

**Washington Health Law Manual – Fourth Edition**  
**Washington State Society of Healthcare Attorneys (WSSHA)**

# **Chapter 7:**

# **Bond Financing for**

# **Health Care and Long**

# **Term Care Facilities**

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## **Volume 3: Financing and Engaging in the Business of Healthcare**

### **7.1 Chapter Summary**

This chapter provides a basic introduction to bond financing for health care and long term care facilities in the State of Washington (the “State”). It begins with an overview of tax-exempt bond financing, including a brief explanation of the basic types of financing. It then describes the major issuers of tax-exempt bonds for health care and long term care facilities in Washington, including: (i) the Washington Health Care Facilities Authority, which is authorized to provide bond financing for all governmental and nonprofit health care facilities except independent nursing homes and facilities maintained primarily for lease to self-employed health care professionals, such as medical office buildings; (ii) the Washington State Housing Finance Commission, which is authorized by law to provide bond financing for long term care facilities as either housing facilities or as nonprofit facilities that cannot be financed through the Washington Health Care Facilities Authority, specifically including independent nursing homes; (iii) public hospital districts, which are authorized to issue bonds to finance health care and long term care facilities used in connection with their own programs; (iv) public housing authorities, which are authorized to issue bonds to finance long term care facilities used in connection with their own programs, as well as to make loans to third parties providing qualifying housing projects; (v) “63-20 issuers,” which are nonprofit entities that are permitted to issue tax-exempt bonds on behalf of a state or local governmental unit in accordance with procedures established under the Internal Revenue Code of 1986, as amended (the “Code”); (vi) the Washington Higher Education Facilities Authority, which is authorized to provide bond financing for health care facilities owned or operated by private, nonprofit colleges and universities in the State; and (vii) various other governmental entities that are authorized to finance facilities for use in their own health care and long term care programs, including the University of Washington and Washington State University, counties, and public development authorities. Next, it briefly discusses the provisions of important federal tax laws governing tax-exempt bond financing of health care and long term care facilities. Following that is a brief discussion of taxable bond financing as an alternative to tax-exempt bond financing for health care and long term care facilities. The chapter concludes with a survey of important federal and state securities laws applicable to both tax-exempt and taxable health care and long term care facilities bond financings.

It is important to note that bond financing transactions are, by their nature, very complex, and this chapter is not intended as a comprehensive summary of all of the issues that may arise in connection with such transactions. For example, it touches only briefly upon the myriad of issues that arise in connection with all financing transactions, but in ways that are particular to individual projects and borrowers, including the underwriting process, credit ratings and credit enhancement, financial covenants and collateral requirements, and other similar matters. Further, this chapter does not include a discussion of important ancillary matters; for example, the federal tax requirements that a nonprofit entity must satisfy in order to obtain and maintain recognition as an organization that is exempt from federal income taxation as described in Section 501(c)(3) of the Code (a “501(c)(3) Organization”). This chapter does not describe State law and federal tax laws applicable to bonds issued to refinance—or refund—other tax-exempt bonds. And finally, it does not discuss other important potential sources of financing for health care and long term care providers beyond bond financing for capital facilities, such as cash flow or working capital financings. Reference must be made to other sources for more information concerning such matters.

### **7.2 Sources of Tax-Exempt Bond Financing in Washington**

#### **7.2.1 Overview**

##### **7.2.1.1 Source and Value of Tax-Exemption**

Section 103 of the Code generally provides that the interest on all state or local bonds is excluded from gross income of the recipient for federal income tax purposes (that is, such interest is “tax-exempt”), except for bonds which fail to satisfy the private business use and arbitrage limitations, and other requirements imposed by federal tax law described in Section 7.3 of this chapter. The term “state or local bonds” in this context is not limited to bonds or other securities, but includes all written interest-bearing obligations incurred by a governmental or quasi-governmental entity in the exercise of its borrowing powers. As a practical matter, such tax-exemption translates into significantly lower borrowing costs than a comparable taxable financing, which makes tax-exempt bond financing the preferred alternative where it can be made to work.

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### **7.2.1.2 Types of Bonds**

Washington law authorizes governmental entities to issue two types of bonds that might be used to finance health care or long term care facilities: general obligation bonds and revenue bonds. General obligation bonds are obligations payable from general revenues of a governmental issuer, including tax revenues, and are usually secured by a pledge of the full faith and credit of the issuer. General obligation bonds are always subject to statutory and constitutional debt limits that vary depending on whether the debt may be paid only from revenues, including taxes, that may be raised without prior voter approval, or from excess tax revenues, which may be levied with specific voter approval to support the payment of debt.

Revenue bonds are obligations that are not payable from tax revenues, but are payable from and secured solely by a designated source of revenues (such as revenues derived from the operation of a hospital), often accounted for separately in a “special fund.” Because recourse for the payment of revenue bonds is limited to the revenues that are pledged to such purposes, revenue bonds are not subject to statutory or constitutional debt limits.

### **7.2.1.3 Types of Governmental Issuers**

Not all Washington governmental entities that are empowered to issue bonds to finance health care or long term care facilities are authorized to issue both types of bonds. Generally speaking, only governmental entities with taxing power are authorized to issue general obligation bonds for such purposes. Most of these same entities may also issue revenue bonds, but only for their own projects.

Other governmental entities that do not have taxing power may nonetheless issue revenue bonds either for their own benefit or for the benefit of third parties. Bond financing by a governmental entity for the benefit of a third party borrower is accomplished through a mechanism commonly referred to as “conduit financing,” because all of the benefits and obligations relating to the bonds pass through the issuer to the third party borrower. Although bonds are issued in the name of the governmental entity, the issuer lends 100% of the proceeds of the bonds to the third party borrower, and agrees to repay the bonds only from revenues derived from payments made by the third party borrower. Because recourse for the payment of conduit bonds is limited to such revenues, these bonds are sometimes referred to as nonrecourse revenue bonds (or, if the revenues are deposited in a special fund, nonrecourse special fund revenue bonds).

### **7.2.1.4 Financing Process**

Both general obligation bonds and revenue bonds can be issued under a bond resolution, trust indenture or financing agreement, which establishes the terms of the bonds, including the terms of repayment and security, and the permissible uses for proceeds of the bonds. Once bonds have been issued, it can be very difficult to amend the terms of such issuing documentation; consequently, considerable care should be taken in structuring bond issues. Bonds can be sold in a number of ways: through an underwriter in a public offering or limited public offering (which can be a negotiated sale or by competitive bid), or through a direct private placement directly to a bank or other qualified investor. In all cases, to be marketable to third parties, bonds must be issued subject to a written opinion of bond counsel—that is, an attorney or firm of attorneys whose opinion is accepted in the national tax-exempt markets as to the issuance and validity of municipal securities and the federal income tax treatment of the interest on such securities—confirming that the bonds are enforceable in accordance with their terms and, if applicable, that the interest on the bonds will be tax-exempt under the Code.

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### 7.2.2 Issuers of Tax-Exempt Bonds for Health Care and Long Term Care Facilities in Washington

#### 7.2.2.1 Washington Health Care Facilities Authority

##### 7.2.2.1.1 Introduction

The Washington Health Care Facilities Authority is a state instrumentality and agency created by the State Legislature in 1974 to:

assist and encourage the building, providing and utilization of modern, well equipped and reasonably priced health care facilities, and the improvement, expansion and modernization of health care facilities in a manner that will minimize the capital costs of construction, financing and use thereof and thereby the costs to the public of the use of such facilities, and to contribute to improving the quality of health care available to our citizens.<sup>1</sup>

The Authority was formally activated in 1979 and undertook its first financing in 1980. Since then, the Authority has issued over \$17.8 billion in aggregate principal amount of bonds to finance or refinance a variety of health care projects, ranging from the acquisition of equipment by small health care clinics, to the acquisition, construction and equipping of state-of-the-art hospital improvements by large multi-state hospital systems.

Pursuant to chapter 70.37 RCW (the “WHCFA Act”), the members of the Authority—including the Governor, Lieutenant Governor, Insurance Commissioner and the Secretary of Health of the State, each *ex officio*, and a public member appointed by the Governor and confirmed by the Senate on the basis of interest or expertise in health care delivery—are responsible for establishing Authority policy and approving all bond transactions based upon findings of both need and feasibility.<sup>2</sup> The Authority’s members have delegated responsibility for day-to-day management of the activities of the Authority, including responsibility for negotiating the terms of particular financing transactions, to its Executive Director and staff.

The Authority has no taxing power and no power to incur obligations on behalf of the State. Although most bonds issued by the Authority are tax-exempt, the Authority may also issue taxable bonds.

##### 7.2.2.1.2 Projects Eligible for Authority Financing

The WHCFA Act authorizes the Authority to serve as a financing conduit for health care capital facilities, through the issuance of nonrecourse special fund revenue bonds for the “construction, purchase, acquisition, rental, leasing or use [of such facilities] by participants . . .”<sup>3</sup> The WHCFA Act defines “participants” to include:

any city, county or other municipal corporation or agency or political subdivision of the State or any corporation, hospital, comprehensive cancer center or health maintenance organization authorized by law to operate nonprofit health care facilities, or any affiliate, as defined by regulations promulgated by the director of the department of financial institutions pursuant to RCW 21.20.450, which is a nonprofit corporation acting for the benefit of any entity described in this subsection.<sup>4</sup>

Thus, all nonprofit, district and other governmental health care providers (including out-of-state nonprofit entities that are financing facilities in the State) qualify to receive Authority assistance for

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<sup>1</sup> RCW 70.37.010.

<sup>2</sup> RCW 70.37.030; RCW 70.37.050.

<sup>3</sup> RCW 70.37.040.

<sup>4</sup> RCW 70.37.020(4).

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appropriate projects, as do their nonprofit “affiliates” (such as parent health care systems), if any. However, only 501(c)(3) Organizations and governmental entities will qualify for tax-exempt financing under the federal tax laws. For-profit corporations and other for-profit entities (even if wholly owned by a 501(c)(3) Organization) cannot obtain financing through the Authority.

The Authority may issue its bonds only to finance or refinance health care facilities located in Washington State, which have received final certificate of need approval where applicable, together with related financing costs, including interest during construction, reserve funds, initial start-up costs and issuance expenses.<sup>5</sup> The term “health care facility” is defined by the WHCFA Act to mean:

any land, structure, system, machinery, equipment or other real or personal property or appurtenances useful for or associated with delivery of inpatient or outpatient health care service or support for such care or any combination thereof which is operated or undertaken in connection with hospital, clinic, health maintenance organization, diagnostic or treatment center, extended care facility, or any facility providing or designed to provide therapeutic, convalescent or preventive health care services, and shall include research and support facilities of a comprehensive cancer center, but excluding, however, any facility which is maintained by a participant primarily for rental or lease to self-employed health care professionals or as an independent nursing home or other facility primarily offering domiciliary care.<sup>6</sup>

Certain health care facilities, such as hospitals, the land on which they sit and the equipment inside them, obviously fit within this definition of “health care facility.” However, the determination of whether or not other projects will qualify as a health care facility under the WHCFA Act is not always as easy. To provide guidance to potential applicants for assistance, the Authority has, by rule, enumerated 44 specific types of facilities that qualify for Authority financing, including a variety of different types of medical clinics, mental health centers, blood centers, drug and alcohol treatment facilities and naturopathic and homeopathic clinics, among others.<sup>7</sup> The rule also creates a process for determining whether other, unlisted facilities might qualify as health care facilities.<sup>8</sup>

The Authority has also adopted a rule to provide guidance regarding the circumstances under which a nursing facility will be considered to be an “independent nursing home,” and therefore, ineligible for Authority financial assistance.<sup>9</sup> Application of this rule requires an analysis of the following four factors to determine the nursing facility’s dependence on an otherwise qualifying participant: legal and practical control, physical proximity, integration of operations and services, and co-obligation on the debt underlying the bonds to be issued by the Authority.<sup>10</sup>

### 7.2.2.1.3 Authority Financing Process

The Authority has established different programs designed to accommodate the needs of potential borrowers to obtain financing on the most-effective basis possible, including traditional, underwritten public bond offerings, as well as the popular “Quick Loan” bonds, which are directly placed with a single financial institution. For larger projects, the Authority has issued bonds under a variety of financing arrangements, including multi-modal variable rate and auction rate bond transactions, letter of credit and

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<sup>5</sup> RCW 70.37.050.

<sup>6</sup> RCW 70.37.020(3).

<sup>7</sup> WAC 247-04-020.

<sup>8</sup> WAC 247-04-030, *et seq.*

<sup>9</sup> WAC 247-06-010, *et seq.*

<sup>10</sup> WAC 247-06-030.

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bond insured transactions, and master indenture transactions involving multiple obligated parties, which typically are sold through public offerings.

