HAWKINS ADVISORY

Tax Developments at the Crossroads

By: John J. Cross III

Introduction

This tax column covers selected Federal tax developments during the last quarter of 2003 and the first quarter of 2004. Despite a flurry of Congressional legislative activity, no significant tax legislative developments affecting tax-exempt bonds were enacted into law. Treasury and the IRS released several notable discrete items of public administrative tax guidance.

On December 29, 2003, the IRS released a stealth bomb to the tax-exempt bond market as part of its crackdown on corporate tax shelters in the form of Proposed Treasury Regulations regarding the standards of tax practice under so-called "Circular 230." These proposed rules would have significant consequences for the tax-exempt bond market and the whole approach taken towards unqualified Federal tax opinions regarding the tax-exempt status of interest on tax-exempt bonds, as discussed briefly herein.

The IRS also issued a Revenue Ruling in which it boldly ruled that a helicopter is not an airplane for purposes of the restriction against the use of tax-exempt private activity bonds to finance airplanes under Code Section 147(e).

A steady stream of Private Letter Rulings continued. In an interesting Private Letter Ruling regarding multifamily low-income housing bonds under Code Section 142(d), the IRS allowed a small percentage of the housing units to be leased to corporate tenants and conduit leasing companies. In another helpful Private Letter Ruling, the IRS allowed the use of different accounting methods for Federal tax purposes and state law purposes, which enabled an issuer to spend tax-exempt bond proceeds more promptly for arbitrage purposes in connection with a long-term state matching fund program for school construction.

Regulations

Proposed Circular 230 Regulations

Introduction. On December 29, 2003, the IRS issued Proposed Treasury Regulations governing practice before (the IRS (31 C.F.R. Part 10, §§10.33, 10.35-10.37, and 10.93, 68 F.R. 75186 (December 30, 2003)) (the "Proposed Circular 230 Rules"). These rules are proposed to apply immediately upon the publication of final Treasury Regulations. An IRS public hearing was held on February 19, 2003, at which NABL President Linda B. Schakel spoke for NABL. In general, the Proposed Circular 230 Rules represent part of Treasury's ongoing initiatives to combat

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Midyear Volume: A Slowing Market

The year-to-date results for 2004, through midyear, reflect the effects of rising interest rates. Volume dropped over eight percent from the same period in 2003, according to figures released by Thomson Financial. The total volume through June 30 was $187.8 billion, compared with $205.9 billion during the same period in 2003. The greatest drop was in refundings, which fell a dramatic 24.1% over prior year levels, $43.5 billion versus $57.4 billion last year. This comes as no surprise, as refundings are highly sensitive to interest rates. It is noteworthy that the actual number of new issues is down by 14.8%, 6,603 versus 7,748 last year. The overall volume, which dropped by a smaller percentage, was spurred by several mega-deals, specifically in California, where economic recovery bonds exceeding $13 billion were issued in the last two months.

We at Hawkins Delafield & Wood LLP were very pleased and proud to once again place first in the national rankings for underwriters' counsel. The Firm was also highly ranked among bond counsel nationally. Our ranking for the first half of 2004, as well as those of our nearest competitors, is listed below.

NATIONAL RANKINGS - UNDERWRITERS' COUNSEL
JANUARY 1 – JUNE 30, 2004

Rank	Firm	Par Amount ($ millions)
1	**Hawkins Delafield & Wood LLP**	**17,579.5**
2	Orrick, Herrington & Sutcliffe L.L.P.	7,167.9
3	Sidley Austin Brown & Wood LLP	6,440.6
4	Clifford Chance US LLP	4,531.1
5	Squire, Sanders & Dempsey LLP	4,513.5
6	Kutak Rock LLP	3,912.4
7	Chapman and Cutler LLP	2,399.0
8	Ballard Spahr Andrews & Ingersoll	2,330.9
9	Mintz Levin Cohn Ferris Glovsky & Popeo	2,147.9
10	Nixon Peabody LLP	2,147.4

Source: Thomson Financial

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Gerry Fernandez receives recognition from Municipal Forum Annual Dinner Chairperson, Steve DeGroat (left) and Municipal Forum President Dominick Antonelli.

The Honor of a Lifetime

Gerry Fernandez is recognized by the Municipal Forum of New York

The Municipal Forum of New York's Annual Dinner in New York has become one of the municipal industry's best-attended gatherings, where members are recognized for professional excellence and significant career contributions. On May 12th, the Forum recognized three honorees: Daniel L. Keating, Senior Managing Director of Bear, Stearns & Co.; Alan Anders, Deputy Budget Director of The City of New York; and Gerry Fernandez, Of Counsel with Hawkins Delafield & Wood LLP, and a partner with the Firm from 1960 through 1994. Below we have included Hawkins partner Arthur M. Cohen's introduction of Mr. Fernandez. Mr. Fernandez's remarks follow thereafter.

Introduction
By: Arthur M. Cohen

This year Hawkins is celebrating our 150th anniversary. For more than one-third of our history, Gerry Fernandez has been a key participant at the Firm, first as an associate, then a partner and in recent years, our very trusted and valued counsel. In deference to Gerry, I will not divulge the year of his birth. However, it did precede each of the 1986 Internal Revenue Code, the 1954 Internal Revenue Code and the 1939 Internal Revenue Code, although it did not precede the Code of Hammurabi.

Gerry was born in Brooklyn and was raised and resides in Long Island. He served in the United States Navy in the Pacific during World War II, received a bachelor of arts degree from Brown University and a law degree from St. John's Law School. Following law school, Gerry began work at Hawkins in 1950 at $58/week--slightly less (but not by much) than public finance law firms pay new associates today. At that time, as a few of you may remember, the business was very different than it is today. Primarily G.O. based, and long before the explosion of revenue (and especially private activity) bonds, the practice of the law of public finance was considered a "gentlemen's" practice. Well, nothing could have suited Gerry more for he was, and is, the consummate gentleman. He learned the business from the masters, Ike Russell, Chuck Kades, Arnold Frye, Lewis Delafield, Jr. and others and soon took his place among them. His keen analytic mind was perfect for consideration of the challenging constitutional and statutory questions that were ever present as our business evolved.

Over the years, Gerry's own practice has ranged far and wide, from Maine to Alaska, from Minnesota to the Virgin Islands. From GO debt, to toll bridges and roads, higher educational and hospital facilities, port facilities, bond banks, stadiums, as well as to governments in financial crisis, Gerry has served as bond counsel, underwriters' counsel and trustee's counsel. But the heart of his practice has always been right here in New York State. He has represented hundreds of cities, towns, counties, school districts and public authorities throughout our great State, giving each, from the largest and most visible to the smallest and little noticed, the professional attention they deserved. Gerry's story is really the story of the bond business in New York. Whether it was helping to craft the intricate relationship between the State and City that resulted in the creation of the Battery Park City Authority, or drafting the legislation that established the New York City Housing Development Corporation, in his more than fifty years of practice Gerry has done and seen it all. His accomplishments are too numerous to mention, but perhaps his most significant one is that after fifty years of participation and leadership in our business, a half century of enormous evolution and change, the first word that most people utter when referring to Gerry remains "gentleman", for that he truly is. Ladies and gentlemen, it is a pleasure and a privilege to introduce my friend and your honoree, Gerry Fernandez.

Arthur M. Cohen
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Mr. Fernandez's Remarks

Good evening Ladies and Gentlemen. This is a very special moment in my life that I shall remember always. I am very happy to be here tonight. In the words of the late George Burns, I am happy to be anywhere tonight!

To be recognized by one's peers is the quintessential honor. To receive this award along with dedicated professionals such as Alan Anders and Dan Keating places me in great company. Alan is at the peak of a multi-faceted career that has accrued benefits to our industry in everything he has addressed. And Dan is the outstanding leader, who has always been at the forefront in terms of innovation and integrity. One of the great attributes of the municipal bond industry is the quality of its leaders; Alan and Dan are outstanding representatives of that quality. They certainly are worthy of your praise and I am most privileged

and pleased to join them as the 2004 honorees of the Municipal Forum.

My membership in the Municipal Forum spans half a century and I have always looked upon the Forum as the role model for the enhancement of state and local government financing.

My tenure at Hawkins Delafield & Wood has afforded me the opportunity to be associated with the finest bond attorneys in the country.

Arthur referred to several of our former partners, each of whom was a very able practitioner and teacher, a combination of professional skills and a scholarly approach to the law which continues to the present day. This year our firm is celebrating its sesquicentennial anniversary, certainly a milestone and testament to the devotion of all those, past and present, who have carried on the traditions of the firm.

Over the years, it has been my pleasure, privilege and good fortune to have developed friendships with Forum founders Jim Carpenter, John Thompson, Floyd Stansbury and Al Milloy, as well as many of the early leaders of the municipal bond industry, including Delmont "Deke" Pfeiffer, John Linen, Alan Browne, Winn Curvin and Wally Niebling. More recently I would thank Andy Gurley, Dave Clapp, Bob Downey, Bill Solari, Brent Harries, Fenn Putman, Steve Hunt, Herman Charbonneau and many others for their courtesies and respect.

My involvement with the Forum includes memberships on the Nominating Committee, the Audit Committee twice, and as a panelist discussing the major industry changes and legal issues resulting from the federally mandated change from bearer bonds to registered bonds. The two Audit Committees to which I refer were chaired by Bruce Bohlen. In order to insure a timely report, the Committee's deliberations were conducted in a windowless room across the hall from Bruce's office with only a single pitcher of water for the Committee and one drinking cup for each member! Photo ID was required for exit and reentrance! Notwithstanding these restrictive conditions, the report was completed in time for submission at the Forum's Annual Meeting and confirmed Bruce's reputation for integrity and professionalism.

We are all well aware of the success of the periodic luncheon programs which have provided representatives from a broad spectrum of knowledgeable, policy making officials access to a convenient forum for the discussion and exchange of ideas concerning current issues.

Supplementing the camaraderie at Forum events, there was for many years its Annual Holiday Party production, essentially a musical lampooning of prominent public officials as well as members of our industry performed by a cast of municipal bond professionals, both public and private.

However, rather than continue reminiscing, I should like to speak briefly of the Forum itself, my perception of its mission and its future role for our industry. Seated in Yankee Stadium many years ago, I overheard a man say to his companion: "Young men look to the future, old men look to the past". Tonight, for a few moments I should like to assume the mantle of a young man and briefly convey my thoughts concerning the future of the Forum.

This organization has always embodied three fundamental principles: integrity, leadership and scholarship.

The integrity of the Forum is unblemished and, whether the alleged wrongdoing is internal or external, it has been most aggressive in its pursuit of real or perceived conflict of interest, fraud or chicanery. It has never hesitated to become involved in these matters. May it always be so!

Leadership is not attainable without integrity! That explains why the Forum has been so effective over the years. Many challenges lie ahead, such as maintenance of the tax exemption of interest on municipal obligations, preserving self-regulation and the campaign for adequate disclosure, to mention a few. There should never be any reluctance by the Forum to exercise its role of leadership in the conduct of activities of the municipal bond industry and the public at large.

As with leadership, scholarship is founded upon integrity. The scholarship role consists of two facets, internal and external. The scholarships created to train interns and new entrants in the industry are illustrative of a continuing effort to ensure that the future of our industry is managed by well trained skilled professionals. Hawkins Delafield & Wood is very proud of the Fund created in honor of our partner, Bob Rosenberg. These programs are most exemplary.

There is a phrase on the wall of my high school auditorium which states "the virtue lies in the struggle not the prize." This very aptly describes the mission of the Forum.

May I again thank each and every one of you for this most wonderful award. More than fifty years ago, General MacArthur concluded his address to the Congress by stating, "Old Soldiers Never Die, They Just Fade Away"; I now close my remarks this evening by paraphrasing that concluding statement as follows: "Old Bond Attorneys Never Die, They Just Seek Redemption"

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Tax Developments at the Crossroads

(Continued from page 1)

corporate tax shelters. For tax-exempt bonds, however, the Proposed Circular 230 Rules were a real surprise (not unlike a drive-by shooting) since they eliminated, without explanation, a proposed exception to the definition of "tax shelter" for tax-exempt bonds which had been contained

in the January 2001 Proposed Regulations on this same topic. Thus, as now proposed, the Proposed Circular 230 Rules would include tax-exempt bonds within the definition of "tax shelters" and would impose significant new requirements on Federal tax opinions for tax-exempt bonds.

Brief Overview. Set forth below is a very brief overview of selected aspects of the Proposed Circular 230 Rules. The Proposed Circular 230 Rules define a "tax shelter" broadly to include "any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code." Although tax opinions with respect to tax-exempt bonds properly ought not to be covered by this definition of tax shelter, the removal of a previous proposed exception to this definition for tax-exempt bonds suggests that Treasury thought otherwise.

Under the Proposed Circular 230 Rules, practitioners who render "more likely than not" tax shelter opinions and "marketed" tax shelter opinions must comply with various specific requirements, selected aspects of which are noted below. Based on the current definitions, most tax opinions with respect to tax-exempt bonds will be covered.

A covered tax opinion, among other things, must consider all relevant facts and must relate the applicable law to the facts. The tax opinion may not rely on unreasonable factual or legal assumptions or representations. The tax opinion must consider all material Federal tax issues (meaning generally any tax issue with respect to which the IRS has a reasonable basis for a successful challenge and the resolution of which could have a significant adverse impact on the overall conclusion). The tax opinion must include conclusions as to the likelihood that the taxpayer will prevail on the merits with respect to each material tax issue and must describe the reasons and analysis for each conclusion. The tax opinion must include a number of specific disclosures, including certain compensation arrangements and referral arrangements.

A marketed tax shelter opinion must include one particularly chilling disclosure to the effect that the opinion may not be sufficient for a taxpayer to use to avoid penalties relating to the understatement of income tax under Code Section 6662(d) (under which provision the standard for avoiding penalties requires a reasonable belief by the taxpayer that the tax treatment was more likely than not) and that taxpayers should seek advice from their own tax advisors based on their own individual circumstances with respect to material tax issues.

The Proposed Circular 230 Rules also propose to impose new procedures and responsibilities upon law firms and responsible supervisory practitioners with respect to tax shelter opinions.

In short, if the Proposed Circular 230 Rules were to become final in their proposed form and were to apply to tax-exempt bonds, the present "short-form" unqualified tax opinions with respect to the tax-exempt status of interest on State and local bonds under Code Section 103 invariably would become lengthy "long-form" reasoned opinions. Moreover, it would become more difficult to distinguish between tax opinions that adhere to NABL's high unqualified opinion standard and other tax opinions. Hopefully, the public finance community will persuade Treasury and the IRS to eliminate or to limit substantially the coverage of tax opinions on tax-exempt bonds under Circular 230.

Public Administrative Guidance

Sections 143: Average Area Purchase Prices. Notably, for the first time since 1994, in IRS Rev. Proc. 2004-18, 2004-9 I.R.B. (March 1, 2004), the IRS provided updated average area purchase price safe harbors for purposes of the purchase price limitations and certain related limitations on qualified mortgage bonds under Code Section 143. These safe harbors included average area purchase price safe harbors for residences located in each state, the District of Columbia, Puerto Rico, the Northern Mariana Islands, American Samoa, the Virgin Islands, and Guam for purposes of the purchase price limitations under Code Section 143(e). In addition, these safe harbors included a nationwide average area purchase price safe harbor of $218,100 for purposes of the ratio of housing costs to income under Code Section 143(f)(5).

Section 147: Helicopters Versus Airplanes. In IRS Rev. Rul. 2003-116, 2003-46 I.R.B. 1083 (November 17, 2003), the IRS ruled that a helicopter is not an airplane for purposes of the prohibition under Code Section 147(e) against the use of tax-exempt private activity bonds to finance airplanes. Code Section 147(e) prohibits the use of tax-exempt private activity bonds to finance things on a "sin" list of prohibited facilities (which includes airplanes, health club facilities, skyboxes, gambling facilities, liquor stores, and the like).

In its rigorous analysis, the IRS boldly resorted to the dictionary. Thus, the IRS cited Webster's Collegiate Dictionary which defines an "airplane" as a "powered heavier-than-air aircraft that has fixed wings from which it derives most of its lift." In stark contrast, Webster's defines a "helicopter" as "an aircraft whose lift is derived from the aerodynamic forces acting on one or more powered rotors turning about substantially vertical axes." Webster's defines an "aircraft" as "a vehicle (as an airplane or balloon) for traveling through the air." In unassailable logic, the IRS reasoned that "airplanes and helicopters are types of aircraft, but a helicopter is not an airplane."

We commend the IRS staff for enduring the ridicule necessary to get this ruling out. IRS Rev. Rul. 2003-116 actually is useful because it will allow nonprofit hospitals to finance emergency helicopters with qualified 501(c)(3) bonds under Code Section 145.

Private Administrative Guidance

[Note: Private Letter Rulings ("PLRs") and Technical Advice Memoranda ("TAMs") are IRS national office final determinations of legal positions in specific cases provided to taxpayers in PLRs and to IRS field agents in TAMs. Field Service Advices ("FSAs") are non-final determinations from the IRS national office to IRS field agents on case-specific matters during audit case development that may be based on an incomplete review of facts of specific cases.]

Section 103: General

Borrowing Power. In PLR 200336004 (May 28, 2003), the IRS ruled favorably that certain State warrants (thought to be those of the State of California) with voluntarily negotiated terms constituted good tax-exempt debt obligations issued pursuant to exercise of the borrowing power under Section 103 of the Code. PLR 200336004 is an analytically sound ruling. In this ruling, the IRS cited the voluntary nature of the obligations and the element of negotiation as support for its conclusion that the State exercised its borrowing power. Any ruling that limits the impact of a peculiar line of old cases on the borrowing power limitation should be commended. In addition, PLR 200336004 included a useful discussion of various factors that bear on whether or not something is debt for Federal income tax purposes.

Section 141: Private Business Tests

Cable TV Transmission. In PLR 200336001 (March 5, 2003), the IRS ruled that a private cable TV provider's transmission of certain governmental digital educational programming which was produced by a state or local governmental entity at certain facilities financed with tax-exempt bonds would not cause the private cable TV provider to be a private business user of the governmental production facilities under Code Section 141.

Off-the-Shelf Generators. In PLR 200336019 (June 3, 2003), the IRS ruled that an issuer's acquisition of certain "off-the-shelf" electric turbine generators from a private business with tax-exempt bond proceeds did not constitute a prohibited acquisition of non-governmental output property under Code Section 141(d).

Instrumentalities. In PLR 200339035 (June 9, 2003) and in PLR 200406003 (October 31, 2003), the IRS found that certain nonprofit corporations under the control of governmental entities were "instrumentalities" of state or local governmental units under Treas. Reg. §1.103-1 and thus were governmental persons under Treas. Reg. §1.141-1(b) for purposes of the private business restrictions under Code Section 141. In PLR 200339035, the facts involved a nonprofit corporation organized by a governmental authority to assist the authority in meeting its obligations to provide energy services. In PLR 200339035, interestingly, the facts stated that the nonprofit corporation expected to derive at least 90% of its gross receipts from governmental transactions and further it would conduct certain activities with non-governmental persons at arm's length for fair market value. In PLR 200406003, the particular nonprofit corporation was organized by a city to oversee the development and operation of a private hotel in conjunction with the city's convention center.

Research License. In PLR 200347009 (August 14, 2003), the IRS addressed whether a particular exclusive, perpetual, non-terminable, worldwide license granted to a private business with respect to all research and patents obtained by a particular nonprofit Section 501(c)(3) research entity would cause private business use of the nonprofit entity's tax-exempt bond financed facilities. Perhaps the breadth of this license may be a hint as to the outcome here. Thus, not surprisingly, in PLR 200347009, the IRS ruled adversely that the particular license agreement violated the private business use restrictions under Code Section 141 and Code Section 145 because the rights granted to the private business conveyed special legal entitlements comparable to ownership under Treas. Reg. §1.141-3(b)(7)(i).

Trench Ruling Two. In PLR 200403055 (September 30, 2003), the IRS issued a second ruling on the railroad trench which was the subject of PLR 9813003 (December 5, 1997). In PLR 200403055, the IRS ruled that, notwithstanding an increase in private railroad use and an elimination of a cap on fees paid by the private railroads, the issuer's allocation of 50% of the trench costs to common-type areas associated with governmental street improvements would not cause the bonds to be private activity bonds under Code Section 141. In PLR 200403055, the IRS also ruled that the anti-abuse rule regarding allocations under Treas. Reg. §1.141-14 was inapplicable. The IRS appeared to base its conclusion on a determination that the trench was functionally related to governmental use. This ruling raises, but leaves unanswered, some interesting questions regarding mixed use facilities. One particular issue raised is whether or to what extent the amount of private payments impacts (or, here, doesn't particularly impact) the amount of private business use.

Section 142: Exempt Facilities

Multifamily Housing Projects and Corporate Tenants. In PLR 200345022 (August 4, 2003), the IRS addressed the effects of certain limited amounts of leasing of multifamily housing units to corporate tenants and to conduit companies in the leasing business on certain rules for qualified residential rental projects under Code Section 142(d). The facts showed that the leases to corporate tenants and conduit leasing companies generally would be substantially the same as those to individual residents, with one-year or two-year terms, termination rights, and restrictions on assignments. The facts further indicated that the leases to the corporate tenants and the conduit leasing companies would have 30-day minimum occupancy requirements, restrictions against hotel or transient use, and requirements to provide information about ultimate residents. Most notably, the facts stated specifically that no single corporate tenant (either directly or indirectly through a conduit leasing company) would lease more than *5%* of the total number of residential units in the project at any time, and that no more than *10%* of the total number of residential units in the

project in the aggregate would be leased to corporate tenants directly or indirectly at any time.

In PLR 200345022, the IRS concluded that described limited leases to corporate tenants and conduit leasing companies would not cause the project to be used on an impermissible transient basis under Treas. Reg. §1.103-8(b)(4)(i) or to fail to be available for general public use under Treas. Reg. §1.103-8(a)(2). PLR 200345022 provides helpful practical guidance through its inclusion of particular percentages of permitted corporate tenant use.

Local Furnishing of Electricity. In PLR 20034007 (June 27, 2003), the IRS ruled that a certain reorganized company was a successor in interest to an historic local furnisher of electricity under Code Section 142(f)(3)(B) and that its facilities would serve or be available on a regular basis for general public use.

Section 143: Qualified Mortgage Bonds

Better Average Area Purchase Data. In PLR 200339011 (June 24, 2003), the IRS ruled that an issuer could use its own average area purchase data that were more accurate and comprehensive than those published by the IRS in 1994 for purposes of the purchase price restrictions on qualified mortgage bonds under Code Section 143(e).

Section 146: Volume Cap

Late Carryforward Elections. In PLR 200339011 (June 12, 2003), PLR 200345004 (August 1, 2003), and PLR 200406028 (November 4, 2003), the IRS permitted issuers to make late carryforward elections for private activity bond volume cap carryforwards under Code Section 146(f) in various dog-ate-my-homework circumstances in which issuers acted reasonably and in good faith.

Section 148: Arbitrage

Student Loan Joint Yield Ruling. In PLR 200403095 (September 30, 2003), the IRS allowed an issuer to compute the yield on several different tax-exempt student loan bond issues as a single joint bond yield for arbitrage purposes under Code Section 148. The IRS noted that the issuer had presented valid business reasons for desiring joint yield treatment, including goals to manage a student loan program more effectively as a single portfolio in a particular State to treat students in a nondiscriminatory way with respect to loan forgiveness.

Treas. Reg. §1.148-4(a) provides the authority for this joint yield ruling and states in relevant part that the "Commissioner may permit issuers of qualified mortgage bonds or qualified student loan bonds to use a single yield for two or more issues." Keep in mind that an issuer can compute a joint yield on bonds for arbitrage purposes only if the issuer obtains a specific ruling from the IRS which expressly permits the particular joint yield treatment.

In light of the typical mountains of calculations associated with a joint yield ruling request and the absence of any specific standards for joint yield treatment, the IRS is known to cringe at the sight of a joint yield ruling request (and sometimes to run away at that sight). Thus, PLR 200403095 is notable as a rare joint yield ruling that came to fruition.

Section 149(g): Hedge Bonds

Different Accounting Methods. In PLR 200338004 (June 16, 2003), the IRS permitted an issuer to use different accounting methods for Federal tax arbitrage purposes and state law purposes to enable the issuer to spend proceeds of tax-exempt bonds sufficiently promptly to avoid taxable hedge bond status under Code Section 149(g). In this ruling, the facts involved a 10-year state matching fund program for school construction purposes. The IRS allowed the issuer to use a "gross-proceeds-spent-first" accounting method for arbitrage purposes under Treas. Reg. §1.148-6(d)(1)(i). The IRS agreed that the issuer had a bona fide governmental purpose under Treas. Reg. §1.148-6(a)(2) that justified use of a different pro rata accounting method for state law purposes.

Section 150: Definitions

Related Parties. In PLR 200404024 (October 15, 2003), the IRS ruled that a regional transportation authority which was organized by two existing transportation authorities was not a related party to either existing authority under Treas. Reg. §§1.150-1(b) and 1.150-1(d)(2)(ii)(A). The IRS based this ruling on all the facts and circumstances. The IRS focused its analysis mainly (and appropriately) on two near bright-line factors for determining related party status for governmental entities under Treas. Reg. §1.150-1(e). These factors consider whether one entity controls either: (i) the right both to approve and to remove a controlling portion of the governing body; or (ii) the right to require the use of funds or assets of the controlled entity for any purpose of the controlling entity. In PLR 200404024, among other things, the facts showed that a "super-majority" vote of the issuer's board was required for certain substantial actions. This favorable ruling makes the hospital acquisition financing saga and the April 2002 Proposed Regulations in response thereto seem a somewhat faded (albeit tortured) memory.

Related Tax Areas

Partnership Accounting for Investments in Tax-exempt Bonds. In Rev. Proc. 2003-84, 2003-48 I.R.B. 1159 ("Rev. Proc. 2003-84"), the IRS provided revised special partnership accounting rules which mainly affect synthetic variable rate tax-exempt investments created in the secondary market with partnerships that own underlying fixed rate tax-exempt bonds. This guidance allows partnerships to employ special monthly partnership accounting periods to reduce a common "mismatch" between the tax years in which these partnerships and their investors, respectively, account for income. This guidance also provides that partnerships that follow these procedures need not provide "K-1" forms to the partners, a desired result. Also, this guidance provides that these investment partnerships are ineligible to elect out of the Code's "Subchapter K" partnership provisions. This guidance appears to be fairly workable. This Revenue

Procedure modifies and supersedes Rev. Proc. 2002-68, 2002-43 I.R.B. 753.

Cases

Section 141: Wastewater Pipeline. On October 1, 2003, the Justice Department decided not to appeal the U.S. Tax Court's decision in *City of Santa Rosa v. Commissioner*, 120 T.C. No. 12 (May 13, 2003). The private business use analysis appeared to focus on the absence of private payments. Thus, tax lawyers can continue to ponder (perhaps forever) what the peculiar analysis in the *Santa Rosa* case really means.

IRS Audit Program

For this fiscal year, the IRS plans to devote more of its audit resources (about 40%) towards abusive transactions in the tax-exempt bond area, as contrasted with random audits or program sampling. In general, targeting limited IRS resources towards abusive transactions should be a positive development, depending, of course, on what the IRS considers to be an abuse. In part, the IRS has indicated that it will focus more attention on potential arbitrage abuses involving the use of financial products.

On a personal note, the author remains mortified that someone gave IRS Tax-exempt Bond audit Director Mark Scott a picture of the author from about 1975 when the author's hair was down to his knees. So much for trying to convey a scholarly or conservative image.

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Acknowledgement

Certain tax material herein written by John J. Cross III is adapted with permission from his tax column entitled "Tax Developments at the Crossroads," which appears quarterly in *The Bond Lawyer* periodical published by the National Association of Bond Lawyers.

Nonprofit Joint Ventures

By: Kenneth B. Roberts

On May 7, 2004, the Internal Revenue Service ("IRS") issued Revenue Ruling 2004-51 clarifying that tax-exempt nonprofit educational organizations can, in limited circumstances, participate in joint ventures with for-profit entities without jeopardizing their nonprofit status or incurring unrelated business income tax liability. The IRS determined that a university (the "University") that had formed a limited liability corporation (the "LLC") with a for-profit company (the "Co-Venturer") to provide teacher training seminars continued to qualify for exemption under §501(c)(3) of the Internal Revenue Code.

Background

Under the ruling, the University and the Co-Venturer each contributed equal amounts of capital to the LLC and could appoint an equal number of LLC directors. The LLC's governing documents provided: (i) that the LLC's sole purpose is to provide the seminars; (ii) that the University and the Co-Venturer have equal capital and distribution rights; (iii) that the University has the exclusive right to approve the curriculum, training materials and instructors, and to determine the standards for successful completion of the seminars; (iv) that the Co-Venturer has the exclusive right to control the seminar location and non-instructional personnel; (v) that all other actions require mutual consent; and (vi) that all contracts and transactions of the LLC be at arm's length and for fair market value. The IRS determined that the University's participation in the LLC was an insubstantial part of the University's activities within the meaning of §501(c)(3). Based on the foregoing, the IRS concluded that such participation would not affect the University's continued qualification under §501(c)(3).

