Internal Revenue Service

Number: **201148005**
Release Date: 12/2/2011

Index Number: 145.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable
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, ID No.
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Refer Reply To:
CC:FIP:BRANCH 5
PLR-143970-10
Date:
August 24, 2011

Legend

Issuer =

Health System =

State =

Subsidiary =

Holding Company =

Organization =

Year 1 =

Year 2 =

Year 3 =

Dear :

This letter responds to the request for a ruling submitted on behalf of Issuer that the Proposed Bonds (described below) will be qualified 501(c)(3) bonds under § 145 of the Internal Revenue Code (the "Code").

FACTS AND REPRESENTATIONS

Issuer proposes to issue bonds to loan the proceeds to Health System (the "Proposed Bonds"). Health System is a not-for-profit corporation duly organized and existing under the laws of the State and described in § 501(c)(3) of the Code.

Subsidiary is a for-profit corporation wholly-owned by Health System through Holding Company, a for-profit holding corporation that is also a wholly-owned subsidiary of Health System. In Year 1, Subsidiary acquired and constructed a wellness and fitness facility (the "Facility"). Subsidiary obtained a line of credit to pay for the costs of acquiring, constructing, and equipping the Facility and related costs. On the date the line of credit was obtained, Subsidiary and Health System expected that Subsidiary would pay the debt service on the line of credit from revenues generated by the Facility. The line of credit was secured by a guarantee from Health System.

In Year 2, the Facility was placed in service. Early in Year 3, Subsidiary refinanced its line of credit. The refinancing debt (the "Debt") is guaranteed by Holding Company and by Health System. The Debt is not secured by a lien against the Facility.

The Facility operated at a loss. Late in Year 3, Subsidiary donated the Facility to Organization, an organization described in § 501(c)(3). The donation is subject to various rights of Health System, including naming rights, the right of patients of Health System or its affiliates to use the Facility for certain purposes, the right of Health System and an affiliate to lease or otherwise use certain portions of the Facility, and the right to own the Facility in the event Organization ceases to use the Facility in furtherance of its exempt purposes. Organization did not assume liability for the Debt.

Since the donation, Subsidiary has not expected to have significant revenues or to make the debt service payments on the Debt independent of the guarantee by Health System, and Health System has expected to make (and under the guarantee, has made) the debt service payments. Health System intends to allocate the proceeds of the Proposed Bonds to the repayment of the Debt. Health System and Organization would sign an agreement requiring the Facility to be used in a manner consistent with the requirements of qualified 501(c)(3) bonds.

LAW AND ANALYSIS

Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b) provides that § 103(a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(a) provides that the term "private activity bond" means any bond issued as part of an issue which: (1) meets the private business use test of § 141(b)(1) and the

private security or payment test of § 141(b)(2); or (2) meets the private loan financing test of § 141(c). Section 141(b)(1) provides, except as otherwise provided in § 141(b), that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use.

Section 141(b)(6) provides that, for purposes of § 141(b), the term "private business use" means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business.

Section 141(c)(1) provides that an issue meets the private loan financing test if the amount of the proceeds of the issue which are to be used (directly or indirectly) to make or finance loans (other than loans described in § 141(c)(2)) to persons other than governmental units exceeds the lesser of (A) 5 percent of such proceeds, or (B) $5,000,000.

Section 141(e)(1) provides, in part, that the term "qualified bond" includes any private activity bond if such bond is a qualified 501(c)(3) bond and meets other specified requirements.

Section 145(a) provides that a "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if (1) 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, and (2) such bonds would not be a private activity bond if -- (A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying § 513(a), and (B) §§ 141(b)(1) and (2) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

Section 1.145-2(a) of the Income Tax Regulations provides that generally §§ 1.141-0 through 1.141-15 apply to § 145(a). Section 1.145-2(b) provides, in part, that in applying §§ 1.141-0 through 1.141-15 to § 145(a), (1) references to governmental persons include 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under § 513(a); and (2) references to "10 percent" and "proceeds" in the context of the private business use test and the private security or payment test mean "5 percent" and "net proceeds".

Section 1.141-2(a) provides that interest on a private activity bond is not excludable from gross income under § 103(a) unless the bond is a qualified bond. The purpose of the private activity bond tests of section 141 is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person. The private activity bond tests serve to identify arrangements that have the potential to transfer the benefit of tax-exempt financing, as well as arrangements that

actually transfer these benefits. The regulations under § 141 may not be applied in a manner that is inconsistent with these purposes.

Section 1.141-3(a)(1) provides that the private business use test relates to the use of the proceeds of an issue. For this purpose, the use of financed property is treated as direct use of proceeds. Section 1.141-3(b) provides that, in determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of the proceeds.

Section 1.141-13(a) provides that, except as provided in § 1.141-13, a refunding issue and a prior issue are tested separately under § 141. Thus, the determination of whether a refunding issue consists of private activity bonds generally does not depend on whether the prior issue consists of private activity bonds. Section 1.141-13(b)(1) provides that in applying the private business use test and the private loan financing test to a refunding issue, the proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the proceeds of the prior issue.

Section 1.150-1(a)(1) provides that the definitions in § 1.150-1 apply for all purposes of §§ 103 and 141 through 150. Section 1.150-1(d)(1) provides that refunding issue means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (a prior issue), including the issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs, if any properly allocable to that refunding issue.