In all cases, the Authority's financing process begins with submission to the Authority by a participant of an application for financing, which must be accepted by motion adopted by the Authority at an open public meeting.<sup>11</sup> The Authority then delegates responsibility for negotiating a plan of finance, and preparation of all necessary legal documents required to put such plan into effect, to its staff, counsel and financial advisors. When documents are substantially final, the Authority reviews the plan of finance at a second open public meeting, approves the participant's application for financing and adopts a bond resolution upon making the following findings:

- It is necessary or advisable for the benefit of the public health for the Authority to provide financing for the proposed project;
- The applicant can reasonably be expected to achieve successful completion of the health care facilities to be financed by the Authority;
- The proposed project and the issuance of bonds by the Authority for such project are economically feasible and can be undertaken on terms economically satisfactory to the Authority;
- The proposed health care facility, if completed as described in the application, will carry out the purposes and policies of the WHCFA Act;
- The applicant has satisfied the Authority that substantially all of the savings realized by the applicant from the availability of financing through tax-exempt bonds, as contrasted to financing through taxable debt, will be passed on by the applicant to its patients; and
- The applicant has reasonably satisfied the requirements of the WHCFA Act and Title 247 WAC.<sup>12</sup>

### 7.2.2.2 Washington State Housing Finance Commission

#### 7.2.2.2.1 Introduction

The Washington State Housing Finance Commission (the "Commission") was established by the State Legislature in 1983 to provide a financing vehicle for the development of affordable housing facilities.<sup>13</sup> Since then, the Commission has issued billions in bonds to assist in the financing of a wide variety of 501(c)(3) nonprofit housing and facility projects throughout the State, including tax-exempt bonds to finance and refinance nursing homes, assisted living facilities, continuing care retirement communities (which typically include a combination of independent living, assisted living and nursing home facilities), and nonprofit facilities which are ineligible to be financed by the Authority.

The Commission is a public body corporate and politic and an instrumentality of the State. Its members include the State Treasurer, the Director of Commerce (formerly known as Community, Trade, and Economic Development), and an elected local government official with experience in local housing programs, who is appointed by the Governor with the consent of the Senate, each *ex officio*; a representative of housing consumer interests, a representative of labor interests, after consultation with representatives of organized labor, and a representative of low-income persons, each of whom is appointed by the Governor with the consent of the Senate; and five members of the public, appointed by

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<sup>11</sup> RCW 70.37.050 (the application forms appear at WAC 247-16-030 and 247-16-035).

<sup>12</sup> WAC 247-16-070(2).

<sup>13</sup> RCW 43.180.010.

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the Governor with the consent of the Senate, on the basis of geographic distribution and expertise in housing, real estate, finance, energy efficiency, or construction (one of whom serves as Chair of the Commission at the pleasure of the Governor).<sup>14</sup>

The Commission does not have the power of eminent domain or of taxation. Bonds issued by the Commission are not obligations of the State, but only nonrecourse revenue obligations of the Commission, payable from the special fund or funds created by the Commission for such payment. Although most of its bonds are tax-exempt, the Commission may also issue taxable bonds.

### **7.2.2.2.2 Authority to Issue Bonds**

The Commission's authority to issue bonds for long term care facilities is derived from two separate statutory schemes. RCW 43.180.010 through 43.180.240 (the "Housing Act") authorizes the Commission to issue bonds to finance and/or refinance the housing projects (specifically including nursing homes licensed under chapter 18.51 RCW) of both for-profit and nonprofit developers which are able to satisfy rules for eligibility established by the Commission from time to time. Financing transactions implemented under the Housing Act must be structured so that the Commission acquires a "mortgage loan."<sup>15</sup> Consequently, such transactions necessarily involve mortgage lenders (usually banks), which originate loans for acquisition by the Commission with the proceeds of bonds issued by the Commission for such purpose. In addition, bonds in such transactions must be secured, usually by a deed of trust against the property that is to be financed.

RCW 43.180.300 through 43.180.360 (the "Nonprofit Facilities Act") authorizes the Commission to issue bonds to finance the acquisition, construction and equipping of "facilities owned or used by a nonprofit corporation for any nonprofit activity described under Section 501(c)(3) of the Code that qualifies such corporation for an exemption from federal income taxes under Section 501(a) of the Code or similar successor provisions . . . ."<sup>16</sup> Under the Nonprofit Facilities Act, the Commission may issue bonds for long term care facilities that do not qualify for financing under the Housing Act, as well as other qualified nonprofit projects; provided in each instance, however, that the facilities to be financed are ineligible for financing through the Authority, the Washington Higher Education Facilities Authority, or public housing authorities.<sup>17</sup> Unlike bonds issued under the Housing Act, bonds issued under the Nonprofit Facilities Act do not have to be secured by real property security.

### **7.2.2.2.3 Commission Financing Process**

Like Authority transactions, bond financing through the Commission begins with submission by a borrower of an application for financing. Responsibility for negotiating the terms of the requested financing and loan documents is delegated to officers and staff of the Commission, its counsel and financial advisors. The Commission has established a number of programs, and staff assignment is made based, in part, upon whether financing is sought under the Housing Act or the Nonprofit Facilities Act. Also like the Authority, the Commission can issue bonds under a variety of programs, from direct private placement of bonds under its "Step Loan" program to public bond offerings of fixed or multi-modal variable rate bonds, typically (in the case of publicly-offered variable rate bonds) backed by a letter of credit. With respect to Commission policies and procedures, a borrower's representative will want to contact the Commission and become informed about the Commission's current policy directives and procedural requirements. The Commission will provide to interested borrowers information explaining the types of financing available, as well as written policies regarding credit enhancement, rating of the bonds, set asides for affordable units, and other factors to ensure that the project meets the Commission's public policy goals. As a general proposition, these policies are usually consistent with most project

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<sup>14</sup> RCW 43.180.040.

<sup>15</sup> RCW 43.180.050.

<sup>16</sup> RCW 43.180.300(6).

<sup>17</sup> *Id.*

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goals but the early understanding of the Commission’s requirements and the early establishment of communication with the Commission will help ensure a smooth financing.

### 7.2.2.3 Public Hospital Districts

#### 7.2.2.3.1 Introduction

Public hospital districts are municipal corporations and taxing districts established pursuant to chapter 70.44 RCW “to own and operate hospitals and other health care facilities and to provide hospital services and other health care services for the residents of such districts and other persons.”<sup>18</sup> Each public hospital district is governed by a three, five or seven member elected board of commissioners.<sup>19</sup> There are public hospital districts in 28 of the 39 counties in the State, operating largely in rural or semi-rural areas. Public hospital districts operate 41 hospitals in the State.

Like nonprofit healthcare organizations, public hospital districts may access tax-exempt financing utilizing the Authority as a financing conduit. However, because they are municipal corporations with general taxing powers, public hospital districts may also issue their own tax-exempt bonds—either as limited or unlimited tax general obligation bonds or as special fund revenue bonds—for “corporate purposes,” including owning and operating hospitals to provide hospital services and owning and operating other health care facilities to provide other health care services.<sup>20</sup> “Other health care facilities” include:

nursing home, extended care, long-term care, outpatient, and rehabilitative facilities; ambulances; facilities that promote health, wellness, and prevention of illness and injury; and such other facilities as are appropriate to the health and wellness needs of the population served.<sup>21</sup>

Public hospital district bond issues may also include funds to pay the incidental costs and costs related to the sale and issuance of the bonds and public hospital district revenue bonds will often include amounts necessary to fund all or a portion of a debt service reserve fund for the bonds.<sup>22</sup> The proceeds of voter-approved public hospital district unlimited tax general obligation bonds, however, may only be used for “capital purposes.”<sup>23</sup>

#### 7.2.2.3.2 Limited Tax (Nonvoted) General Obligation Bond Authority

Public hospital districts may issue bonds without voter approval (“limited tax general obligation bonds”), supported by their “regular” property tax revenues, so long as the principal amount of all such outstanding limited tax general obligation bonds does not exceed 3/4 of 1% of the assessed value of all taxable property within the district.<sup>24</sup> The regular property tax revenues of a public hospital district include such taxes as may be levied without voter approval, in an amount not to exceed 50¢ per \$1,000 of assessed value, plus an additional annual regular tax not to exceed 25¢ per \$1,000 of assessed value;<sup>25</sup> subject to the further limitation that the regular property tax levied in any year shall not exceed the amount of regular property taxes levied in the district in the highest of the three most recent years, multiplied by a limit factor, plus an adjustment to account for increases in assessed value resulting from

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<sup>18</sup> RCW 70.44.003.

<sup>19</sup> RCW 70.44.040.

<sup>20</sup> RCW 70.44.060(5).

<sup>21</sup> RCW 70.44.007(1).

<sup>22</sup> RCW 39.46.070.

<sup>23</sup> WASH. CONST. art. VII, § 2(b).

<sup>24</sup> RCW 39.36.020(2)(a)(i).

<sup>25</sup> RCW 70.44.060(6).

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new construction and improvements, and increases in assessed value of State-assessed property.<sup>26</sup> The limit factor is defined as 101% or less unless an increase greater than this limit is approved by the voters.<sup>27</sup> With a majority vote of its voters, a public hospital district may levy, within the rate limitations described above, more than what otherwise would be allowed by the tax increase limitation.<sup>28</sup> This is known as a “levy lid lift.” A public hospital district may seek voter approval of a single-year levy lid lift for any purpose or a multi-year levy lid lift for up to six years for a specified purpose and, in each case, may also seek voter approval to treat the increased levy as the new “base” amount for computation of future levies.<sup>29</sup>

### 7.2.2.3.3 Unlimited Tax (Voted) General Obligation Bond Authority

Public hospital districts may also levy annual property taxes in excess of their regular property taxes when authorized to do so for a legally permitted purpose at a special election.<sup>30</sup> (Such an excess levy is separate from any regular tax levy and can exist even if no regular taxes are currently being levied.) A public hospital district may seek voter approval for an excess levy to support general obligation bonds for capital purposes.<sup>31</sup> Such bonds must also be approved by the voters (by a 60% vote) in order to exceed the 3/4 of 1% debt limit.<sup>32</sup> Typically, such approvals are sought concurrently in a single ballot, to avoid the possibility that the voters might approve just the bonds or the excess levy but not both. Voter-approved bonds which are supported by a voter-approved excess levy are called “unlimited tax general obligation bonds.” The outstanding principal amount of unlimited tax general obligation bonds of a public hospital district, together with the outstanding principal amount of any limited tax general obligation bonds of the district, may not exceed 2-1/2% of the assessed value of all taxable property within the district.<sup>33</sup> Unlimited tax general obligation bonds will typically be supported by a pledge of the full faith, credit and resources of the public hospital district to levy taxes without limit as to rate or amount sufficient in each year to pay debt service on the bonds.

### 7.2.2.3.4 Public Hospital District Financing Process

General obligation bonds issued by a public hospital district must be issued and sold in accordance with the applicable requirements of the State’s local government bond act, chapter 39.46 RCW, which provides, among other things, uniform procedures mandatory for all general obligation bonds issued by all local governmental entities in Washington.<sup>34</sup> Public hospital districts may also issue revenue bonds, payable solely out of a special fund or funds into which the district may pledge revenues of the hospitals thereof and the revenues of any other facilities or services that the district is or may be authorized by law to provide.<sup>35</sup> Such authority may be exercised, either pursuant to the municipal revenue bond act, chapter 35.41 RCW or, alternatively, pursuant to the optional uniform procedures for local governmental revenue bonds established in the local government bond act, chapter 39.46 RCW.<sup>36</sup>

To issue bonds, the commission of a public hospital district is directed to provide by resolution for a plan for the acquisition, construction or improvement of hospitals or health care facilities, declaring the estimated cost and the amount of debt to be incurred for such purposes.<sup>37</sup> The bonds so authorized may

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<sup>26</sup> RCW 84.55.010.

<sup>27</sup> RCW 84.55.0101.

<sup>28</sup> RCW 84.55.050.

<sup>29</sup> *Id.*

<sup>30</sup> RCW 70.44.060(6).

<sup>31</sup> RCW 84.52.056.

<sup>32</sup> RCW 39.36.020(2)(b).

<sup>33</sup> *Id.*

<sup>34</sup> RCW 70.44.060(5).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> RCW 70.44.110.

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be sold either at competitive sale undertaken pursuant to such resolution to the best bidder established by subsequent resolution at the time of sale or by negotiated sale pursuant to the authorizing resolution. The commission is given great latitude regarding the determination of the essential terms of the bonds with the single exception that public hospital district general obligation bonds must mature within 30 years.<sup>38</sup>

### 7.2.2.4 Public Housing Authorities

#### 7.2.2.4.1 Introduction

Pursuant to chapter 35.82 RCW, a public housing authority has been established as a public body corporate and politic in each city and county of the State to address public needs for low income and senior housing (among other purposes).<sup>39</sup> However, the public housing authority of a particular city or county must be activated by adoption by the governing body of such jurisdiction of a resolution finding:

(1) that insanitary or unsafe inhabited dwelling accommodations exist in such city or county; (2) that there is a shortage of safe or sanitary dwelling accommodations in such city or county available to persons of low income at rentals they can afford; or (3) that there is a shortage of safe or sanitary dwellings, apartments, mobile home parks, or other living accommodations available for senior citizens.<sup>40</sup>

Each public housing authority is governed by a five (or seven in the case of public housing authorities in cities which have a population of four hundred thousand or more) member appointed board of commissioners.<sup>41</sup>

#### 7.2.2.4.2 Authority to Issue Bonds

Public housing authorities do not have taxing power and cannot issue general obligation bonds. However, a public housing authority may issue revenue bonds payable from the income and revenues of the housing project financed with the proceeds of the bonds, from the income and revenues of designated housing projects (whether or not financed with such bonds), or from all or a part of its revenues or assets generally.<sup>42</sup> In all cases, however, bonds issued by a public housing authority are the obligation of the authority only, and do not create a debt of the city, county, State, or any other political subdivision thereof.<sup>43</sup>

Public housing authorities may issue such revenue bonds for any of its corporate purposes.<sup>44</sup> Such purposes include the acquisition, construction, reconstruction and improvement, among other things, of its own housing projects, including dwellings, apartments or other accommodations for poor or infirm senior citizens.<sup>45</sup> Public housing authorities may also make conduit loans to finance or refinance “the acquisition, construction, . . . [or] rehabilitation of . . . developments for housing for persons of low income,”<sup>46</sup> which includes long term care facilities for low income senior citizens. To achieve this purpose, the State law applicable to such conduit financings requires that at least 50% of the housing units in projects financed by a public housing authority, or 50% of the interior space in the project (whichever results in the larger number of housing units), must be reserved for use by low-income

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<sup>38</sup> See generally RCW 39.46.040; 35.41.030; 70.44.110.

<sup>39</sup> RCW 35.82.030.

<sup>40</sup> *Id.*

<sup>41</sup> RCW 35.82.040 to .045.

<sup>42</sup> RCW 35.82.130.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> See RCW 35.82.070(2); 35.82.020(9); 35.82.020(16).

<sup>46</sup> RCW 35.82.070(18).

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residents (*i.e.*, persons whose incomes, adjusted for family size, do not exceed 80% of the area median income) for a period of 20 years.<sup>47</sup> If the bond-financed project is more than four stories high and has commercial space, that space cannot constitute more than 20% of the interior space in the project.<sup>48</sup>

### 7.2.2.4.3 Financing Process

Unlike the Authority and the Commission, which have established uniform policies and procedures that govern their respective financing transactions, most public housing authorities approach the financing process on a more individualized basis. A potential borrower should contact the public housing authority having jurisdiction over the area where its project is to be located to ensure a complete understanding of the legal and policy requirements that will be applicable to such financing.

### 7.2.2.5 63-20 Issuers

Nonprofit corporations operating health care or long term care facilities may also obtain tax-exempt financing on their own if they can qualify as “63-20 corporations” under the Code, the obligations of which will be treated as issued “on behalf of” a state or a local government. Under Revenue Ruling 63-20 and Revenue Procedure 82-26, a corporation must meet each of the following tests in order to achieve such “on behalf of” issuer status:

- The corporation must engage in activities which are essentially public in nature;
- The corporation must be one which is not organized for profit (except to the extent of retiring indebtedness);
- The corporate income must not inure to any private person;
- A state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; and
- The corporation must have been approved by a state or a political subdivision thereof, which must also have approved the specific obligations issued by the corporation.

The requirement that a state or local government retain beneficial and reversionary interests in the property to be financed with 63-20 bond proceeds is generally deemed to be burdensome to most nonprofit health care and long term care providers, which would prefer not to have to give up the financed facilities at the end of the bond term. As a result, there have been relatively few 63-20 health care financings in Washington. However, in some situations, special purpose 63-20 nonprofit issuers may be formed specifically to undertake financings on behalf of a state or a local government; in these instances, the requirement that the financed project be transferred to the governmental entity does not raise the same issues. King County has utilized such 63-20 issuers to finance facilities at Harborview Medical Center.

### 7.2.2.6 Washington Higher Education Facilities Authority

Like the Authority and the Commission, the Washington Higher Education Facilities Authority (“WHEFA”) is a public body corporate and politic and an agency of the State that serves as a financing conduit for higher education capital projects through the issuance of nonrecourse revenue bonds. Eligible projects specifically include health care facilities owned or operated by a “higher education institution,” which is defined as “a private, nonprofit educational institution, the main campus of which is permanently situated in the state, which is open to residents of the state, which neither restricts entry on racial or religious grounds, which provides programs of education beyond high school leading at least to the baccalaureate degree, and which

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<sup>47</sup> RCW 35.82.070(18)(a). The requirement is more restrictive for for-profit borrowers. RCW 35.82.070(18)(b).

<sup>48</sup> RCW 35.82.070(18)(c).

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is accredited by the Northwest Association of Schools and Colleges or by an accrediting association recognized by the council for higher education.”<sup>49</sup> WHEFA has financed academic and administrative buildings, research facilities and laboratories for Pacific Northwest University of Health Sciences, the only private nonprofit medical school in the State.

### 7.2.2.7 Other Issuers

#### 7.2.2.7.1 Introduction

A number of other Washington governmental entities that own or operate health care facilities also have authority to issue tax-exempt bonds for their own purposes. Among these are the University of Washington (University of Washington Medical Center), Washington State University (Elson S. Floyd College of Medicine) and King County (Harborview Medical Center). Moreover, the potential exists for other counties to issue tax-exempt bonds to finance the acquisition, construction or improvement of health care facilities that they do not now own.

#### 7.2.2.7.2 The University of Washington and Washington State University

The University of Washington and Washington State University are each state agencies authorized by law to issue their own revenue bonds to finance or refinance the acquisition, construction or improvement of certain revenue-generating facilities, including hospitals and infirmaries.<sup>50</sup> Such bonds would be special fund revenue bonds of the issuing University, payable from the income derived through the ownership, operation and use of such facilities. The issuing University’s board of regents has great latitude in establishing the essential terms of such bonds.<sup>51</sup> To date, neither University has issued any revenue bonds to finance its health care facilities.

In addition, each such University has supplemental statutory authority to issue bonds “for any university purpose,” including its health care programs.<sup>52</sup> Such bonds are payable only from fees or other revenue streams that are not subject to appropriation by the Legislature and do not constitute general state revenues.<sup>53</sup> In lieu of following the procedures governing the issuance of bonds by public colleges and universities, each University may instead follow the procedures established for bond issuance by state and local governments.<sup>54</sup> In either case, the bonds would be tax-exempt obligations if they are structured to meet the requirements of the Code.

Each such University may also utilize “financing contracts” to acquire real or personal property for University purposes, including its health care programs.<sup>55</sup> Such contracts require the prior approval of the State Finance Committee, unless the contracts are payable solely from revenues derived from the issuing University’s ownership and operation of its facilities not subject to appropriation by the Legislature and not constituting “general state revenues.”<sup>56</sup> If properly structured to meet the requirements of the Code, such financing contracts (or certificates of participation issued from them) will be tax-exempt obligations of the issuing University.

Each of the University of Washington and Washington State University also receives tax-exempt capital financing in the form of direct grants of State bond proceeds. For example, many of the capital improvements to the University of Washington Medical Center have been financed in this manner. Such bonds are issued by the State Finance Committee at the direction of the Legislature to finance facilities

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<sup>49</sup> RCW 28B.07.020.

<sup>50</sup> RCW 28B.10.300.

<sup>51</sup> See generally RCW 28B.10.310; 28B.10.315; 28B.10.325.

<sup>52</sup> RCW 28B.142.010; 28B.142.040.

<sup>53</sup> RCW 28B.142.010.

<sup>54</sup> *Id.* (referencing RCW 28B.10.310 and 28B.10.315 and chapters 39.46 and 39.53 RCW).

<sup>55</sup> RCW 28B.10.022.

<sup>56</sup> *Id.*

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for which appropriations have been made in the State's capital budget. Such bonds are general obligations of the State, backed by the full faith and credit of the State and the resources of the State's general fund.

### 7.2.2.7.3 Counties

Each county in the State is required to be organized as a local health department for the purposes of providing public health services within its jurisdiction.<sup>57</sup> It is possible that in the exercise of those services, a county could choose to acquire, construct or enlarge its own hospital facilities and utilize its own general obligation or revenue bonding powers to do so.<sup>58</sup> In addition, counties are specifically authorized to “establish, provide, and maintain hospitals for the care and treatment of the indigent, sick, injured, or infirm,”<sup>59</sup> and to issue unlimited tax general obligation bonds for the establishment thereof.<sup>60</sup>

Currently, the only county hospital in Washington is Harborview Medical Center, owned by King County and operated under contract by the University of Washington. King County has issued limited tax and unlimited tax general obligation bonds to finance capital improvements at Harborview Medical Center, and has served as the approving government with respect to 63-20 tax-exempt bond financings for facilities at Harborview Medical Center.

### 7.2.2.7.4 Public Development Authorities

Washington cities and counties are authorized to create certain public corporations (“public development authorities” or “PDAs”) to “improve the administration of authorized federal grants or programs, to improve governmental efficiency and services, or to improve the general living conditions in the urban areas of the state.”<sup>61</sup> PDAs are authorized to issue bonds for their own corporate purposes but have no taxing power.<sup>62</sup> A PDA may not act as a financing conduit for a hospital that it does not own and operate.<sup>63</sup>

### 7.2.2.7.5 Out-of-State Issuers

In the past decade, states other than Washington have established conduit financing agencies with the authority to issue nonrecourse revenue bonds to finance facilities, including health care and long term care facilities, located outside of the state that established the issuing agency.<sup>64</sup> Discussion of these agencies is beyond the scope of this chapter other than to note that, under Washington State law, before such bonds issued to finance facilities within the State may receive the public approval required under federal tax law, such bonds must receive prior approval from the relevant Washington statewide issuer authorized by Washington law to issue bonds for the proposed project.<sup>65</sup>

## 7.3 Federal Tax Issues

To qualify for tax-exemption under the Code, bonds issued by a governmental entity to finance health care or long term care facilities must satisfy a variety of federal tax law rules governing use of the financed facilities, investment of bond proceeds, and a variety of other matters. Certain of these rules, such as those applying to investment of bond

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<sup>57</sup> See generally chapter 70.05 RCW.

<sup>58</sup> See generally chapters 35.37, 35.41 and 36.67 RCW.

<sup>59</sup> RCW 36.62.010.

<sup>60</sup> See chapter 36.62 RCW.

<sup>61</sup> RCW 35.21.730.

<sup>62</sup> *Id.*

<sup>63</sup> Memorandum from David E. Walsh, Deputy Attorney General, to Robert V. Graham, State Auditor (Mar. 10, 1989).

<sup>64</sup> Both Wisconsin and New Hampshire have created bond financing agencies for the express purpose of issuing conduit nonrecourse revenue bonds for projects located in other states. Bond issuing authorities in a number of other states have similar extraterritorial powers for projects with a nexus to the issuer's state.

<sup>65</sup> RCW 39.46.170.

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proceeds, apply to all bonds, regardless of the issuer or the type of facility financed. Other rules are applicable, depending upon whether the bonds are considered to be “governmental bonds” or “private activity bonds.”

### 7.3.1 Governmental Bonds and Private Activity Bonds

Governmental bonds are bonds that are not “private activity bonds” under the Code. A private activity bond is a bond which meets either the “private loan financing test” or both the “private business use” and the “private security or payment” prongs of the “private business test” set forth in section 141 of the Code. All governmental bonds issued to finance health care and long term care facilities are tax-exempt. However, only “qualified private activity bonds,” issued to finance health care or long term care facilities to be owned and operated by 501(c)(3) Organizations, or qualifying as qualified residential rental projects, will be eligible for federal tax-exemption.

#### 7.3.1.1 Private Loan Financing Test

Satisfying the private loan financing test can be avoided by insuring that no more than the lesser of 5% or \$5,000,000 of bond proceeds are to be used, directly or indirectly, to make or finance loans to persons other than governmental units.<sup>66</sup> All bonds issued by a governmental entity for loan to a nonprofit corporation satisfy this test and are therefore private activity bonds. Most bonds issued by governmental entities for their own programs do not typically involve loans, and therefore would usually fail this test.

#### 7.3.1.2 The Private Business Test

The “private business test” consists of two parts — the “private business use test” and the “private security or payment test,” each of which must be satisfied for a bond to be a private activity bond.<sup>67</sup> Failure of either test is sufficient to negate that status.

