

Letter Ruling Alert

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Hospital Obtains Ruling that Process for Setting Interest Rates on Tax-Exempt Bonds Meets Requirements of Section 4958

Although the Service will not issue rulings on whether an exempt organization has established a rebuttable presumption that a transaction is not an excess benefit transaction under the intermediate sanctions rules, a recent private letter ruling illustrates that organizations may obtain rulings on important components of the criteria for establishing the rebuttable presumption.

In LTR 200413014 (see p. 197), the Service ruled that an organization's proposed process for setting the coupon rate for tax-exempt bonds that would be purchased indirectly by disqualified persons is an "offer received as part of an open and competitive bidding process" within the meaning of Treasury reg. section 53.4958-6(c)(2)(i). As discussed below, this ruling was a critical component in establishing the rebuttable presumption.

The facts of the ruling are that a section 501(c)(3) hospital plans to expand and renovate its existing facility. It intends to finance this project with the proceeds of tax-exempt bonds, consisting of a senior bond series and a subordinated bond series. The proceeds from the senior bonds and subordinated bonds will fund 90 percent and 10 percent of the project, respectively. The underwriter will establish the interest rate for the senior bonds after receiving competitive bids from prospective purchasers. The subordinated bonds will have a single fixed interest rate. The underwriter of the senior bonds, in the capacity of broker for the sale of the subordinated bonds, will determine the coupon rate for the subordinated bonds through an auction process. It is this auction process that was at issue in the ruling request.

The auction process involves seeking oral competitive bids on the subordinated bonds from a minimum of 10 accredited institutional and/or individual investors who will be identified by the broker. The bids must be in multiples of \$100,000 with a maximum bid of \$1.5 million from any one bidder. The total amount of the bids must be equal to or greater than \$3 million. The broker will maintain a bid summary sheet that sorts the bids by coupon rate in ascending order. The broker will then set the coupon rate at the lowest rate at which the bid amounts at or below that rate will purchase the face amount of subordinated bonds to be issued. The broker has no interest in the hospital other than the performance of services in connection with the issu-

ance of the bonds and provision of other unspecified financial services.

Sixty percent of the subordinated bonds will be issued in a private placement to accredited investors who are not related in any way to the hospital. However, 40 percent of the subordinated bonds will be issued to a limited liability company (LLC) whose owners will include three physicians who are voting members of the board of directors of the hospital, one physician who is a nonvoting director, and an affiliate of the hospital. The affiliate will also act as the LLC's manager. The sole purpose of the LLC is to own the subordinated bonds, disburse bond interest, facilitate transfers of ownership interests in the LLC, and regulate compliance with certain healthcare regulatory and tax requirements.

The members of the LLC will be limited to the manager, which as noted above is an affiliate of the hospital, and 20 to 35 physicians. All physician members must agree that they will not provide services to, or invest in, competitors of the hospital in the county in which the hospital is located. If a physician breaches his contract with the hospital or any of its affiliates, the LLC may purchase the defaulting member's units at 90 percent of par value plus accumulated interest.

The physicians who are directors of the hospital did not participate in the board's discussion or approval of issuance of the subordinated bonds and formation of the LLC, and they will not participate in the LLC's approval of its investment in the subordinated bonds.

The hospital requested a ruling that the process for setting the coupon rate for the subordinated bonds is an "offer received as part of an open and competitive bidding process" within the meaning of Treasury reg. section 53.4958-6(c)(2)(i). The Service concluded that because an independent broker set the coupon rate after receiving bids in a "common commercial competitive bidding process" involving disinterested investors, the "process constitutes an offer received as part of an open and competitive bidding process." The Service did not address whether any party to the transaction was a "disqualified person" under section 4958(f)(1), or whether the hospital would establish a rebuttable presumption that the transaction was not an excess benefit transaction under section 53.4958-6 of the regulations.

