

FAT-FREE FINANCING FOR ASSISTED LIVING FACILITIES

It's tax-exempt, non-recourse and doesn't add unsightly debt to your balance sheet.

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Have you been overindulging in expensive REIT financing? Binging on construction loans which have troublesome account maintenance and guarantee requirements? Tax-exempt bonds may then be the answer for your assisted living development needs. As more fully described below, tax-exempt bonds allow developers of assisted living facilities to borrow non-recourse for thirty years at approximately 7%, with 10% equity. We will refer to these bonds as Assisted Living Bonds.

Assisted Living Bonds are ideally suited for loans in excess of \$5 million to develop and construct assisted living facilities which contain, among other things, "separate and complete facilities for living, sleeping, eating, cooking and sanitation" in each unit.¹ The Internal Revenue Service ("IRS") has advised that cooking facilities must give the resident "the capacity of food storage (including refrigeration), food preparation and clean up."² In some cases, the "cooking facilities" requirement may be satisfied by constructing each unit with a separate area equipped with a small refrigerator, a sink and a mounted microwave.³

To finance an assisted living facility with the type of Assisted Living Bonds described in this article, at least 20% of the units must be rented to individuals with an income of 50% or less of area median gross income or at least 40% to individuals with an income of 60% or less of area median gross income.⁴ This test is easier than one might think to satisfy for elderly residents since it is an income test, not an asset test. Furthermore, the facility may not provide "continual or frequent nursing, medical or psychiatric services."⁵ A recent IRS Revenue Ruling clarifies that facilities that provide significant health services may not be financed with the type of Assisted Living Bonds described here.⁶ The types of health services that the Assisted Living Bond financed facility may provide include the following: (1) assistance with medication, (2) maintenance of health records, (3) consultation with a nurse regarding medication and health concerns, (4) assistance with daily living activities during waking hours by a non-medically certified

aide, and (5) routine checks by the facility's staff as to the residents' general well-being.⁷

To take advantage of Assisted Living Bonds, the developer should set up a single purpose entity. This entity (the "Borrower") will apply to a local housing authority, health care authority or industrial development authority for Assisted Living Bonds to be issued on its behalf.⁸ Other essential parties in the application process are the Underwriter who will sell the Assisted Living Bonds and Bond Counsel, the law firm charged with giving an opinion that the Bonds are tax-exempt. Once the application is approved by the authority, the authority will adopt an inducement resolution which will be adopted by the authority, permitting the Borrower to be reimbursed from proceeds of the Assisted Living Bonds for most development costs incurred within sixty days prior to the date of such inducement resolution and thereafter.⁹

The use of the proceeds of Assisted Living Bonds is subject to additional limitations. No more than 2% of the net proceeds may be spent on costs of issuance (including Underwriter's fee, counsel fees and accounting fees) and no more than 3% of the net proceeds may be spent on other non-capitalized costs, including working capital.¹⁰ The 10% equity which must be funded by the Borrower at closing therefore covers the excess costs of issuance above the 2% limitation and provides an operating deficit account to cover working capital needs during fill-up. The Borrower should be able to generate a portion of the required equity through the sale or syndication of interests in the Borrower, the ownership of which may entitle the holder to favorable low income housing tax credits for federal income tax purposes.

The developer of the project gets compensated through Assisted Living Bonds in three important ways. First, in a typical fee arrangement, a development fee of approximately 5% of the costs of the project is paid from proceeds of the Assisted Living Bonds, usually one-third at closing, one-third at break-even and one-third at stabilization. Second, the developer (or an affiliate) and the Borrower may enter

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into a management contract, which may include a certain amount of incentive compensation based on gross revenues of the facility.¹¹ Third, the developer can get a one-time incentive management fee from the Borrower for early fill-up according to a predetermined schedule, with the amount of such incentive fee to be calculated by determining the value of early fill-up to the Borrower.¹²

The common barrier to Assisted Living Bonds is volume cap. Volume cap is the dollar limit on the amount of tax-exempt private activity bonds (including Assisted Living Bonds) that each state is permitted to issue annually. Your Bond Counsel will know whether the state in which your project is located is currently under its limit.

An additional benefit of Assisted Living Bonds is that because the asset and the liability are on the balance sheet of the Borrower, if the developer does not consolidate with the Borrower for reporting purposes, the bonds may be off-balance sheet and non-recourse with respect to the developer.¹³ A recent change in the American Institute of

charged at the time they are incurred rather than capitalized over time (as is the current practice).¹⁴ Although the effect of this change will be to depress the earnings of the Borrower, if the developer does not consolidate with the Borrower for reporting purposes, it should not have the same effect on the developer.

Assisted Living Bonds are a creative way to take unwanted assets and liabilities off of an overweight balance sheet, yet still maintain both control of the asset and a stream of management income. In the current market, the Bonds are low-interest rate and low equity, and they may even decrease the chance of a heart attack when the REIT market falters. ♦

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- 1 This term is excerpted from the definition of a "residential rental unit" set forth in H.R. Conf. Rep. No. 99-841 at II-699 (1986), *reprinted in* 1986-3 (Vol. 4) C.B. 699.
- 2 Priv. Ltr. Rul. 97-11-021 (Mar. 14, 1997). Although Private Letter Rulings may not be relied upon by persons other than the taxpayer requesting the ruling, they illustrate the IRS's interpretation of the issue.
- 3 See Rev. Rul. 98-47, 1998-39 I.R.B. 4; Priv. Ltr. Rul. 97-11-021 (Mar. 14, 1997).
- 4 I.R.C. § 142 (d) (1).
- 5 Rev. Rul. 98-47, 1998-39 I.R.B. 4.
- 6 Facilities providing such services are best financed with qualified 501(c) (3) bonds. See I.R.C. §145 and Priv. Ltr. Rul. 97-40-007 (Oct. 3, 1997).
- 7 Rev. Rul. 98-47, 1998-39 I.R.B. 4.
- 8 The appropriate authority will vary from state to state.
- 9 Treas. Reg. §§ 1.142-4 (b), 1.150-2(d). The costs which can be reimbursed include capitalized costs incurred in the development of the project. In addition, certain preliminary expenditures (e.g., architectural and engineering costs) incurred more than sixty days prior to the inducement date may be reimbursed. Treas. Reg. § 1.150-2 (g) (2).
- 10 I.R.C. §§ 142 (a) (7), 147 (g).
- 11 Revenue Procedure 97-13 sets forth the permissible arrangements for management contracts relating to property which has been financed with tax-exempt bonds. 1997-5 I.R.B. 18. For example, the developer and the Borrower may enter into a fifteen year management contract, provided that at least 95% of the compensation for services is based on a periodic fixed fee, which may be adjusted for inflation, and the useful life of the property is reasonably expected to be at least 18.75 years.
- 12 Revenue Procedure 97-13 sets forth the permissible arrangements for management contracts related to property which has been financed with tax-exempt bonds. 1997-5 I.R.B. 18.
- 13 Consolidation turns on whether the developer owns or controls 50% or more of the Borrower. One possible structure is for the developer to form a limited partnership in which the developer (or an affiliate) owns a 10% equity interest as the general partner. The remaining equity would be owned by unrelated individuals and entities as limited partners. Your accountant will determine whether the developer and the Borrower are required to report on a consolidated basis.
- 14 AICPA, *Statement of Position*, 98-5 (Apr. 2, 1998).

Certified Public Accountants' position with respect to reporting costs of start-up activities requires such costs to be