##### 7.3.1.2.1 The Private Business Use Test

To insure failure of the private business use test, no more than 10% of the bond proceeds may be used, directly or indirectly, in the “trade or business” (which includes any activity carried on by a person other than a natural person) carried on by any entity (including any unit of the federal government) that is not a state or local governmental entity.<sup>68</sup> This threshold drops to 5% if such use is either unrelated or disproportionate to the governmental use financed by the bonds. Private business use of bond proceeds is related to a governmental use if the two activities are operationally related and generally occur in the same facility or adjacent facilities.<sup>69</sup> For example, a privately owned pharmacy in a governmentally owned hospital does not ordinarily result in unrelated use solely because the pharmacy also serves individuals not using the hospital.<sup>70</sup> A private business use is disproportionate to a related governmental use to the extent that the amount of proceeds used for the private business use exceeds the amount of proceeds used for the related governmental use.<sup>71</sup> Due to the inherently subjective nature of these rules, it is always safer to attempt to meet the stricter 5% threshold.

Of all the tests for tax-exemption, the private business use test is the hardest for health care and long term care facilities to fail (and thus, is the test most likely to prevent tax-exemption). There are multiple opportunities for even governmentally owned and operated health care and long term care facilities to permit other entities to utilize bond proceeds in connection with a trade or business. Examples of such uses include use of bond-financed facilities pursuant to leases, licenses or management contracts, as well as many physicians’ contracts.

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<sup>66</sup> I.R.C. § 141(c).

<sup>67</sup> I.R.C. § 141(b).

<sup>68</sup> *Id.*

<sup>69</sup> Treas. Reg. § 1.141-9(b)(1).

<sup>70</sup> Treas. Reg. § 1.141-9(b)(2).

<sup>71</sup> Treas. Reg. § 1.141-9(c)(1).

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The Internal Revenue Service (the “IRS”) has adopted certain safe harbor arrangements for management contracts and supported research arrangements, which can be helpful in avoiding private business uses.<sup>72</sup> These safe harbors are described in Sections 7.3.9 and 7.3.10 of this chapter, respectively.

### **7.3.1.2.2 The Private Security or Payment Test**

In order to fail the private security or payment test, an issuer should insure that the payment of the principal of or interest on no more than 5% of the proceeds of its bonds will be directly or indirectly secured by any property used for private business use or payments in respect of such property or will be derived from payments in respect of property or borrowed money used or to be used for private business use.<sup>73</sup> The Code actually permits payment of up to 10% of the principal or interest on bonds to be so secured or repaid, but only if the private business use is not unrelated or disproportionate to the governmental use financed by the bonds. However, as noted above, the inherent subjectivity of concepts of relativity and disproportionality makes the lower threshold a safer option.

Typically, the private security or payment test is satisfied where payment of the bonds is derived, in whole or in part, from rental payments in respect of leased, bond-financed property or where such payments are secured by a deed of trust or mortgage against such property. The latter seldom rises in transactions involving financings by governmental entities of their owned or operated facilities. However, leases of such property are common.

Failing either the private business use test or the private security or payment test will be effective to avoid treating bonds as private activity bonds; failing both tests is even more certain. It is common for bonds issued by governmental entities for their own programs to fail either or both prongs of the private business test, thus qualifying for tax-exempt treatment as governmental bonds. On the other hand, conduit bonds issued by entities such as the Authority, the Commission, WHEFA and/or public housing authorities for the benefit of third parties typically satisfy both tests. To achieve tax-exemption, such bonds must satisfy further requirements to be considered one of the two following types of qualified private activity bonds: “qualified 501(c)(3) bonds” or “exempt facility bonds” for a “qualified residential rental project.”

## **7.3.2 Qualified Private Activity Bonds**

### **7.3.2.1 Qualified 501(c)(3) Bonds**

Private activity bonds issued for the benefit of 501(c)(3) Organizations are eligible for tax-exemption as qualified 501(c)(3) bonds, if they meet all of the following requirements:

- At least 95% of the net proceeds of the bonds must be used by a 501(c)(3) Organization in furtherance of its exempt purpose or by a state or local governmental unit;
- All of the property which is provided by the net proceeds of the issue must be owned by a 501(c)(3) Organization or a state or local governmental unit; and
- The debt service on at least 95% of the proceeds of the bond issue must either be secured by an interest in property or payments in respect of property used by a 501(c)(3) Organization in furtherance of its exempt purpose or by a state or local governmental unit or be derived from payments in respect of property or borrowed money used by a 501(c)(3) Organization in furtherance of its exempt purpose or by a state or local governmental unit.<sup>74</sup>

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<sup>72</sup> Rev. Proc. 2017-13; Rev. Proc. 2007-47.

<sup>73</sup> I.R.C. § 141(b)(2).

<sup>74</sup> I.R.C. § 145(a).

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### 7.3.2.2 \$150 Million Limitation on Non-Hospital Bonds

Prior to August 5, 1997, the effective date of the Taxpayer Relief Act of 1997 (the “1997 Tax Act”), each 501(c)(3) Organization, together with all of its affiliated entities under common management and control, was limited to no more than \$150 million of outstanding qualified 501(c)(3) bonds that are not “qualified hospital bonds.” The 1997 Tax Act provides partial relief from this limitation. It repealed the \$150 million limit for bonds issued after August 5, 1997, to finance capital expenditures incurred after August 5, 1997. The \$150 million limit continues to apply to the issuance of other qualified 501(c)(3) bonds. For example, bonds issued to refund taxable or tax-exempt debt for nonhospital purposes incurred prior to August 5, 1997, would still be subject to the limitation.<sup>75</sup>

“Qualified hospital bonds” are bonds at least 95% of the net proceeds of which are used with respect to a “hospital.” For this purpose, a hospital is an institution which:

- is accredited by The Joint Commission or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of The Joint Commission;
- is primarily used to provide, by or under the supervision of physicians, to inpatients diagnostic services and therapeutic services for medical diagnosis, treatment and care of injured, disabled or sick persons;
- has a requirement that every patient be under the care and supervision of a physician; and
- provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or registered nurse on duty at all times.<sup>76</sup>

The term “hospital” does not include rest or nursing homes, daycare centers, medical school facilities, research laboratories or ambulatory care facilities (e.g., “surgicenters”).<sup>77</sup> Note that, if the “primary use” test cannot be met, it is possible to allocate a facility into hospital and nonhospital facilities. Note also that certain outpatient facilities and long term care facilities will not satisfy the definition of “hospital.”

If bonds are used partly for hospital facilities and partly for other purposes, only the portion of the bonds actually used for hospitals is exempt from the \$150 million limitation.<sup>78</sup> If 95% or more of the net proceeds of the bond issue are used with respect to a hospital, then the entire issue is treated as a qualified hospital bond issue.<sup>79</sup>

### 7.3.2.3 Qualified 501(c)(3) Bonds Issued to Provide Residential Housing

If any portion of the proceeds of an issue of otherwise qualified 501(c)(3) bonds is to be used, directly or indirectly, to provide residential rental property for family units, the financed project must either be new construction, a “qualified residential rental project” (as described in further detail in the next section), or property that will be substantially rehabilitated during a two-year period ending one year after acquisition of the property.<sup>80</sup> Because of these restrictions, it is important, in the case of long term care facilities, to determine whether the facilities to be financed constitute residential rental property. Although Section 145 of the Code does not define “residential rental property for family units,” the term is generally understood to

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<sup>75</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788; I.R.C. § 145(b)(5).

<sup>76</sup> H.R. Rep. No. 99-426, 99<sup>th</sup> Cong., 1<sup>st</sup> Sess. 540-41 (1985).

<sup>77</sup> *Id.*

<sup>78</sup> I.R.C. § 145(b)(2)(C)(i).

<sup>79</sup> I.R.C. § 145(c).

<sup>80</sup> I.R.C. § 145(d).

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mean a building or any portion thereof which contains complete living facilities for living, sleeping, eating, cooking and sanitation, which are to be used on other than a transient basis by one or more persons, and facilities functionally related and subordinate thereto. To qualify as a family unit the living facilities must be a separate, self-contained building or constitute one unit in a building substantially all of which consists of similar units, together with functionally related and subordinate facilities or areas. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, sanitariums, rest homes, and trailer parks and courts for use on a transient basis do not constitute residential rental property for family units.<sup>81</sup>

While nursing homes clearly do not meet this definition, the analysis in the case of other types of long term care facilities, including assisted living and congregate care facilities and continuing care retirement communities must be made on a case by case basis.

### 7.3.2.4 Exempt Facility Bonds for Residential Rental Projects

Those long term care facilities bonds that do not meet the standards for treatment as qualified 501(c)(3) bonds may nevertheless qualify for tax-exemption as “exempt facility bonds” for a “qualified residential rental project.” To gain such status, the facilities financed must be used for residential use, and must consist of units that contain complete living facilities that are to be used on other than a transient basis.<sup>82</sup> In addition, the qualified residential rental project must meet certain low income set asides at all times during the “qualified project period.” An issuer is permitted to elect one of two unit/tenant income set-aside tests for purposes of this test:

- *20-50 Test.* At least 20% of the residential units in the project must be occupied by individuals whose income is 50% or less of the area median gross income; or
- *40-60 Test.* At least 40% of the residential units in the project must be occupied by individuals whose income is 60% of the area median gross income.<sup>83</sup>

The qualified project period for long term care facilities financed with qualified residential rental project bonds begins on the first day on which 10% of the residential rental units in the project are occupied, and ends on the latest of: (i) the date which is 15 years after the date on which 50% of the residential units in the project are occupied; (ii) the first day on which no tax-exempt private activity bond issued with respect to the project is outstanding; or (iii) the date on which any assistance provided with respect to the project under Section 8 of the United States Housing Act of 1937 terminates.<sup>84</sup>

To be eligible as a qualified residential rental project, the facility must serve or be available on a regular basis for general public use, and not for the exclusive use of a limited class of nonexempt persons in their trade or business (such as members of a social organization or employees of a particular company).<sup>85</sup> Furthermore, if such bonds are issued to acquire existing property, the rehabilitation expenditures with respect to buildings and equipment must equal or exceed 15% of the costs of acquiring the same with net proceeds of the qualified bond issue, and in the case of structures other than a building, rehabilitation expenditures must equal or exceed 100%.<sup>86</sup> Finally, exempt facility bonds issued to finance long term care facilities as qualified residential rental projects must receive an allocation of the State’s private activity bond volume cap (qualified 501(c)(3) bonds do not receive an allocation of volume cap).<sup>87</sup> Such allocation is made by the State

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<sup>81</sup> See Treas. Reg. § 1.103-8(b)(10)(ii).

<sup>82</sup> See generally Treas. Reg. § 1.103-8(b).

<sup>83</sup> I.R.C. § 142(d)(1).

<sup>84</sup> I.R.C. § 145(d)(2)(A).

<sup>85</sup> Treas. Reg. § 1.103-8(a)(2).

<sup>86</sup> I.R.C. § 147(d).

<sup>87</sup> I.R.C. § 146.

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Department of Commerce upon application in accordance with procedures established by State law<sup>88</sup> and applicable rules.<sup>89</sup>

### 7.3.2.5 “TEFRA” Hearing and Public Approval

As a condition of tax-exemption, qualified 501(c)(3) bonds and exempt facility bonds for qualified residential rental projects must obtain “public approval” by being approved either by (1) voter referendum or (2) the governmental unit which issued the bonds and each governmental unit having jurisdiction over the area in which facilities to be financed are located (if one governmental unit has jurisdiction over the entire area where the facilities are located, then only that unit need approve of the project), following a public hearing for which reasonable public notice was provided (a “TEFRA hearing”).<sup>90</sup> The State is the only governmental unit that must approve such qualified private activity bonds issued by the Authority, the Commission and WHEFA.

In the absence of a referendum, public approval must be given by the “applicable elected representative.”<sup>91</sup> This term is defined to include: (1) the elected legislative body of the governmental unit; (2) the chief elected executive officer, the chief elected state legal officer of the executive branch, or a designated elected official of the governmental unit for this purpose; or (3) if the governmental unit has no elected representative(s), then an applicable elected representative of the next higher governmental unit from which the issuing governmental unit derives authority.<sup>92</sup> The applicable elected representative must approve the private activity bond issue after the public hearing for which reasonable notice was given. The approving official(s) need not attend the public hearing. The Governor, as the chief elected executive officer of the State, generally approves the qualified 501(c)(3) bonds of the Authority, the Commission and WHEFA, and exempt facility bonds for qualified residential rental projects issued by the Commission.

On December 28, 2018, the U.S. Department of the Treasury released final regulations regarding certain public notice, hearing and approval requirements. The provisions described below generally apply to bonds issued pursuant to a public approval occurring on or after April 1, 2019.

The Code is silent on what constitutes reasonable notice, but notice is presumed reasonable if it is given no fewer than seven (7) days before the hearing in one or more of the following ways:

- Publication in one or more newspapers of general circulation available to the residents of the governmental unit,
- Radio or television broadcast to the residents of the governmental unit,
- Electronic posting on the approving governmental unit’s primary public website, or
- In accordance with state law requirements for giving public notices for public hearings, if the public notice is reasonably accessible.<sup>93</sup>

The following information must be contained in the notice of public hearings:

- The time and place for the public hearing,
- A general, functional description of the type and use of the project to be financed,

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<sup>88</sup> See generally chapter 39.86 RCW.

