

HEALTH CARE BONDS: GINSENG FOR YOUR ASSISTED LIVING STOCK PRICE

Selling Assisted Living Facilities While Retaining Management

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It is another beautiful Friday morning and your mind starts to wander to your 3 o'clock tee-off time. Line one lights up: it is some health care analyst from New York who has been panning your assisted living company's stock since the first of the year. "I'll call back." Line two is your best friend from last year: your REIT lender. He wants to know if you want to buy back any of the properties he has in his REIT. He's got no money ... something about problems in the Far East. You take a deep breath, get a fresh cup of coffee and place a call to a nonprofit which has offered to buy some facilities from you using "Health Care Bonds."¹

Health Care Bonds are tax-exempt bonds used by nonprofit corporations to finance the purchase of existing assisted living facilities. Currently, the Bonds can be issued on a non-recourse basis for thirty years with an interest rate of about 7%. With only a 10% equity requirement, a seller can maximize the sales price while retaining management of day-to-day affairs at the facility. A recent ruling by the Internal Revenue Service has clarified situations in which the use of Health Care Bonds to buy assisted living facilities is appropriate.²

Acquiring Existing Assisted Living Facilities

Health Care Bonds can be issued by a nonprofit corporation to finance the acquisition of existing assisted living facilities in a variety of situations. First, if each unit in the facility does not contain "separate and complete facilities for living, sleeping, eating, cooking and sanitation,"³ then purchase of the facility by a 501(c)(3) organization using Health Care Bonds is permitted. To meet the requirement described in the previous sentence, the separate cooking facilities are most frequently omitted from the units. Many assisted living facilities (particularly Alzheimer's units) are designed without full kitchens for the safety of the residents. For these purposes, a "separate cooking facility" is, at a minimum, a separate area equipped with a small refrigerator, sink and mounted microwave.⁴ If each unit in the assisted living facility does not contain a separate

cooking facility, a 501(c)(3) organization may acquire the assisted living facility with Health Care Bonds. The bottom line: no kitchens; no problem.

If one or more of the units in the assisted living facility contain separate facilities for living, sleeping, eating, cooking and sanitation, the facility may still be financed with Health Care Bonds if the facility provides frequent or continual nursing, medical or psychiatric services.⁵ The types of services which, in addition to the types of services generally provided by an assisted living facility (i.e., assistance with medication, maintenance of health records, consultation with a nurse regarding medication and health concerns, assistance with daily living activities during waking hours by a non-medically certified aide, and routine checks by the facility's staff as to the residents' general well-being), constitute frequent or continual nursing, medical or psychiatric services are (1) registered nurses on duty 12 hours each day, (2) licensed practical nurses on duty 24 hours each day, and (3) licensed nurses' aides available 24 hours each day to provide nursing care for the residents' nursing or psychiatric needs.⁶ If the assisted living facility provides these types of services, a 501(c)(3) organization may finance the acquisition of such facility with Health Care Bonds regardless of whether any unit contains separate cooking facilities.

If the assisted living facility has separate cooking facilities and does not provide frequent or continual nursing, medical or psychiatric care to its residents, the third option for the 501(c)(3) organization to acquire the existing assisted living facility is to meet the low-income set-aside requirements. Under this scenario, 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.⁷ When dealing with elderly residents, this test is easier to satisfy than one might think because it is an income test, not an asset test. Note that under the low-income housing scenario, the acquiring entity may either be a for-profit entity or a nonprofit organization.

Finding the Nonprofit Purchaser

To finance the acquisition of an assisted living facility with Health Care Bonds, the purchaser of the assisted living facility must be a qualified nonprofit organization under Section 501(c)(3) of the Code, and generally is one of two types of entities. The prime buyer is a nonprofit health system in your service area which appreciates the value of adding another level of care to its health care delivery system, and having that level be all private pay. It is advisable for the purchasing corporation to be an empty corporation with no assets other than the facility to be purchased. This new corporation can be formed if the system has a group exemption from the IRS which allows subordinate entities to be formed under the parent nonprofit. Alternatively, the parent nonprofit organization may be able to form a single-member limited liability company without having such a group exemption letter.⁸ The single-member limited liability company shares the parent's tax-exempt status for federal tax purposes, but is a separate corporation for state law purposes. Neither avenue requires any action from the IRS prior to the issuance of the Health Care Bonds.

A second potential purchaser is an independent 501(c)(3) organization which has been approved by the IRS to purchase assisted living facilities or has applied to be so approved. A streamlined process with the IRS permits such an entity to go from filing its Form 1023 application to receiving its IRS determination letter in approximately three months. In either case, as with the health care system described above, it is critical that the purchaser and seller be unrelated. The assisted living company selling the facility must engage in an arms-length transaction with the purchaser (i.e., neither officers, shareholders nor employees of the seller can control the purchaser).

Sales Price and Management Agreement

To ensure that the Health Care Bonds are not being issued to benefit a private party, the assisted living facility may only be sold for an amount up to its appraised fair market value. As a practical matter, the sales price will be further limited by the fact that financial

projections examined by an independent certified public accountant must conclude that the facility will be able to produce a Maximum Annual Debt Service Coverage Ratio on the Health Care Bonds of at least 1.40 at stabilization. An inflated purchase price would make the debt service too large for the facility to satisfy the coverage ratio which bond buyers typically demand.

The management contract between the purchaser and the seller-manager is governed by IRS Revenue Procedure 97-13 which generally permits a management contract of up to 15 years, provided at least 95% of the management fee compensation is a fixed dollar amount for each year of the contract.⁹ The balance of the fee may float based on a performance indicator other than net profits of the facility (e.g., 5% of Gross Revenues), giving the manager incentive as it benefits from the facility's good performance. For certain management contracts, including 15-year contracts, the Revenue Procedure also permits a one-time stated dollar incentive management fee payable upon the achievement of a gross revenue or expense target.

Revenue Procedure 97-13 permits a larger portion of the management fee to be floating instead of fixed for shorter term contracts. For example, a five-year management contract can have up to 50% of the management fee floating. Whatever the management contract's term, it needs to be negotiated at arm's length with an unrelated party at market rates. It is advisable for the purchaser to have documented two other offers to manage the facility at comparable levels.

Conclusion

Health Care Bonds enable a for-profit assisted living company to sell an existing facility to a nonprofit corporation for cash while maintaining management of the facility for up to fifteen years. Interest rates for the purchasers of such facilities are at historic lows, and Health Care Bonds allow the for-profit company to remove the asset (and its associated liability) from its balance sheet and replace it with cash and a management fee income stream. Like ginseng, Health Care Bonds require no prescription and they aren't habit-forming, but the benefits can last up to fifteen years.

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¹ As used in this article, the term "Health Care Bonds" refers to tax-exempt bonds issued by a 501(c)(3) organization under Section 145 of the Internal Revenue Code.

² Rev. Rul. 98-47, 1998-39 I.R.B. 4.

³ 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.

⁴ See Rev. Rul. 98-47, 1998-39 I.R.B. 4; Priv. Ltr. Rul. 97-11-021 (Mar. 14, 1997).

⁵ See Rev. Rul. 98-47, 1998-39 I.R.B. 4.

⁶ Rev. Rul. 98-47, 1998-39 I.R.B. 4.

⁷ I.R.C. §§ 142(d)(1); 145(d)(2)(B).

⁸ The IRS is currently reviewing six cases where taxpayers have asked the IRS for a ruling on this issue.

⁹ Rev. Proc. 97-13, 1997-5 I.R.B. 18.