Section 4958 imposes excise taxes on any "disqualified person" who engages in an "excess benefit transaction" with an organization exempt under section 501(c)(3) or (4). An "excess benefit transaction" is any transaction in which an applicable organization

directly or indirectly provides an economic benefit to or for the use of a disqualified person that exceeds the value of the consideration received by the tax-exempt organization. Section 4958(c)(1)(A). Thus, the issue is whether the amount paid by the exempt organization to the disqualified person represents fair market value for the consideration received. In the context of LTR 200413014, the question is whether the interest rate paid on the subordinated bonds is fair market value. The regulations provide only that appraisals and "offers received by an open and competitive bidding process" are relevant information for valuing the transfer of property or the right to use property. Treas. reg. section 53.4958-6(c)(2).

Although the Service did not rule on whether any party to the transaction is a disqualified person, the ruling request is premised on the assumption that the subordinated bonds will be held by disqualified persons. The three physicians who are voting members of the hospital's board are per se disqualified persons with respect to the hospital under section 53.4958-3(c)(1) of the regulations, and the nonvoting physician/director could be a disqualified person under a facts and circumstances analysis. Although the subordinated bonds are purchased, not by the physicians but by the LLC in which they hold units, the sale of the bonds to the LLC and payment of interest to the LLC might be regarded as providing a benefit to the physician/directors indirectly through an intermediary. See Treas. reg. section 53.4958-4(a)(2). The ruling states that the director/physicians will not participate in the LLC's decision to purchase the bonds, a procedure that may be an effort by the physicians to avoid disqualified person status. In light of the fact that the sole purpose of the LLC is to purchase the bonds and conduct activities related to investing in the subordinated bonds, that the manager is an affiliate of the hospital, and that membership in the LLC is limited to physicians who agree not to provide services to or invest in competitors of the hospital, it is questionable whether the physicians' lack of participation in that decision would be considered meaningful. The LLC itself would be a disqualified person if the physicians owned 35 percent or more of the LLC, but it is not clear from the ruling whether this is a possibility.

The underlying issue of concern to the hospital is whether it will meet the requirements to establish a rebuttable presumption that purchase of the bonds by the LLC is not an excess benefit transaction. Section 53.4958-6(c) of the regulations provides that a transfer of property, or the right to use property, is presumed to be at fair market value if the following conditions are satisfied: (1) an authorized body composed entirely of individuals who do not have a conflict of interest approves the compensation package or property transfer in advance; (2) the authorized body obtains and relies on appropriate data (e.g., comparing the compensation or property transfer to others in the industry) prior to determining whether the amount payable is reasonable or the property transfer is at fair market value; and (3) the authorized body adequately documents the reasoning behind its determination.

In most transactions, a well advised exempt organization should be able to determine with a fair degree of certainty whether it has met the first and third requirements. Indeed, in LTR 200413014, the recited facts indicate that the hospital has taken routine steps to meet the test of an independent authorized body by removing the physicians who would be owners of the units in the LLC from the decisionmaking process. Presumably, the hospital would also provide the necessary documentation to meet the third requirement.

The second requirement — whether the data that the authorized body relies on is appropriate — is often more problematic. If this data is deemed inappropriate, not only will the exempt organization not get the benefit of the rebuttable presumption, it may also find it has engaged in an excess benefit transaction. Exempt organizations thus desire a high degree of certainty that they have relied on appropriate data in determining fair market value.

In this case, the hospital's board wanted assurance that the data obtained through the auction process conducted by the independent broker was appropriate. Had the hospital requested a ruling that it met the rebuttable presumption, the Service would have declined to rule under Revenue Procedure 2004-4, IRB 2004-1, Section 6.10. However, by requesting a ruling that the process it used to set the coupon rate was "an open and competitive bidding process," it presented the Service with a legal question and obtained a ruling on an issue that was of critical importance in meeting the rebuttable presumption. This ruling illustrates that, notwithstanding the Service's policy of not ruling on whether an organization has established a rebuttable presumption, it will rule on specific questions that arise in meeting the requirements for the rebuttable presumption, if those questions can be posed as legal issues.