<sup>89</sup> See generally chapter 130-16 WAC.

<sup>90</sup> I.R.C. § 147(f).

<sup>91</sup> I.R.C. § 147(f)(2)(E).

<sup>92</sup> *Id.*

<sup>93</sup> Treas. Reg. § 1.147(f)-1(d)(4).

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- The maximum stated principal amount of obligations to be issued with respect to the project, and if an issue finances multiple projects, the notice must specify separately the maximum stated principal amount of bonds to be issued to finance each separate project,
- The initial legal owner or principal user of the project (a beneficial party of interest may be named, including the general partner of a partnership that owns the facility), and
- The prospective location of the project by its street address, reference to boundary streets or other geographic boundaries, or other description of the specific geographic location that is reasonably designed to inform readers of its specific location.<sup>94</sup>

The public hearing must be held in a place, time and manner providing convenient and reasonable opportunity for persons affected by the bond issue and the project to be heard.

The required public approval must be obtained within one year before the issuance of the bonds, with certain exceptions applying in the case of multiple issuances pursuant to a plan of financing.

### 7.3.3 Limitations on Financing Costs of Issuance

No more than 2% of the proceeds of qualified 501(c)(3) bonds or exempt facility bonds for qualified residential rental projects may be used to finance bond issuance costs, including the underwriter's discount.<sup>95</sup> Costs of credit enhancement are generally excluded from this 2% limitation.<sup>96</sup> Moreover, the amount of bond proceeds used to pay costs of issuance will be allocated to the 5% of net proceeds permitted to be used for a nonqualifying use (the so-called "bad money" allowance), effectively causing that amount to drop to 3% in most tax-exempt health care or long term care facilities bond financings.<sup>97</sup>

### 7.3.4 Maturity Limitations

The weighted average maturity of qualified 501(c)(3) bonds may not exceed 120% of the average reasonably expected economic life of the facilities being financed with the proceeds of the bond issue.<sup>98</sup>

### 7.3.5 Financing of Certain Types of Facilities Prohibited

Generally speaking, qualified private activity bonds may not be used to provide any airplane, skybox or other private luxury box, health club facility, facility primarily used for gambling or store the principal business of which is the sale of alcoholic beverages for consumption off premises.<sup>99</sup> However, the prohibition on financing health club facilities does not apply to qualified 501(c)(3) bonds,<sup>100</sup> and the prohibition on financing airplanes does not apply to helicopters.<sup>101</sup>

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<sup>94</sup> Treas. Reg. § 1.147(f)-1(f)(2).

<sup>95</sup> I.R.C. § 147(g).

<sup>96</sup> H.R. Rep. No. 99-841 at II-730.

<sup>97</sup> H.R. Rep. No. 99-841 at II-729.

<sup>98</sup> I.R.C. § 147(b).

<sup>99</sup> I.R.C. § 147(e).

<sup>100</sup> I.R.C. § 147(h)(2).

<sup>101</sup> Rev. Rul. 2003-116.

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### 7.3.6 Arbitrage Considerations

Arbitrage bonds do not qualify for tax-exemption under the Code.<sup>102</sup>

#### 7.3.6.1 Arbitrage Yield Restrictions

Unless specifically provided otherwise in the Code and the regulations thereunder, bonds will be considered to be arbitrage bonds (and the interest on such bonds will be includable in gross income for purposes of federal income taxation) if the bond proceeds and other monies treated as bond proceeds are invested in investment property which produces a yield over the term of the issue which is materially higher than the yield on the bonds (“higher yielding investments”).<sup>103</sup>

##### 7.3.6.1.1 Temporary Period Exceptions

The Code and regulations permit bond proceeds to be invested in higher-yielding investments for certain “temporary periods” without causing the bonds to be arbitrage bonds.<sup>104</sup> The most important of these for health care and long term care facilities bond financings are the 13-month temporary period for *bona fide* debt service funds, the three-year (or five-year) temporary period for capital projects and the general 30-day temporary period.

###### 7.3.6.1.1.1 Thirteen-Month Temporary Period for Bona Fide Debt Service Funds

Amounts held in a “*bona fide* debt service fund” may be invested in higher-yielding investments for a temporary period not exceeding 13 months.<sup>105</sup>

Most tax-exempt bond issues for health care or long term care facilities, regardless of issuer, are repaid from a special fund entitled the “bond fund” or “bond debt service fund,” or the like, with one or more accounts in which revenues are accumulated for the payment of principal and interest on the bonds. These accounts and debt service payment requirements are typically structured to qualify for the 13-month temporary period available to *bona fide* debt service funds under the Code.

###### 7.3.6.1.1.2 Three-Year (or Five-Year) Temporary Period for Capital Projects

Proceeds of bonds reasonably excepted to be allocated to expenditures for capital projects may be invested in higher yielding investments for a temporary period of three years beginning on their issue date if: (i) the issuer reasonably expects to spend at least 85% of such proceeds on capital projects within three years after the date of issue (the “Expenditure Test”); (ii) the issuer incurs, within six months of the date of issue, a substantial binding obligation to a third party to expend at least 5% of such proceeds of the issue on capital projects (the “Time Test”); and (iii) completion of the capital projects and allocation of such bond proceeds to capital expenditures proceeds with due diligence (the “Due Diligence Test”). If the issuer expects to allocate bond proceeds to a capital project involving a substantial amount of construction expenditures, a five-year temporary period will apply in lieu of the three-year temporary period, if the issuer can satisfy the Expenditure Test, the Time Test and the Due Diligence Test and both the issuer and a licensed architect or engineer certifies that the longer period is necessary to complete the project.<sup>106</sup>

Most tax-exempt health care and long term care facilities bond issues, regardless of issuer, require new money for capital purposes to be deposited into a special fund entitled the “project fund” or “capital projects fund.” Prior to bond issuance, bond counsel will ascertain that the issuer expects to meet the Expenditure Test, the Time Test and the Due Diligence Test with respect to the money

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<sup>102</sup> I.R.C. § 103(b)(2).

<sup>103</sup> I.R.C. § 148.

<sup>104</sup> Treas. Reg. § 1.148-2(a).

<sup>105</sup> Treas. Reg. § 1.148-2(e)(5)(ii).

<sup>106</sup> Treas. Reg. § 1.148-2(e)(2).

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in such funds, and the issuer will certify those expectations in a nonarbitrage certificate or tax agreement delivered at closing. As a result, the bond proceeds in such funds will typically qualify for the three (or five, as applicable) year temporary period permitted under the Code.

### 7.3.6.1.1.3 General Temporary Periods for Other Bond Proceeds

The temporary period for most other bond proceeds, including proceeds of a short term current refunding issue, proceeds allocable to the payment of issuance costs and proceeds not otherwise eligible for a temporary period, is 30 days.<sup>107</sup> The temporary period for proceeds of any other current refunding issue is 90 days.<sup>108</sup>

Tax-exempt health care and long term facilities bond transactions are typically structured to insure early expenditure of such proceeds and most qualify for this temporary period exception to the Code's arbitrage yield restrictions with respect to such proceeds.

### 7.3.6.1.2 Reasonably Required Reserve and Replacement Fund Exception

Another important exception to the Code's arbitrage yield restrictions is applicable to proceeds that are part of a "reasonably required reserve or replacement fund." So long as no more than 10% of the stated principal amount of a bond issue is used to finance a reserve or replacement fund and the amount of proceeds in such fund does not exceed (i) an amount equal to the least of 10% of the stated principal amount of the issue, (ii) the maximum annual principal and interest requirements on the issue or (iii) 125% of the average annual principal and interest requirements on the issue, the amounts in such reasonably required reserve or replacement fund may be invested in higher-yielding investments.<sup>109</sup> Many tax-exempt health care and long term care facilities revenue bond issues (but not general obligation bond issues) have a reserve fund or account which has been structured to meet these requirements.

## 7.3.6.2 Arbitrage Rebate

Even if bond proceeds qualify for a temporary period or other exception to the Code's arbitrage yield restriction requirements, rebate of arbitrage earnings may be required under the Code.<sup>110</sup> Section 148 of the Code generally provides that bonds will be considered arbitrage bonds unless the income earned on the investment of the gross proceeds of such bonds in excess of the amount that would have been earned had such proceeds been invested at a rate equal to the yield on the issue is paid to the United States in installments which are made at least once every five years. However, the Code and regulations also provide the following important exceptions from rebate: (i) the six-month expenditure exception; (ii) the 18-month expenditure exception; (iii) the two-year construction expenditure exception; (iv) the *bona fide* debt service fund exception; and (v) the \$5,000,000 small issuer exception. Whenever possible, tax-exempt bond issues are structured to take advantage of one or more of these exceptions to rebate.

### 7.3.6.2.1 Six-Month Expenditure Exception

The Code and regulations provide generally that if the gross proceeds of a bond issue (not including amounts in a *bona fide* debt service fund, a reasonably required reserve or replacement fund and certain other amounts) are fully expended for the governmental purposes of the issue within six months after the issue date, the bond issue will be treated as having met the rebate requirements as long as amounts not required to be spent (excluding amounts in a *bona fide* debt service fund, which is otherwise exempt from rebate) continue to meet the rebate requirement.<sup>111</sup>

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<sup>107</sup> Treas. Reg. §§ 1.148-2(e)(7); 1.148-9(d)(2)(i); 1.148-9(d)(2)(ii)(B).

<sup>108</sup> Treas. Reg. § 1.148-9(d)(2)(ii)(A).

<sup>109</sup> Treas. Reg. § 1.148-2(f).

<sup>110</sup> I.R.C. § 148(f).

<sup>111</sup> I.R.C. § 148(f)(4)(B); Treas. Reg. § 1.148-7(c).

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### 7.3.6.2.2 Eighteen-Month Expenditure Exception

Even if all of the proceeds of an issue of tax-exempt bonds are not spent within six months of their issue date, the earnings on such proceeds will still be exempt from rebate if the gross proceeds of the bonds are spent for the governmental purposes of the issue within 18 months of the issue date in accordance with the following schedule:

- At least 15% within six months following the date of issue;
- At least 60% within 12 months following the date of issue; and
- 100% of the gross proceeds of the bonds (including 100% of actual investment earnings on such gross proceeds) within 18 months following the date of issue; provided that, if necessary to ensure compliance with the contracts for construction or other reasonable business purposes, the issuer may elect to retain an amount equal to not more than 5% of the net sale proceeds of the bond at the end of this 18-month period as a reasonable retainage and, if so, must expend all of the gross proceeds of the bonds except for the reasonable retainage within 18 months after the date of issue and 100% of such gross proceeds including the reasonable retainage within 30 months after the date of issue.<sup>112</sup>

### 7.3.6.2.3 Two-Year Construction Expenditure Exception

An exception similar to the 18-month exception applies to “available construction proceeds” of governmental bonds or qualified 501(c)(3) bonds that are “construction issues.” A “construction issue” means any issue that is not a refunding issue if “the issuer reasonably expects, as of the issue date, that at least 75% of the ‘available construction proceeds’ of the issue will be allocated to construction expenditures.”<sup>113</sup> Construction is deemed to include reconstruction and rehabilitation.<sup>114</sup> An issuer may elect to “bifurcate” a multi-purpose nonrefunding issue (or the nonrefunding portion of any multi-purpose issue, including a refunding issue) into a construction issue and a non-construction issue to qualify the construction issue for the two-year expenditure exception from rebate and, potentially, the other for a different rebate exception.<sup>115</sup>

“Available construction proceeds” means the issue price of the construction issue, plus the earnings thereon and on amounts in a reasonably required reserve or replacement fund not funded from the issue (and earnings on all of the foregoing earnings), less amounts in any reasonably required reserve or replacement fund and issuance costs financed by the issue.<sup>116</sup>

The two-year expenditure exception will apply to the available construction proceeds of a construction issue if they are spent for the governmental purposes of the issue within two years after the date of issue in accordance with the following schedule:

- At least 10% of the available construction proceeds are expended within six months following the date of issue;
- At least 45% of the available construction proceeds are expended within one year following the date of issue;
- At least 75% of the available construction proceeds are expended with 18 months following the date of issue; and

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<sup>112</sup> Treas. Reg. § 1.148-7(d).

<sup>113</sup> Treas. Reg. § 1.148-7(f)(1).

<sup>114</sup> I.R.C. § 148(f)(4)(C)(iv).

<sup>115</sup> I.R.C. § 148(f)(4)(C)(v); Treas. Reg. § 1.148-7(j)(1).

<sup>116</sup> I.R.C. § 148(f)(4)(C)(vi).

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- 100% of the available construction proceeds are expended within two years following the date of issue; provided that, if necessary to ensure or promote compliance with the construction contracts or other reasonable business purposes, the issuer may elect to retain an amount equal to not more than 5% of the available construction proceeds as a reasonable retainage and, if so, must spend all of the available construction proceeds of the bonds except for the reasonable retainage within two years following the date of issue and 100% of the available construction proceeds including the reasonable retainage within three years following the date of issue.<sup>117</sup>

### 7.3.6.2.4 Bona Fide Debt Service Fund Exception

Under the Code, amounts earned on a *bona fide* debt service fund are not taken into account for the computation of rebate if the gross earnings on such fund during any bond year are less than \$100,000.<sup>118</sup> The regulations further provide that an issue will be deemed to satisfy the \$100,000 earnings exception if annual debt service does not exceed \$2,500,000.<sup>119</sup> For governmental bonds with an average maturity of at least five years and with a fixed rate of interest for the term of the issue, the \$100,000 limit is waived and all gross earnings on *bona fide* debt service funds are excluded from the rebate requirements; however, qualified 501(c)(3) bonds and exempt facility bonds for qualified residential rental projects must observe the \$100,000 limit.<sup>120</sup> Tax-exempt bonds for health care and long term care facilities (regardless of issuer) will usually qualify for this exception given the typical amounts and timing of payments into and out of their *bona fide* debt service funds.

### 7.3.6.2.5 \$5 Million Small Issuer Exception

The Code provides that bonds issued to finance governmental activities of certain “small issuers” are relieved of the arbitrage rebate requirement.<sup>121</sup> To qualify for this exception, the so-called small issuer must be a governmental unit with general taxing powers, the bonds may not be private activity bonds (including qualified 501(c)(3) bonds), at least 95% of the net proceeds of the bonds are to be used for the local governmental activities of the issuer and the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by such issuer during the same calendar year is not reasonably expected to exceed \$5,000,000.<sup>122</sup> In Washington, this exception will be primarily useful with respect to small governmental bond issues of public hospital districts. Statewide agencies, such as the Authority and the Commission, have historically issued more than \$5 million in tax-exempt bonds in every calendar year since this exception became available.

### 7.3.6.3 Reimbursement from Bond Proceeds

To promote the early expenditure of bond proceeds and facilitate compliance with both the temporary exceptions to the Code’s arbitrage yield restrictions as well as the various spenddown exceptions to the Code’s arbitrage rebate requirements, the Code permits the use of tax-exempt bond proceeds to reimburse certain expenditures made prior to the issuance of the bonds. Such reimbursements must be for capital expenditures or issuance costs related to a project undertaken pursuant to a statement of “official intent” by the issuer (or in the case of qualified 501(c)(3) bonds, a conduit borrower) to reimburse itself from bond proceeds.<sup>123</sup> The statement of official intent must be adopted not later than 60 days after payment of the expenditure to be reimbursed.<sup>124</sup> The statement of official intent can be made in any reasonable form,

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<sup>117</sup> I.R.C. § 148(f)(4)(C); Treas. Reg. § 1.148-7(e).

<sup>118</sup> I.R.C. § 148(f)(4)(A)(ii).

<sup>119</sup> Treas. Reg. § 1.148-3(k).

<sup>120</sup> I.R.C. § 148(f)(4)(A)(ii).

<sup>121</sup> I.R.C. § 148(f)(4)(D).

<sup>122</sup> See also Treas. Reg. § 1.148-8.

<sup>123</sup> See generally Treas. Reg. § 1.150-2.

<sup>124</sup> Treas. Reg. § 1.150-2(d).

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including issuer or 501(c)(3) conduit borrower resolution, and must contain a general description of the project or, alternatively, the name and functional purpose of the fund or account to be reimbursed and a statement of a maximum principal amount of bonds expected to be issued for the project.<sup>125</sup> An exception is provided to permit the reimbursement of expenditures for costs of issuance, a *de minimis* amount of the lesser of 5% of proceeds or \$100,000 and preliminary “soft costs” up to 20% of the issue price of the bonds without the need for any statement of official intent.<sup>126</sup>

To qualify, the allocation of bond proceeds to the reimbursement must be made no later than 18 months after the later of the date of expenditure or the date the project is placed in service or abandoned and in no event more than three years after the date of expenditure.<sup>127</sup> However, if the issuer qualifies as a “small issuer” under the arbitrage rebate rules discussed above, the issuer has three years instead of 18 months to make the reimbursement allocation.<sup>128</sup> Additionally, if the project is a “construction project” for which both the issuer and a licensed architect or engineer certify that at least five years is necessary to complete construction of the project, the maximum reimbursement allocation period is five years instead of three.<sup>129</sup> In any case, the reimbursement allocation must be made in writing, evidencing the use of proceeds to reimburse the original expenditure.<sup>130</sup>

### 7.3.7 Additional Requirements Applicable to All Tax-Exempt Bonds

In addition to the specific requirements applicable only to governmental bonds and qualified 501(c)(3) bonds, respectively, and the generally applicable arbitrage rebate requirements, the Code also contains a variety of miscellaneous requirements that are applicable to all tax-exempt obligations. The most important of these to tax-exempt health care and long term care facilities financings are the prohibition on tax-exempt advance refundings, the registration requirement, the prohibition against federal guaranties, the information reporting requirement and the change of use restrictions.

#### 7.3.7.1 Prohibition on Tax-Exempt Advance Refundings

“Advance refunding bonds” are refunding bonds that are issued more than 90 days prior to the redemption date of the refunded bonds.<sup>131</sup> Tax-exempt advance refunding transactions are prohibited.<sup>132</sup>

#### 7.3.7.2 Bond Registration

Most tax-exempt bonds must be issued in registered form; coupon or bearer bonds are no longer permitted. There are exceptions for bonds, which are of a type not offered to the public, and bonds that have a maturity of not more than a year.<sup>133</sup>

#### 7.3.7.3 Prohibition on Federal Guaranties

Generally, bonds will not qualify for tax-exemption if the payment of debt service is directly or indirectly guaranteed by the United States or most agencies or instrumentalities thereof (but not including the FHA, VA, FNMA, FHLMC, GNMA, SLMA (student loans only), BPA (pre-1984 only), or any of the Federal Home Loan Banks (but only through 2010)).<sup>134</sup> Participation in the federally supported Medicare and

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<sup>125</sup> Treas. Reg. § 1.150-2(e).

<sup>126</sup> Treas. Reg. § 1.150-2(f).

<sup>127</sup> Treas. Reg. § 1.150-2(d)(2)(i).

<sup>128</sup> Treas. Reg. § 1.150-2(d)(2)(ii).

<sup>129</sup> Treas. Reg. § 1.150-2(d)(2)(iii).

<sup>130</sup> Treas. Reg. § 1.150-2(c).

<sup>131</sup> I.R.C. § 149(d)(2).

<sup>132</sup> I.R.C. § 149(d)(1).

<sup>133</sup> I.R.C. § 149(a).

<sup>134</sup> I.R.C. § 149(b).

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Medicaid programs, which have been significant sources of revenues for most hospitals, does not constitute a federal guaranty of tax-exempt bonds.

### 7.3.7.4 Information Reporting, Post-Issuance Compliance and Schedule K

All issuers of tax-exempt bonds are required to report the issuance of such bonds to the IRS on forms 8038 (for private activity bonds, including qualified 501(c)(3) bonds and exempt facility bonds for qualified residential rental projects), 8038-G (for most governmental bonds, such as public hospital district general obligation or revenue bonds) and 8038-GC (for governmental bonds aggregating under \$100,000).<sup>135</sup>

Among other things, forms 8038 and 8038-G require an issuer to disclose whether it has established written procedures to monitor its ongoing compliance with the requirements of the Code relating to arbitrage/rebate and private business use. Many issuers, including conduit issuers, have adopted such procedures, and that may create requirements for borrowers in conduit financings. For example, by policy, the Authority and the Commission both require borrowers to adopt procedures for monitoring their own post-issuance compliance.

501(c)(3) Organizations are also required to file a form 990, an informational return, each year with the IRS. Schedule K to the form 990 requires that the organization provide certain supplemental information on their outstanding liabilities associated with all types of tax-exempt bond issues benefiting the organization. “Tax-exempt bond” for purposes of Schedule K includes any form of indebtedness under federal law, including a bond, note, loan or lease-purchase agreement. While both the form 8038 and Schedule K to the form 990 require reporting information on tax-exempt bond issues, the information to be reported differs slightly for each form. Thus, a 501(c)(3) Organization that has obtained tax-exempt bond financing for its health care or long term care facilities should ensure that the information reported on its Schedule K regarding those bonds is consistent with the information on the use of proceeds reported on the form 8038 filed by the issuer of those bonds.

### 7.3.7.5 Change in Use

The private activity bond rules under the Code make clear that the initial treatment of bonds as either tax-exempt governmental bonds, qualified 501(c)(3) bonds or exempt facility bonds for qualified residential rental projects depends on the reasonable expectations of the issuer and each conduit borrower on the date of issue as to the use of bond proceeds over the entire stated term of the issue.<sup>136</sup>

Notwithstanding the reasonable expectations on the date of issue, bonds that were tax-exempt at issuance might become taxable private activity bonds post-issuance if the issuer or the conduit borrower were to take a “deliberate action” subsequent to the issue date that causes the conditions of either the private business tests or the private loan financing test to be met.<sup>137</sup> Any action taken by the issuer or the conduit borrower that is within such entity’s control is a “deliberate action,” regardless of intent.<sup>138</sup> Actions that are treated as involuntary or compulsory conversions and actions that are taken in response to a regulatory directive made by the federal government are not treated as deliberate actions.<sup>139</sup> Additionally, dispositions of personal property in the ordinary course of an established governmental program are not treated as deliberate actions if: (a) the weighted average maturity of the bonds financing that personal property is not greater than 120% of the reasonably expected actual use of that property for governmental purposes; (b) the issuer reasonably expects on the issue date that the fair market value of that property on the date of disposition will not be greater than 25% of its cost; and (c) the property is no longer suitable for its governmental purposes on the date of disposition.<sup>140</sup> A disposition will be treated as occurring in the ordinary course if the issuer is required

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<sup>135</sup> I.R.C. § 149(e); Treas. Reg. § 1.149(e)-1.

<sup>136</sup> Treas. Reg. § 1.141-2(d).

<sup>137</sup> Treas. Reg. § 1.141-2(d)(1).

<sup>138</sup> Treas. Reg. § 1.141-2(d)(3).

<sup>139</sup> *Id.*

<sup>140</sup> Treas. Reg. § 1.141-2(d)(4).

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to deposit amounts received from such disposition in a commingled fund with substantial tax or other governmental revenues and the issuer reasonably expects to spend the amounts on government programs within six months from the date of commingling.<sup>141</sup>

Certain remedial actions, if taken, will prevent a deliberate action with respect to property financed by an issue of tax-exempt bonds from causing that issue to become an issue of taxable private activity bonds if:

- The issuer and the conduit borrower, if any, reasonably expected that the issue would meet neither the private business tests nor the private loan financing test for the entire term of the bonds;
- The weighted average maturity of the bonds is not greater than 120% of the average reasonably expected economic life of the financed property (as of the issue date) or the term of the bonds is not otherwise longer than is reasonably necessary for the governmental purposes of the issue;
- The terms of any arrangement that might otherwise have been a deliberate action are *bona fide* and arm's length, and the new user of the financed property pays fair market value;
- Any disposition proceeds received are treated as "gross proceeds" subject to the Code's arbitrage provisions; and
- Unless the remedial action taken involves the redemption or defeasance of all of the nonqualified bonds of the issue, all of the proceeds of the affected issue were expended on the governmental purpose prior to the date of the deliberate action.<sup>142</sup>

Any of the following remedial actions will negate a deliberate action involving private business use:

- Redemption of all of the nonqualified bonds within 90 days of the deliberate action, or alternatively, the establishment of an irrevocable defeasance escrow to redeem such bonds on their earliest redemption date.<sup>143</sup>
- A similar method may be used as an "anticipatory" remedial action. This occurs if the issuer declares its official intent to redeem or defease all of the bonds that would become nonqualified bonds in the event of a subsequent deliberate action and redeems or defeases such bonds prior to that deliberate action.
- If the deliberate action is a disposition for which the consideration received is exclusively cash, application of such disposition proceeds for an alternative qualifying use (which, if the disposition proceeds will be used by a 501(c)(3) Organization, must satisfy all of the applicable requirements (such as a new TEFRA notice and hearing, if necessary) for qualified 501(c)(3) bonds as if the bonds were reissued on the date of the deliberate action).<sup>144</sup>
- Use of the bond financed property in an alternative manner that can be made to qualify by treating the bonds as reissued on the date of the deliberate action, and if (i) the deliberate action does not involve a disposition to a purchaser that finances the acquisition with proceeds of another issue of tax-exempt bonds, and (ii) any disposition proceeds (other than those arising from an agreement to provide services) are used to pay debt service on the bonds on the next

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<sup>141</sup> Treas. Reg. § 1.141-2(d)(4)(ii).

<sup>142</sup> Treas. Reg. § 1.141-12(a).

<sup>143</sup> Treas. Reg. § 1.141-12(d).

<sup>144</sup> Treas. Reg. § 1.141-12(e).