Section 1.150-1(d)(2)(ii)(A) provides that generally an issue is not a refunding issue to the extent that the obligor (as defined in § 1.150-1(d)(2)(ii)(B)) of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue. Section 1.150-1(d)(2)(ii)(B) provides that the obligor of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment.

Section 1.141-6(a) provides that for purposes of §§ 1.141-1 through 1.141-15, the provisions of § 1.148-6(d) apply for purposes of allocating proceeds to expenditures. Thus, allocations generally may be made using any reasonable, consistently applied accounting method, and allocations under § 141 and § 148 must be consistent with each other.

Section 1.141-14(a) provides that if an issuer enters into a transaction or series of transactions with respect to one or more issues with a principal purpose of transferring to nongovernmental persons (other than as members of the general public) significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of § 141, the Commissioner may take any action to reflect the substance of the transaction or series of transactions, including—

(1) Treating separate issues as a single issue for purposes of the private activity bond tests;
(2) Reallocating proceeds to expenditures, property, use, or bonds;
(3) Reallocating payments to use or proceeds;
(4) Measuring private business use on a basis that reasonably reflects the economic benefit in a manner different than provided in § 1.141-3(g); and
(5) Measuring private payments or security on a basis that reasonably reflects the economic substance in a manner different than as provided in § 1.141-4.

The Debt, the proceeds of which were used to refinance the acquiring, constructing and equipping of the Facility, was incurred by Subsidiary and guaranteed by Holding Company and by Health System. Although the Facility is no longer owned by it, Subsidiary continues to be the debtor on the Debt, and both Health System and Holding Company continue to guarantee the Debt. Subsidiary, being neither a governmental person nor a 501(c)(3) organization, cannot avail itself of a loan of the proceeds of qualified 501(c)(3) bonds. Similarly, Holding Company cannot avail itself of a loan of the proceeds of qualified 501(c)(3) bonds. Instead, Health System, a related party to Subsidiary and a 501(c)(3) organization treated under § 145 as a governmental person with respect to its activities that do not constitute unrelated trades or businesses under § 513(a), proposes to borrow the proceeds of the Proposed Bonds and use them to refund the Debt.

The regulations cited above provide that use of the financed property is treated as direct use of the proceeds and that, in applying the private business use test and the private loan financing test to a refunding issue, the proceeds of the refunding issue are allocated to the same expenditures as the proceeds of the prior issue. Here, the Proposed Bonds would be refunding bonds because the Proposed Bond proceeds would be used to pay the principal and interest on the Debt and Health System is a related party to Subsidiary. However, Health System was not the previous owner nor is it the current owner of the Facility. Although generally under § 1.141-1(d), all related parties are treated as one person, Health System could not have financed the Facility with tax-exempt financing while Subsidiary owned it. The facts presented here raise the question of whether the proceeds of the Proposed Bonds would be properly allocable to the Facility, such that the Proposed Bonds would be qualified 501(c)(3) bonds. For reasons set forth below, we conclude that the proceeds of Proposed Bonds would not be properly allocable to the Facility.

The Facility, when constructed, and until divestiture, was owned and used by Subsidiary, a for-profit entity. Consequently, at the time Subsidiary acquired, constructed, and equipped the Facility and when it incurred the Debt, the Facility could not have been financed with qualified 501(c)(3) bonds because neither was the Facility expected to be owned by a 501(c)(3) organization or a governmental unit, nor was the Facility expected to be used by an organization that could have been treated as a

governmental unit for § 145 purposes. The Facility currently is owned by Organization, a 501(c)(3) organization, and is expected from the issue date of the Proposed Bonds to be used by organizations treated as a governmental persons under § 145.

However, the ownership and use of the Facility by persons treated as governmental persons under § 145 is not a principal purpose of the Proposed Bonds. Organization, as owner of the Facility, would receive no benefit whatsoever from the Proposed Bonds. Specifically, Organization acquired the Facility as a donation without assuming the Debt and without the Facility being subject to the Debt. Thus, Health System's use of proceeds of the Proposed Bonds could not be characterized as a grant to Organization to pay an acquisition indebtedness. Similarly, Organization, Health System, or other governmental persons as users of the Facility would not benefit from the Proposed Bonds in any way.

Although Health System, as guarantor of the Debt and the party expected to pay the debt service on the Debt, might benefit from lower interest costs of tax-exempt refinancing of the Debt, the principal purpose of the Proposed Bonds is to refinance the Debt, the liability incurred by Subsidiary to finance its ownership of the Facility. The use of the proceeds of the Proposed Bonds to refund the Debt would transfer to Subsidiary and its parent, Holding Company, both nongovernmental persons, significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of § 145. Accordingly, to reflect the substance of the transaction, the proceeds of the Proposed Bonds would be allocable to the expenditure of repaying the Debt, but not, however, properly allocable to the Facility.

CONCLUSION

We conclude that the Proposed Bonds would not be qualified 501(c)(3) bonds because the expenditure of proceeds to repay the Debt would transfer to Subsidiary and its parent, Holding Company, both nongovernmental persons, significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of § 145.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter, including the effect of any such transaction or item on the tax-exempt status of any entity referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Associate Chief Counsel
(Financial Institutions and Products)

By: _____
Johanna Som de Cerff
Senior Technician Reviewer
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cc: