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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

May 10, 2001

LEGEND:

- Bonds =
- Authority =
- State =
- University =
- Medical School =
- Date 1 =
- Date 2 =
- a =
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Dear

This letter is in reply to your request for a ruling that the proceeds of the Bonds may be allocated to the portions of the Research Facilities (hereinafter defined) used for research arrangements that do not constitute private business use based on a revenue allocation test.

Facts and Representations

You make the following factual representations. The Authority is a body corporate and politic constituting a public benefit corporation created by the State, and has been granted the authority to issue bonds to finance facilities for, in part, certain not-for-profit institutions.

The University is a 501(c)(3) organization. The Medical School is a part of the University. One of the objectives of the Medical School is the creation, acquisition, and dissemination of new knowledge as the result of fundamental research in the delivery of health care. It is also an objective of the Medical School to foster the development of research collaboration between its faculty and the private sector, both to expand its faculty's access to emerging therapeutic technologies and to ensure the transfer of new discoveries and inventions made by its faculty and students to full application in patient care.

Currently, the University owns facilities in which research is conducted. Those facilities were not financed with the proceeds of tax-exempt bonds. The University enters into research arrangements (e.g., contracts, gifts, grants) of varying length and subject matter with various parties, including the federal government, state or local government units or state universities, 501(c)(3) organizations, private industry sources, and foundations and other organizations that do not constitute 501(c)(3) organizations.

All of the University's research arrangements are in furtherance of the exempt purposes of the Medical School. Some arrangements do not constitute private business use within the meaning of § 141(b) ("Qualified Research Arrangements"). Other arrangements constitute private business use under § 141(b) ("Non-Qualified Research Arrangements").

Over the last a years, Medical School research revenue from Qualified Research Arrangements, net of royalties and license fees (the "Qualified Research Revenue"), has averaged b percent of gross research revenue annually, net of royalties and license fees. Over that same period, Medical School research revenue from Non-Qualified Research Arrangements, net of royalties and license fees (the "Non-Qualified Research Revenues"), has averaged c percent of gross research revenue annually, net of royalties and license fees.

Pursuant to resolutions adopted by the Authority on Date 1 and Date 2, the Authority proposes to issue the Bonds and apply a portion of the proceeds thereof, together with other amounts, to finance a portion of the costs of new research facilities (the "Research Facilities") for the Medical School. The amount of the Bonds issued to finance the Research Facilities is expected to be approximately \$d.

More than 5 percent of the Research Facilities will be used for Non-Qualified Research Arrangements each year throughout the term of the Bonds. Payments received by the Medical School pursuant to such arrangements will exceed 5 percent of the present value of the debt service on the Bonds.

Based on the University's current experience with its existing facilities, the University represents the following: (1) the research performed pursuant to Non-Qualified Research Arrangements and Qualified Research Arrangements will take place simultaneously in all laboratories within the Research Facilities; (2) all laboratory equipment in the Research Facilities will be available continuously for use by workers who will perform research under Non-Qualified Research Arrangements and Qualified Research Arrangements; (3) a researcher will often use a single laboratory in the Research Facilities to perform identical research that may be funded either by a Non-Qualified Research Arrangement or a Qualified Research Arrangement; (4) many of the procedures conducted by the researchers in the Research Facilities may relate to any number of research projects, some of which may be Non-Qualified Research Arrangements and some of which may be Qualified Research Arrangements; and (5) as a result of the foregoing, it is not possible for the Medical School to allocate the

usage of the laboratories and equipment in the Research Facilities between Non-Qualified Research Arrangements and Qualified Research Arrangements other than based on the relative amounts of revenue from such arrangements.

The University does not believe the manner in which it will operate the Research Facilities to be unique. This is the manner in which the University's existing facilities are operated and how it believes many other research institutions are operated. The University believes that to segregate researchers and research labs by funding source would be inefficient, impracticable, and would impose an unacceptable burden on medical research.

As a result, the Authority proposes that proceeds of the Bonds be allocated to the portions of the Research Facilities used for Qualified Research Arrangements, and not to the portions of the Research Facilities used for Non-Qualified Research Arrangements, with such portions based on the ratio of the present value of Qualified Research Revenue to the present value of gross research revenue (Qualified Research Revenue plus Non-Qualified Research Revenue), using the yield on the Bonds (determined under § 148) as the discount rate.

Law and Analysis

Section 103(a) provides that gross income does not include interest on a State or local bond. Section 103(b)(1) provides that § 103(a) does not apply to any private activity bond, unless it is a qualified bond under § 141.

Section 141(a) provides that the term "private activity bond" means any bond issued as part of an issue (1) which meets the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2), or (2) which meets the private loan financing test of § 141(c).

Section 141(b)(1) provides in general that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Private business use is defined in § 141(b)(6) as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business.

Section 141(b)(2) provides in general that an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of the issue is (under the terms of the issue or any underlying arrangement) directly or indirectly (A) secured by any interest in property used or to be used for a private business use, or payments in respect of such property, or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Section 141(e) provides that a qualified bond includes a qualified 501(c)(3) bond.

Section 145(a) provides that, except as otherwise provided in § 145, the term qualified 501(c)(3) bond means any private activity bond issued as part of an issue if all of the property that is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and such bond would not be a private activity bond if § 501(c)(3) organizations were treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses, determined by applying § 513(a). For this purpose, paragraphs (1) and (2) of § 141(b) are applied by substituting "5 percent" for "10 percent" each place it appears and "net proceeds" for "proceeds" each place it appears.

Section 1.145-2(a) of the Income Tax Regulations provides that §§ 1.141-0 through 1.141-15 generally apply to § 145(a).

Section 1.141-3 provides rules pertaining to the definition of private business use. Section 1.141-3(a) states, in part, that the use of financed property is treated as the direct use of proceeds. In determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct use of the proceeds. Use of proceeds by all nongovernmental persons is aggregated.

Section 1.141-3(b) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or other incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

Section 1.141-3(b)(6)(i) provides in part that an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research, based on all of the facts and circumstances.

Section 1.141-3(g)(1) provides that, in general, the private business use of proceeds is allocated to property under § 1.141-6. The amount of private business use of that property is determined according to the average percentage of private business use of that property during the measurement period.

Section 1.141-3(g)(2)(i) provides in general that the measurement period of property financed by an issue begins on the later of the issue date of that issue or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). In general, the period of reasonably expected economic life of the property for this purpose is based on reasonable expectations as of the issue date.

Section 1.141-3(g)(4)(iii) provides in general that for a facility in which governmental use and private business use occur simultaneously, the entire facility is treated as having private business use. However, if there is simultaneous private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility (*e.g.*, reasonably expected fair market value of use). This provision is illustrated by *Example 1* set forth in § 1.141-3(g)(8), as follows:

University U, a state owned and operated university, owns and operates a research facility. U proposes to finance general improvements to the facility with the proceeds of an issue of bonds. U enters into sponsored research agreements with nongovernmental persons that result in private business use because the sponsors will own title to any patents resulting from the research. The governmental research conducted by U and the research U conducts for the sponsors take place simultaneously in all laboratories within the research facility. All laboratory equipment is available continuously for use by workers who perform both types of research. Because it is not possible to predict which research projects will be successful, it is not reasonably practicable to estimate the relative revenues expected to result from the governmental and nongovernmental research. U contributed 90 percent of the cost of the facility and the nongovernmental persons contributed 10 percent of the cost. Under this section, the nongovernmental persons are using the facility for a private business use on the same basis as the government use of the facility. The portions of the costs contributed by the various users of the facility provide a reasonable basis that properly reflects the proportionate benefit to be derived by the users of the facility. The nongovernmental persons are treated as using 10 percent of the proceeds of the issue.

Section 1.141-4 provides rules pertaining to the private security or payment test. Section 1.141-4(a)(1) provides that the private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test takes into account the payment of debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private use. The private security portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use.

Section 1.141-4(b) provides that in determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue. For this purpose, present values are determined by using the yield on the issue as the discount rate and by discounting all amounts to the issue date.

Section 1.141-6(a) provides in part that, for purposes of allocating proceeds to expenditures, allocations generally may be made using any reasonable, consistently applied accounting method.

The Report on the Committee of Ways and Means of the House of Representatives on H.R. 3838, H.R. Rep. No. 426, 99th Cong., 1st Sess. 538 (1985), 1986-3 (Vol. 2) C.B. 538 (the "House Report"), states as follows:

The committee understands that certain facilities eligible for financing with section 501(c)(3) organization bonds may comprise part of a larger facility otherwise ineligible for such financing or that portions of a section 501(c)(3) organization facility may be used for activities of persons other than section 501(c)(3) organizations. The committee intends that the Treasury Department may adopt rules for allocating the costs of such mixed use facilities (including common elements) according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the various users of the facility. Only the portions of such mixed use facilities owned and used by a section 501(c)(3) organization may be financed with bonds for such organizations.

The same language appears in the Report of the Committee on Finance of the Senate on H.R. 3838, S. Rep. No. 99-313, 99th Cong., 1st Sess. 841 (1986), 1986-3 (Vol. 3) C.B. 841 (the "Senate Report").

The issue presented here is whether the proceeds of the Bonds may be allocated to portions of the Research Facilities that are used for research arrangements that do not constitute private business use based on a revenue allocation test, with the result being that such portions qualify for tax exempt financing under § 145.

Both the House Report and the Senate Report acknowledge that there are facilities used by 501(c)(3) organizations that qualify for tax exempt financing under § 145 that may be part of a larger facility that, for whatever reason, do not qualify for such financing. In these cases, the portion of such "mixed use" facilities owned and used by a 501(c)(3) organization may be financed under § 145 to the extent that the costs of such facilities are allocated according to a reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the various users of the facility.

You represent that the only reasonable method for the Medical School to allocate the costs of the Research Facility is a revenue allocation test that allocates use between governmental use and private business use based on the relative amounts of Qualified Research Revenue and Non-Qualified Research Revenue. Any other method would be unworkable due to the manner in which the Research Facilities operate. In particular, the research performed pursuant to Non-Qualified Research Arrangements and Qualified Research Arrangements will take place simultaneously in all laboratories within the Research Facilities. Moreover, all laboratory equipment in the Research

Facilities will be available continuously for use by workers who will perform research under Non-Qualified Research Arrangements and Qualified Research Arrangements. A researcher will often use a single laboratory in the Research Facilities to perform identical research that may be funded either by a Non-Qualified Research Arrangement or a Qualified Research Arrangement. Many of the procedures conducted by the researchers in the Research Facilities may relate to any number of research projects, some of which may be Non-Qualified Research Arrangements and some of which may be Qualified Research Arrangements. Finally, the University does not believe that the manner in which it will operate the Research Facilities to be unlike other research institutions.

Accordingly, and because other available methods are unworkable, the revenue allocation method is reasonable. Allocating the portion of the Research Facilities that may be financed with the Bonds based on the relative amounts of Qualified Research Revenue and Non-Qualified Research Revenue is a reasonable method of allocating the costs of the Research Facilities. This allocation method properly reflects the proportionate benefit to be derived, directly or indirectly, by the various users of the Research Facilities.

Conclusion

We conclude that the proceeds of the Bonds may be allocated to the portions of the Research Facilities that are used for Qualified Research Arrangements, with such portions based on the ratio of the present value of Qualified Research Revenue to the present value of gross research revenue (Qualified Research Revenue plus Non-Qualified Research Revenue), using the yield on the Bonds (determined under § 148) as the discount rate. As a result, the University may finance such portions of the Research Facilities under § 145.

Except as specifically ruled above, no opinion is expressed concerning this transaction under any provision of the Code or regulations thereunder. Specifically, no opinion is expressed concerning whether interest on the Bonds will be excludable from gross income under § 103(a) or regarding the application of the change in use rules to the Bonds should the relative percentages of Qualified Research Revenue and Non-Qualified Research Revenue change.

This ruling letter is addressed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,
Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)
By: Bruce M. Serchuk
Senior Technician Reviewer
Tax Exempt Bond Branch