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available payment date or, within 90 days of the date receipt, are deposited into a restricted yield escrow to pay such debt service on the next available payment date.<sup>145</sup>

### 7.3.8 Qualification for Bank Eligibility

In 1986, Congress amended the Code to eliminate a partial deduction previously allowable to banks and other financial institutions for that portion of their interest expense which is allocable to carrying tax-exempt bonds, subject to an exception for governmental bonds and qualified 501(c)(3) bonds specifically designated by an issuer which reasonably anticipates to issue, together with its subordinate (but not controlling) entities, not more than \$10,000,000 of tax-exempt obligations (other than private activity bonds) during the calendar year.<sup>146</sup> Where available, this exception will make bonds qualifying for its provisions more attractive to a broader market of financial institutions than nonqualifying bonds.

### 7.3.9 Management Contracts in Tax-Exempt Bond-Financed Facilities (Summary of Revenue Procedure 2017-13)

The Code restricts the amount of tax-exempt bond proceeds that may be allocated to private business use. In the context of a tax-exempt health care or long term care financing, private business use may arise whenever a 501(c)(3) or local governmental health care or long term care provider (a “Health Care Provider”) enters into a “management contract” with a third party (e.g., a physician group or a management company). A “management contract” means a management, service, or incentive payment contract between the Health Care Provider and a service provider (such as a physician group or a management service) under which the service provider provides services for a managed facility after it is placed in service. For example, a contract for provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

Revenue Procedure 2017-13 provides a safe harbor that, if the requirements are satisfied, will ensure a management contract does not give rise to private business use.

#### 7.3.9.1 Safe Harbor Requirements under Revenue Procedure 2017-13

To ensure a management contract does not give rise to private business use, the contract must satisfy the following requirements:

1. The contract must provide for reasonable compensation for services rendered. Compensation includes payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider.
2. Compensation to the service provider under the management contract must not be based, in whole or in part, on net profits or net losses from the operation of the managed facility.
  - Incentive compensation is allowed if it is determined by the service provider’s performance in meeting one or more standards that measure quality of services, performance or productivity.
  - The timing and payment of compensation may not be contingent upon the managed facility’s net losses.

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<sup>145</sup> Treas. Reg. § 1.141-12(f).

<sup>146</sup> I.R.C. § 265(b).

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- A service provider whose compensation is reduced by a stated dollar amount for failure to keep the managed facility's expenses below a specified target will not be treated as bearing a share of net losses.
  - Deferrals of payment of compensation due to insufficient net cash flows from the operation of the managed property is allowed so long as the management contract includes requirements that (i) the compensation is payable at least annually, (ii) the Health Care Provider is subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees, and (iii) the Health Care Provider will pay such deferred compensation and interest or late payment fees no later than the end of five years after the original due date of the payment.
  - Compensation based on a capitation fee, a periodic fixed fee or a per-unit fee, each as defined below in Section 7.3.9.4, is allowed.
3. The term of the contract, including all renewal options, must not be longer than 30 years or 80% of the weighted average reasonably expected economic life of the managed property, whichever is shorter.
  4. The Health Care Provider must exercise a significant degree of control over the use of the managed property. This requirement is met if the management contract requires the Health Care Provider to approve (i) the annual budget of the managed facility, (ii) capital expenditures with respect to the managed property, (iii) each disposition of property that is part of the managed property, (iv) rates charged for the use of the managed property and the general nature and (v) type of use of the managed property.
  5. The Health Care Provider must bear the risk of loss upon damage or destruction of the managed property (for example, due to force majeure). Insuring against risk of loss through a third party, or imposing upon the service provider a penalty for failure to operate the managed facility in accordance with standards set forth in the management contract, are allowed.
  6. The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider with respect to the managed property, including claiming depreciation or amortization deduction, investment tax credit or deduction for any payment as rent with respect to the managed property.
  7. The service provider must not have any role or relationship with the Health Care Provider that substantially limits the Health Care Provider's ability to exercise its rights under the management contract. In this regard:
    - No more than 20% of the voting power of the governing body of the Health Care Provider may be vested in the service provider's directors, officers, shareholders, partners, members and employees.
    - The Health Care Provider's governing body must not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body.
    - The service provider's chief executive officer may not be the chief executive officer of the Health Care Provider or any of its related parties.

### 7.3.9.2 Functionally Related and Subordinate Use

A service provider's use of a project that is functionally related and subordinate to performance of its services under a management contract will not result in private business use of that project. For example, use of storage areas to store equipment used to perform activities required under a management contract does not result in private business use.

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### 7.3.9.3 Authorized Contracts

The following arrangements generally are not treated as management contracts that give rise to private business use:

- Contracts for services that are solely incidental to the primary governmental function of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing or similar services);
- Mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services if those privileges are available to all qualified physicians in the area, consistent with the size and nature of the hospital's facilities; and
- A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.<sup>147</sup>

### 7.3.9.4 Definitions

*“Capitation fee”* means a fixed periodic amount for each person for whom the service provider or the Health Care Provider assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially. For example, a capitation fee includes a fixed dollar amount payable per month to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified period. A fixed periodic amount may include an automatic increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective, external standards. A capitation fee may include a variable component of up to 20 percent of the total capitation fee designed to protect the service provider against risks such as a catastrophic loss.

*“Periodic fixed fee”* means a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective, external standards. Capitation fees and per-unit fees are not periodic fixed fees.

*“Per-unit fee”* means a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the Health Care Provider. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fee arrangements. A fee that is a stated dollar amount specified in the contract does not fail to be a per-unit fee as a result of a provision under which the fee may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective, external standards.

### 7.3.9.5 Applicability of Revenue Procedure 2017-13

Revenue Procedure 2017-13 replaces prior guidance relating to management contracts, most notably Revenue Procedure 97-13. Revenue Procedure 2017-13 applies to all management contracts entered into or materially modified after August 18, 2017. For all other prior management contracts, prior guidance will apply.

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<sup>147</sup> Treas. Reg. § 1.141-3(b)(4)(iii).

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### **7.3.10 Research Agreements in Tax-Exempt Bond-Financed Facilities (Summary of Revenue Procedure 2007-47)**

The Code restricts the amount of tax-exempt bond proceeds that may be allocated to private business use. Private business use may arise whenever a Health Care Provider enters into a research agreement with a third party, such as a drug company or a medical corporation, which involves the use of bond-financed facilities by such third party in its trade or business.

Revenue Procedure 2007-47 provides certain safe harbors for determining whether a research agreement involving the use of bond-financed facilities gives rise to private business use. The following summary describes the safe harbor conditions, which if satisfied by a research agreement, will not result in private business use.

#### **7.3.10.1 Corporate-Sponsored Research**

A research agreement relating to bond-financed property used for basic research supported or sponsored by a sponsor will not result in private business use if:

1. Any license or other use of resulting technology by the sponsor is permitted only on the same terms as would be permitted to any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use); and
2. The price to be paid for such use will be determined at the time the license or other resulting technology is available for use. Although the recipient need not permit persons other than the sponsor to use any license or other resulting technology, the price paid by the sponsor must be no less than the price that would be paid by any non-sponsoring party for those same rights.

#### **7.3.10.2 Industry or Federally Sponsored Research Agreements**

A research agreement relating to bond-financed property used pursuant to an industry or federally-sponsored research arrangement will not result in private business use if:

1. A single sponsor agrees, or multiple sponsors agree, to fund governmentally performed basic research;
2. The research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research) is determined by the Health Care Provider;
3. Title to any patent or other product incidentally resulting from the basic research must lie exclusively with the Health Care Provider; and
4. The sponsor or sponsors may receive only a nonexclusive, royalty-free license to use any product of the research.

Under the Bayh-Dole Act, the federal government and sponsoring federal agencies receive certain rights to inventions that result from federally funded research activities performed by non-sponsoring parties pursuant to contracts, grants or cooperative research agreements with the sponsoring federal agencies. Revenue Procedure 2007-47 also clarifies that the rights reserved to the federal government and its agencies under the Bayh-Dole Act will not cause an industry or federally sponsored research agreement to fail to meet the above requirements so long as the requirements set forth in items 2 and 3 above are met and the license granted to any party other than the Health Care Provider to use the product of the research is no more than a nonexclusive, royalty-free license.

#### **7.3.10.3 Definitions**

“*Basic research*” means any original investigation for the advancement of scientific knowledge not having a specific commercial objective. For example, product testing supporting the trade or business of a specific nongovernmental person is not treated as basic research.

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“*Sponsor*” means any person, other than a qualified user, that supports or sponsors research under the contract.

### 7.4 Taxable Bonds

Simply put, taxable bonds are bonds that do not qualify for tax-exemption under the Code. All of the Washington governmental issuers authorized to issue tax-exempt bonds to finance health care or long term care facilities may also issue taxable bonds for the same purposes, simply by choosing to ignore the federal tax law requirements to attain tax-exemption. Moreover, as a matter of law, nongovernmental Health Care Providers may directly issue their own taxable obligations to finance capital facilities. Such taxable bonds are most frequently issued when the spread between taxable interest rates and tax-exempt interest rates is low, and particularly where the operational flexibility resulting from not having to comply with the federal tax law’s private business and arbitrage requirements is desirable or necessary. Taxable bonds may be issued on their own or in conjunction with tax-exempt bonds, which is most common in connection with mixed use projects that include components that might not qualify for tax-exempt financing, such as a capital improvements to a hospital campus including a medical office building to be leased to private physicians, or to finance bond issuance costs in excess of the 2% limit imposed by the Code. While large issues of taxable bonds for highly rated health care or long term care systems may be publicly offered, most such taxable bonds are directly placed with a financial institution, such as a commercial bank.

### 7.5 Securities Laws Issues

Federal and state securities laws are generally aimed at protecting the investing public. Through the process of “registration” of an issuer’s securities, with state and/or federal regulators, specific information about the issuer and the securities to be offered is compiled and disseminated to the investing public. There are state and federal exemptions to the registration requirement for certain kinds of issuers as well as for certain kinds of securities. Whether registration is required or not, the framework of the securities laws is designed to blend two distinct but related strains: disclosure of material information to adequately inform the investing public and prevention of fraud in the purchase and sale of securities.

#### 7.5.1 Securities Registration Under State and Federal Securities Laws

As stated above, unless a security or a transaction qualifies for an exemption under the relevant securities laws, securities must be registered (i) with the Securities and Exchange Commission (the “SEC”) before they are offered or sold to investors, and (ii) if issued by a Washington issuer, with the Securities Division of the State Department of Financial Institutions. Pursuant to 1996 amendments to the federal Securities Act of 1933<sup>148</sup> (as amended, the “1933 Act”), federal law pre-empts most state laws requiring registration of securities issued by issuers located in another state. During the registration process, the issuer must follow strict disclosure guidelines which detail relevant and material information about the issuer, its business, operations and management and financial condition. Registration is often a time-consuming and expensive procedure (in part because financial statements audited by independent accountants are required to be included in the disclosure document) and issuers will avoid the necessity of registration where possible. To escape from the registration requirement, an issuer must be able to draw one of three conclusions: (1) the security to be issued is not a “security” within the meaning of the various applicable securities acts; (2) the security is statutorily exempt from the registration requirement; or (3) the transaction in which the securities are to be offered is statutorily exempt from such requirement.

##### 7.5.1.1 Definition of “Security;” Separate Securities

The starting point in the analysis of whether registration is required is an examination of the instrument to be issued to determine whether it is a security. The definition of “security” for these purposes under federal securities law is found in the 1933 Act. It is an extremely broad definition and includes, among other things, any note, stock, treasury stock, bond, debenture, evidence of indebtedness, . . . investment contract, . . . any put,

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<sup>148</sup> 15 U.S.C. §§ 77a to 77aa (the “1933 Act”).

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call, straddle, option or privilege on any security,...or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of or warrant or right to subscribe to or purchase, any of the foregoing.<sup>149</sup> A similarly broad definition is also included in the Securities Act of Washington (the “Washington Securities Act”).<sup>150</sup>

An issuer must look at the entire transaction in which securities are to be offered to determine whether and how many different types of securities are involved. For example, consider a conduit bond financing for a nonprofit 501(c)(3) hospital through the Authority. At its most basic, the transaction will be structured as follows: the Authority issues bonds that will be sold to an underwriter, for further resale by the underwriter to the investing public. The Authority loans the proceeds of the bonds to the hospital. The hospital promises to repay the loan pursuant to a loan agreement between the Authority and the hospital. Further, assume that the hospital obtains a letter of credit from a bank to secure the hospital’s obligations to repay the loan under the loan agreement. The hospital also enters into a “reimbursement agreement” with the bank issuing the letter of credit, which obligates the hospital to repay to the bank any draws, made under the letter of credit. Under this scenario, there are at least three distinct securities—the bonds issued by the Authority, the loan agreement (in that it is an “evidence of indebtedness”) and the letter of credit “issued” by the bank, which “guarantees” payment of the bonds or payment of the loan.

