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Advisory

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PUBLIC FINANCE

IRS Issues Proposed Regulations and Closing Agreement Procedures for Hospital Acquisition Bonds

The Internal Revenue Service on April 5, 2002 released proposed regulations that are likely to spur the resumption of bond issues which finance consolidations of hospitals and other non-profit entities. Such consolidations often require the defeasance of outstanding bonds that financed the acquired assets. IRS audits of certain such “acquisition refinancings” had placed a cloud over the associated bond issues and resulted in a halt in new issuance for such purposes. The audits focused on whether the bonds issued by the acquiring entity should be treated as “new money” bonds or as refunding bonds that refunded the defeased debt. Refunding characterization could result in taxability if the bonds issued by the acquirer were deemed to constitute an impermissible additional advance refunding of the defeased bonds or a violation of arbitrage restrictions applicable to advance refundings.

The proposed regulations are generally supportive of the continued issuance of bonds in the context of hospital consolidations. The regulations clarify that an “acquisition refinancing” may be achieved through the acquisition from an unrelated party of (i) assets, (ii) stock (if an election is made to treat the stock purchase as an asset acquisition for tax purposes), or (iii) membership or similar interests conferring control of a 501(c)(3) organization or governmental unit. The ability to effectuate these types of financings through the acquisition of stock or membership interests was unclear prior to the proposed regulations. The proposed regulations provide that a refinancing of pre-existing tax-exempt debt associated with the acquired assets or acquired entity will not be treated as a refunding for tax purposes (including the limitations on the number of times tax-exempt bonds can be advance refunded) if it occurs within six months of the acquisition date (the so-called “six-month rule”).

Two additional conditions apply under the proposed regulations if the buyer and the seller of the acquired assets, stock or membership or other interests are “affiliated persons.” (A buyer is deemed “affiliated” to the seller if at any time during the six months preceding the acquisition more than 5% of the voting power of the governing body of the seller is held by the buyer and its directors, officers, owners or employees, or vice versa. Affiliation also exists for this purpose if during the one-year period beginning six months prior to the acquisition, the governing body of the buyer, or of any person that controls the buyer, is modified or established in a manner that grants direct or indirect representation on such governing body of the seller or the acquired entity.) If the transaction involves

“affiliated persons”, the defeased bonds must be redeemed on the earliest date on which such bonds are subject to redemption or, if later, within 90 days of the acquisition. In addition, the refinancing bonds must be treated as financing the assets that were financed by the defeased bonds for useful life and other tax purposes. The principal effect of these requirements is to preclude the escrowing of the defeased bonds to a date beyond their first call date. These restrictions do not apply to acquisition transactions between unaffiliated persons.

The proposed regulations also clarify that the obligor of bonds defeased in an acquisition financing cannot acquire control of the acquirer of the assets financed by such bonds. Accordingly, if the transaction documents provide that the obligor on the defeased bonds or any person related to such obligor prior to the transaction will have the right to appoint, directly or indirectly, the majority of the members of the governing body of the obligor on the refinancing bonds, such defeasance will be considered a refunding.

The proposed regulations are prospective in application, and do not clarify the status of bonds issued prior to their effective date. Although the proposed effective date of the regulations is the date such regulations are finalized, the IRS notice accompanying the regulations indicates that issuers may elect to apply the proposed regulations to any bond issue sold after the publication of the proposed regulations and prior to the publication of final regulations.

Together with the proposed regulations, the IRS announced the establishment of a closing agreement program for outstanding hospital consolidation bond issues that fit the following description: (1) the refinancing bonds were not characterized as refunding bonds and (2) the proceeds of the refinancing bonds were not treated as used for the purposes of the refinanced

bonds. The announcement indicates that this closing agreement program is not limited to bonds under audit. Any closing agreement pursuant to the announced program must be executed by December 31, 2002. The announcement does not clearly establish on what basis participants in prior acquisition refinancings should conclude that particular bond issues are at risk of being declared taxable by the IRS if they do not volunteer for a closing agreement. The closing agreement program requires that issuers of bonds seeking protection under the program either (1) pay to the IRS an amount equal to 30% of the present value of any earnings in excess of the yield on the refinancing bonds earned on investments in a defeasance escrow funded as part of an acquisition refinancing, or (2) restructure the refinancing bonds in such manner that they comply with tax code requirements if the proceeds of such bonds are deemed to have been used for the purposes of the refinanced bonds. While the meaning of the second option is not entirely clear, it appears to be directed at the useful life assumptions used in structuring some outstanding acquisition refinancing bond issues, and to require in certain instances a reduction of the average life of the refinancing bonds through early calls or tender offers.

The proposed regulations suggest that a political compromise was reached under which the IRS agreed to permit acquisition refinancings to go forward prospectively, whether structured as asset acquisitions or as corporate acquisitions, without being treated as refundings, subject to some regulatory changes designed (as is the case with the limitations on the number of advance refundings) to minimize the period during which two sets of tax-exempt bonds are outstanding for the same facilities. The closing agreement announcement likewise signals a compromise under which the IRS will not treat outstanding transactions that

“jumped the gun” on the proposed regulations as taxable as long as the hospitals in question forego some, but not all, of the economic benefits of having two sets of tax-exempt bonds outstanding with respect to the same facilities. It is noteworthy that the proposed regulations do not contain the arbitrage limitation which the closing agreement announcement’s sharing-of-“excess”-earnings rule would impose in certain circumstances on prior transactions (although the proposed regulations do, in certain circumstances, cut off the period during which such arguable arbitrage could be earned.)

The proposed regulations also may have the effect of clarifying the application of the six-month rule to bond issues for the benefit of for-profit entities. As noted above, in the context of non-profit hospital mergers the desirable outcome in most instances is to avoid refunding characterization of bonds issued within six months of a change in ownership of bond-financed assets. In the case of housing bonds and other exempt facility bonds involving for-profit obligors, the reverse is true. Because characterization as a new money issue of bonds issued within six months of a transfer of bond-financed assets to a for-profit obligor may require, for example, a new volume cap allocation, a refunding characterization is often essential in that context. The proposed regulations suggest that, in such a context, structuring the transaction as a stock purchase that is not treated as an asset acquisition may permit bonds issued to finance the transaction to be characterized as refunding bonds.

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