds. Pursuant to special rules establishing corporate preference items, interest paid on deposits, which were used to purchase or acquire tax exempt bonds after December 31, 1982, was considered a “financial institution preference item”. I.R.C. § 291(c)(1)(B)(i). The deduction otherwise allowable with respect to such interest expense was reduced by 20 percent. Total interest expense was allocated to tax exempt bonds by a ratio of the financial institution’s average adjusted basis of the tax exempt obligations to the average adjusted basis of all its assets, with basis adjusted in accordance with the rules included in Section 1016 of the 1954 Code. Id. § 291(c)(1)(B)(ii). I.R.C. § 149(b) (1986). The 1954 Code contained similar prohibitions. See I.R.C. § 265(2) (1954).

\(^{400}\) See I.R.C. § 1016 (1986).

\(^{401}\) Id. § 265(b)(4)(A), (b)(2).

\(^{402}\) Id. § 265(b)(3)(A).
than a qualified 501(c)(3) bond. An addition, the issuer must designate the bond, upon its issuance, as a qualified tax-exempt obligation. An issuer cannot designate a bond as a qualified tax-exempt obligation unless it reasonably expects that the amount of such qualified tax-exempt obligation to be issued by the issuer and its “subordinate entities” during the calendar year will not exceed $10,000,000 and the actual amount of such bonds so issued during a calendar year does not exceed $10,000,000. An issuer's “subordinate entities” are those governmental entities deriving their authority from the issuer and which are subject to “substantial control” by the issuer.

In addition to these exceptions, there are certain transitional exceptions. Any tax-exempt obligation acquired after August 7, 1986, pursuant to a written commitment to purchase or repurchase the obligation that was entered into on or before September 25, 1985 is treated as having been acquired before August 8, 1986.

D. Reporting Tax-exempt Income

Commencing with tax returns filed with respect to tax years commencing after December 31, 1986, taxpayers must include on the return the amount of tax-exempt income received or accrued during the taxable year. Such reporting is a new requirement applicable to all taxpayers.

VIII. ADDITIONAL RESTRICTIONS

A. Prohibited Use of Bond Proceeds

Proceeds of private activity bonds cannot be used for certain designated types of facilities, including airplanes, skyboxes, or other private luxury boxes, facilities primarily used for gambling or a retail store the principal business of which is the sale of alcoholic beverages for consumption off premises. In addition, proceeds may not be used to finance health club facilities, unless the facility

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403. Id. § 265 (b)(3)(B)(i).
404. Id. § 265(b)(3)(B)(ii).
405. Id. § 265(b)(3)(D). An amendment to Section 265(b)(3)(C) of the 1986 Code included in HCR 395 (see supra note 175) would clarify that if an issuer issues more than $10,000,000 of bonds during a calendar year, none of the bonds could be qualified bonds. See GENERAL EXPLANATION supra note 3, at 565.
406. BLANK
407. CONF. COMM. REP. supra note 4, at 11-234.
is financed with the proceeds of qualified 501(c)(3) bonds and the facility is used directly for the purpose of the Section 501(c)(3) organization on whose behalf the bonds were issued.

B. Prohibition on Federal Guarantees

Tax-exempt bonds may not be federally guaranteed. Prohibited federal guarantees include direct or indirect guarantees of the payment of principal or interest on the bonds by the United States government or any federal agency; guarantees of the repayment of the loan of bond proceeds, if five percent or more of the bond proceeds are so loaned; or the direct or indirect investment in federally insured deposits of five percent or more of the bond proceeds. There are numerous exceptions, including bonds guaranteed by the Federal Housing Administration, the Veterans' Administration, and other designated federal agencies; certain housing and mortgage bonds; proceeds invested for a temporary period until needed; investments of a bona fide debt service fund; investments of a reasonably required reserve or replacement fund; investments in United States Treasury obligations; and investments permitted by regulation of the Treasury Department.

If the proceeds of bonds are loaned to financial institutions, the bonds are not considered federally guaranteed. In addition, guarantees of principal or interest on bonds by a financial institution are not considered federally guaranteed, unless the guarantee is a federally issued deposit or account.

C. Registration and Information Reporting Requirements

Publicly offered bonds with a maturity of more than one year must be registered. Furthermore, the issuer of certain types of tax-exempt bonds is required to provide to the Treasury Department certain information regarding the bond issue no later than the fifteenth day of the second calendar month following the close

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410. Id. § 147(e). Similar prohibitions were included in the 1954 Code, but applied only to exempt facility and small issue bonds. I.R.C. § 103(b)(15), 103(b)(18) (1954).
411. Id. § 147(h)(2).
412. CONF. COMM. REP., supra note 4, at II-731.
414. I.R.C. § 149(b)(3).
415. Id. § 149(b)(3)(D).
416. Id.
IX. CERTAIN PROVISIONS OF THE 1986 CODE WHICH DO NOT APPLY TO QUALIFIED 501(c)(3) BONDS

A. Volume Cap

The 1986 Code limits the aggregate principal amount of private purpose bonds, with certain exceptions, that may be issued annually by each state. Qualified 501(c)(3) bonds, qualified veterans' mortgage bonds, and certain exempt facility bonds issued to finance airports, docks, and wharves, are exempt from this limit.