Following determination of what securities, if any, are involved, registration of each such security will be required unless, in each instance, there is either an applicable exemption or the security, although distinct, is not deemed to be “separate” from the underlying security.

### 7.5.1.2 Exempt Securities

The 1933 Act exempts from the registration provisions (but not from the so-called “antifraud provisions”) any “security issued or guaranteed by . . . any State of the United States, or by any political subdivision of a State . . . or by any public instrumentality of one or more States . . . .”<sup>151</sup> Thus, in the example given above, the Authority’s bonds do not need to be registered under the 1933 Act, because the Authority qualifies as a “political subdivision.” The same is true for bonds issued by the Commission and WHEFA. Public hospital districts and public housing authorities are “public instrumentalities” and their bonds are likewise exempt.<sup>152</sup>

The loan agreement in the example given above may not be treated as a separate security if it is sufficiently linked to the bonds to share its exemption. No express language in the 1933 Act supports this conclusion. However, in a series of no-action letters, the staff of the SEC has taken the position that when the obligor under the loan agreement (or a guaranty) is also a participant and user of the project to be financed with tax-exempt bonds, the promise to pay which is evidenced by the loan agreement (or the guaranty) is inseparable from the underlying bond and could, therefore, share its exemption. Alternatively, if the loan agreement in a conduit financing for a health care or long term care facility owned and operated by a 501(c)(3) Organization were to be treated as a separate security, it would be eligible for a separate exemption under the 1933 Act for any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit and no part of the net earnings of which inures to the benefit of any person, private stockholder or individual.<sup>153</sup>

The 1933 Act also exempts “any security issued or guaranteed by any bank” where the definition of “bank” is “any national bank, or any banking institution organized under the laws of any State, . . . the business of which is substantially confined to banking and is supervised by the State . . . .”<sup>154</sup> Thus, the third distinct

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<sup>149</sup> 1933 Act § 2(9)(1).

<sup>150</sup> Chapter 21.20 RCW; RCW 21.20.005(17).

<sup>151</sup> 1933 Act § 3(a)(2).

<sup>152</sup> *Id.*

<sup>153</sup> 1933 Act § 3(a)(4).

<sup>154</sup> 1933 Act § 3(a)(2).

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security in the example above, the letter of credit, also will be exempt from the registration requirements of the 1933 Act.

The same analysis must be undertaken to insure compliance with the registration requirements of the Washington Securities Act. Analogous to the 1933 Act, an exemption is provided for any “security (including a revenue obligation) issued or guaranteed by . . . any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing . . . ,”<sup>155</sup> but it does not apply if the security is “payable solely from revenues to be received from a nongovernmental industrial or commercial enterprise . . . : PROVIDED, That the director [of the State Department of Financial Institutions], by rule or order, may exempt any security payable solely from revenues to be received from a nongovernmental industrial or commercial enterprise if the director finds that registration with respect to such securities is not necessary in the public interest and for the protection of investors.”<sup>156</sup> Hospitals and health care facilities are specifically deemed to be an industrial or commercial enterprise.<sup>157</sup> The exemption is nonetheless available for bonds financing governmental or long term care facilities, such as those owned by public hospital districts. Authority bonds to finance nonprofit hospitals or other health care facilities do not qualify for the statutory exemption but must either be sold in exempt transactions or qualify for exemption under the terms of an Order of Exemption issued to the Authority for those of its bonds which are rated “at least ‘A’ from a nationally recognized bond rating service firm.”<sup>158</sup>

The Washington Securities Act also includes an exemption for securities “issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States, or any bank or trust company organized or supervised under the laws of any state.”<sup>159</sup> Therefore, the letter of credit and any bonds that it guarantees in the example given above will also be exempt.

Finally, by rule, the State Securities Division has declared exempt any security which would otherwise be exempt from registration except that it is payable from a nongovernmental industrial or commercial enterprise if (1) it receives a rating from Standard & Poor’s of “AA” or better or the equivalent rating from Moody’s Investors Service, or (2) the security is issued to fund a single-family mortgage loan program established and operated by a state housing finance agency and Standard & Poor’s and Moody’s has rated it at least “A+” or its equivalent.<sup>160</sup> This exemption and the one available for bonds guaranteed by a bank letter of credit are the ones most often utilized for bonds issued by the Commission and conduit bonds issued by public housing authorities.

Under either the federal or State securities laws, an exempt security retains that characteristic and generally may be resold without restriction.

### 7.5.1.3 Exempt Transactions

Even if the securities to be issued and sold are not exempt from registration, registration still may not be required if the transaction is an “exempt transaction.” Such transactions are exempt because the purchasers of the securities have the necessary business experience and sophistication or have a high enough net worth and also have access to the kind of information which would have been disclosed through the registration process, so that such purchasers can make an informed judgment about whether to make an investment in the issuer’s securities without the need for registration.

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<sup>155</sup> RCW 21.20.310(1).

<sup>156</sup> *Id.*

<sup>157</sup> WAC 460-42A-020.

<sup>158</sup> *In re Wash. Health Care Facilities Auth.*, SDO-121-89 (Sept. 18, 1989) (Granting an order of exemption under RCW 21.20.310(1)).

<sup>159</sup> RCW 21.20.310(3).

<sup>160</sup> WAC 460-42A-030.

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Under the 1933 Act and its related regulations,<sup>161</sup> as well as the Washington Securities Act and its regulations,<sup>162</sup> direct placements and private placements are exempt transactions. Thus, the direct sale of a security to most financial institutions do not require registration.

It is important to remember that such security is not exempt, only the transaction would be. Therefore, any attempt to resell such security must be effected pursuant to registration, unless that subsequent transaction also qualifies as an exempt transaction.

### 7.5.2 Antifraud Provisions and Disclosure

The securities laws, as noted above, are structured to provide disclosure to potential investors through the registration process unless the security to be issued and sold, or the offer of sale itself, is exempt. Regardless of whether registration is required, the information disclosed must be complete and accurate so that the potential and actual investors may make informed investment decisions. Failure to meet this standard may invoke certain penalties under both state and federal law—the so-called “antifraud provisions.”

#### 7.5.2.1 Federal Law

The federal antifraud provisions are found in both the 1933 Act and the federal Securities and Exchange Act of 1934, as amended (the “1934 Act”).<sup>163</sup> Section 17(a) of the 1933 Act prohibits making false or misleading statements in connection with offers or sales of securities. This provision applies only to buyers; therefore, a defrauded seller cannot seek relief under this section. Section 10(b) of the 1934 Act, as implemented by the related SEC Rule 10b-5, also prohibits the making of materially false or misleading statements in the purchase or sale of securities. Both purchasers and sellers of securities may find protection under this provision of the 1934 Act, but only in connection with sales, as opposed to offers to sell.

“Scienter,” which is a mental state embracing a person’s intent to deceive, manipulate or defraud, is a necessary element in both SEC enforcement actions and private suits under Rule 10b-5.<sup>164</sup> Proof of negligence alone will support a SEC enforcement action for most violations of Section 17 of the 1933 Act, but scienter must be proven in private suits under Section 17(a) of the 1933 Act.<sup>165</sup>

#### 7.5.2.2 State Law

Under Washington law, it is unlawful to make any untrue or materially misleading statement in connection with an offer, sale or purchase of any security.<sup>166</sup>

Violations of the State’s antifraud requirements are punishable by criminal penalties<sup>167</sup> and private damage actions.<sup>168</sup> Liability for private causes of action will generally be found if the seller was negligent in failing to ensure that the disclosure was free of material misstatements or omissions.<sup>169</sup> However, scienter must be proven against issuer officials (but not bond counsel or underwriters) of municipal bonds exempt from registration.<sup>170</sup>

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<sup>161</sup> See generally 1933 Act, § 4; 17 C.F.R. § 230.144 (“Rule 144”); 17 C.F.R. § 230.144A (“Rule 144A”).

<sup>162</sup> See generally RCW 21.20.320; chapter 460-44A WAC.

<sup>163</sup> 15 U.S.C. §§ 77a, *et seq.*

<sup>164</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *Aaron v. S.E.C.*, 446 U.S. 680, 691 (1980).

<sup>165</sup> *Aaron*, 446 U.S. at 695-700.

<sup>166</sup> RCW 21.20.010.

<sup>167</sup> RCW 21.20.400.

<sup>168</sup> RCW 21.20.430.

<sup>169</sup> *Kittilson v. Ford*, 93 Wn. 2d 223, 225 (1980) (holding that scienter is not required).

<sup>170</sup> RCW 21.20.430(7).

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### 7.5.2.3 Due Diligence Defense

It is the view of the SEC that an underwriter impliedly makes a recommendation to purchase securities when it takes part in an offering. The underwriter is assumed to have a reasonable belief for making such recommendation. Thus, an underwriter may be held liable under the antifraud provisions if the disclosure provided in the official statement is inadequate. To satisfy its obligations and provide a defense to such a charge, an underwriter must investigate the information provided and included in the official statement. This inquiry is known as “due diligence” and its benefits have been informally extended, by analogy, to the other participants in the securities transaction, including counsel and conduit issuer officials. Whether any party’s inquiry will be sufficient to provide such a defense depends on a number of factors, including whether such underwriter relied on municipal officials, employees, experts and other persons whose duties have given them knowledge of particular fact, the type of bonds being offered and the familiarity of that party with the issuer.<sup>171</sup>

### 7.5.2.4 Continuing Disclosure Obligations

Underwriters who purchase municipal securities through a primary offering to the public, whether through a negotiated sale or by competitive bid, generally must comply with the SEC’s Rule 15c2-12 (the “Rule”). Although the Rule technically applies only to the underwriters of municipal securities, the duties imposed by the Rule on such underwriters have the practical effect of imposing on issuers and certain other “obligated persons”<sup>172</sup> disclosure requirements for their primary offerings and the duty to update the market with ongoing periodic disclosures. Under the Rule, before an underwriter may purchase municipal securities in a primary offering, the underwriter must have obtained (A) an “official statement” from the issuer containing the information required under the Rule, and (B) a written undertaking from the issuer and/or other obligated persons that, at a minimum, requires the following information be provided to the secondary market through the Municipal Securities Rulemaking Board’s EMMA website ([www.emma.msrb.org](http://www.emma.msrb.org)) by the deadlines set forth in the undertaking: (1) updates to financial and operating information presented in the final official statement on an annual basis; (2) if not submitted as part of the annual financial data, audited financial statements; (3) notice of certain listed events within 10 business days of their occurrence; and (4) notices of failure to comply with the annual disclosure requirements.<sup>173</sup>

There are exemptions from the Rule for offerings in an aggregate principal amount of less than \$1,000,000<sup>174</sup> and for certain private placements.<sup>175</sup> Further partial exemptions are provided for issuers and obligated persons with less than \$10,000,000 in securities outstanding and for bonds with less than 18-month maturities.<sup>176</sup>

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<sup>171</sup> Securities Exchange Act Release No. 26100 (Sept. 22, 1988).

<sup>172</sup> The term “obligated persons” is defined in the Rule to include entities that are committed by contract to support payment of all or part of an issuer’s bonds, which would include conduit borrowers that receive bond proceeds through a government issuer, such as the Authority, the Commission, WHEFA or a public housing authority.

<sup>173</sup> 17 CFR § 240.15c2-12(b)(5)(i). The list of events for which notice is to be provided was amended, effective February 27, 2019, to include (a) incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material; and (b) default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties. The Rule was further amended to define the term “financial obligation” to mean a (x) debt obligation; (y) derivative instrument entered into in connection with, or pledged as a security or a source of payment for, an existing or planned debt obligation; or (z) a guarantee of (x) or (y). Undertakings entered into on or after the effective date must reflect these amendments.

<sup>174</sup> 17 CFR § 240.15c2-12(a).

<sup>175</sup> 17 CFR § 240.15c2-12(d)(1).

<sup>176</sup> 17 CFR §§ 240.15c2-12(d)(2), 240.15c2-12(d)(3).

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A failure to comply with such undertaking may give rise to both a contractual claim (because the issuer has not lived up to its undertaking to provide information) as well as an antifraud claim (because the issuer has failed to provide material information to the secondary market).

Note that, even broader than the scope of the Rule, federal and State securities laws impose an obligation to correct any insufficient or misleading information previously disclosed, unless the prior misinformation has become stale or it is otherwise determined that investors would not be continuing to rely upon it.<sup>177</sup> Further, whenever the issuer “speaks,” whether formally (e.g., in the form of an official statement) or informally (e.g., in a press release), the information must be accurate and complete if it is reasonable to believe that such information will reach the investing public.<sup>178</sup>

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<sup>177</sup> *Ross v. A.G. Robins Co., Inc.*, 465 F. Supp. 904, 908 (S.D.N.Y. 1979), *rev'd in part*, 607 F.2d 545 (2<sup>nd</sup> Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

<sup>178</sup> *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 908 (2<sup>nd</sup> Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).