The state ceiling or “volume cap” for bonds subject to the requirement for any calendar year is the greater of seventy-five dollars per person or $250 million through December 31, 1987; for bonds issued after this date, the per capita amount decreases to fifty dollars and the minimum decreases to $150 million. The volume cap is allocated between a state, its agencies, and local governmental units.

The private use portion of governmental bond proceeds in excess of $15 million must be supported by an allocation of a portion of the volume cap for the private use in excess of $15 million. If the private use constitutes use by a Section 501(c)(3) organization, however, such use does not require a volume cap allocation when the proceeds used by the Section 501(c)(3) organization are assumed to result from the issuance of qualified 501(c)(3) bonds, all the requirements applicable to the issuance of qualified 501(c)(3) bonds are satisfied, and the issuer elects to treat such portion as the issuance of qualified 501(c)(3) bonds.

B. Limitation on Acquisitions of Land and Existing Property

With certain exceptions, no more than twenty-five percent of the net proceeds of a private activity bond may be used to finance the acquisition of land or an interest in land. This restriction does not apply to qualified 501(c)(3) bonds. Similar restrictions appli-
cable to the acquisition of existing property also do not apply to qualified 501(c)(3) bonds.

X. CONCLUSION

Under the 1986 Code, the use of tax-exempt bonds by a Section 501(c)(3) organization engaged in health care will pose more significant legal, financial, and strategic issues than the 1954 Code. Many of the more restrictive provisions of the Act, however, do not apply to qualified 501(c)(3) bonds. Not for profit, tax-exempt private health care organizations will continue to benefit from tax-exempt bonds to a more significant degree than will other private enterprises whose access to the tax-exempt bond market has been more severely affected by the Act.

More precise fiscal and legal analysis of the consequences of the use of tax-exempt bonds to provide debt capital has become imperative. To the extent that facilities financed with tax-exempt bonds may be used by organizations or persons other than the borrowing tax-exempt organization, or that this may be used in the borrowing tax-exempt organization's unrelated trade or business activities, serious consideration should be given to avoiding the use of tax-exempt bonds in favor of traditional commercial taxable securities. Moreover, because the permitted use of tax-exempt bond financed facilities in an unrelated trade or business has been significantly restricted, the type of activity to which such facilities will be devoted must be unquestionably related to the charitable purposes for which the borrower's tax-exempt status exists. The very narrow range of permitted unrelated trade or business activities to be undertaken in tax-exempt bond financed property, considered in relation to the elimination of small issue industrial development bonds, may increase the cost of some of the newer ventures and enterprises in which the not-for-profit, tax-exempt health care industry is engaging.

The costs associated with incurring and maintaining tax-exempt debt capital will increase. Because of the limits upon the costs of issuance that may be paid with the proceeds of tax-exempt bonds and the limits upon bond proceeds that may be deposited to a debt service reserve fund, the up-front costs to the borrower will be higher and must be funded by the borrower directly or through the incurrence of taxable debt to provide funds for such costs. The maturity requirements may adversely affect the cost of technologi-

427. Id. § 147(d).
428. Id. § 147(h)(2).
cally innovative equipment with typically short lives; the bonds will be amortized over a relatively short period, which increases the cash flow which must be generated by the equipment to service the debt. The new definition of yield, which excludes issuance costs from the yield calculation, may preclude certain advance refundings. Moreover, the number of advance refundings are numerically limited, requiring a more thorough analysis of broader market trends to borrow at the most favorable rates. In addition, the rebate requirement may require a higher level of debt to replace the arbitrage earnings which has historically been used to finance a portion of the project financed with tax-exempt bonds.

Other difficulties can be anticipated as a consequence of the $150,000,000 aggregate limit on non hospital bonds, particularly in the large multi-institutional setting or with national or regional secular sponsorship. Certain mergers, acquisitions, and affiliations may be precluded if the effect of the combination will be to pierce the $150,000,000 limit, thereby requiring major refinancings on a taxable basis or undesirable corporate structures. The limit also has an immediate effect on major teaching institutions and not for profit systems engaged extensively in long-term care and elderly housing. In addition, the strict five percent limitation on use of proceeds and facilities financed with proceeds may preclude asset restructuring.

One can reasonably project that the volume of tax-exempt bonds to benefit Section 501(c)(3) health care organizations will decline. Moreover, in a period of numerically high federal budget deficits and shifting social objectives, there is always the possibility that the 1986 Code may be amended to narrow even further the permitted use of bond proceeds and perhaps to eliminate the availability of tax-exempt bonds for Section 501(c)(3) organizations. Other less dramatic amendments may occur, for example, the extension of the alternative minimum tax to include interest income earned on qualified 501(c)(3) bonds. In any event, any further restriction on the use or cost of tax-exempt bonds by or to Section 501(c)(3) organizations should be carefully monitored.