The IRS also applied the unrelated business income rules under §511 of the Code in determining that the manner in which the LLC conducts the seminars "contributes importantly" to the accomplishment of the University's educational purposes and, accordingly, that the LLC's activities are substantially related to the University's exempt educational purpose. Based upon these facts and circumstances, the IRS further concluded that the University would not be subject to unrelated business income tax on its distributive share of LLC income.

Analysis and Planning

Universities, colleges, hospitals, research institutions and other nonprofit organizations have increasingly entered into a variety of joint ventures with for-profit partners in recent years. Several aspects of this ruling may be worth noting for planning purposes. The facts presented included: (i) parity between the University and the Co-Venturer with respect to all structural indicia of control of the LLC; (ii) University control of decisions likely to have a qualitative effect upon the accomplishment by the LLC of the University's exempt purpose; and (iii) University veto power over all other decisions, with the exception of those bearing only on the cost or the quantitative accomplishment of the University's exempt purpose.

We believe that the University obtained a favorable ruling because, in part, the LLC's activities resulted in an important contribution to the University's achieving its exempt purpose without absorbing a substantial portion of its exempt activities. Even where the proposed activities of the LLC may be characterized in this manner, it is questionable whether either the same degree of structural control without substantial ability to direct, or of decisional control without substantial indicia of ownership, would be a sufficient basis for a favorable ruling. For instance, it is unclear whether a nonprofit university or research institution wishing to structure a research facility on a joint venture basis (which is not to be financed with tax-exempt debt) could obtain a favorable ruling under any state of facts if it shares control of the conduct of

research with its for-profit partner. Alternatively, if a nonprofit organization has the exclusive right to approve the choice of research to be conducted and the design and scientific staffing of those experiments, it is unclear whether a favorable ruling could be obtained if the nonprofit permitted its for-profit partner to retain more than half of the resulting profits. Would, in either event, the proportion of the nonprofit's overall research activity conducted through the joint venture be determinative, in view of the speculative nature of research activity?

It should also be noted that the facts presented by the ruling request did not require the IRS to consider the status of the LLC as a potential user of facilities financed with the proceeds of tax-exempt debt. It may be speculated that a nonprofit organization might be able to obtain, on the basis of similar facts, a favorable ruling with respect to a more capital intensive joint venture that approved an allocation of such use half to the nonprofit and half to its for-profit partner for the purposes of certain restrictions applicable to tax-exempt debt. It may be further speculated, however, that the availability of such a favorable result might hinge upon the details of the ownership of the financed facilities.

Joint Venture Research Facilities

It should be noted that if the joint venture is a research facility and is proposed to be financed with the proceeds of tax-exempt debt, it would be expected that the ruling process would require consideration of Revenue Procedure 97-14. This Revenue Procedure addressed joint-venture research agreements between a nonprofit entity, or a state entity such as a public university (a "Qualified User"), and one or more persons other than a Qualified User who provide research support (a "Sponsor"), which might include a for-profit or federal entity, an individual or a nonprofit whose use of the financed property is deemed to be an unrelated trade or business, that permit the Sponsor to use property financed with proceeds of state or local bonds. The procedure establishes that a research agreement will not, by itself, result in a private business use of bond proceeds (which might disqualify interest paid on the bonds from otherwise applicable tax-exempt treatment) if the research agreement complies with one of two safe harbors. The first safe harbor requires that: (i) the research agreement relate to property used for original investigation for the advancement of scientific knowledge not having a specific commercial objective ("Basic Research"); and (ii) any license (which may be exclusive) or other use of resulting technology by the Sponsor be conditioned upon payment of a price that is determined at the time the technology becomes available to be no less than would be charged to a non-sponsoring entity. The second safe harbor requires that: (i) there be multiple, unrelated Sponsors; (ii) the Basic Research program and manner of performance be determined by the Qualified User; (iii) the Qualified User have exclusive title to any resulting patent or other product; and (iv) no Sponsor be entitled to more than a non-exclusive license to use any research product, which may, however, be royalty-free. Revenue Ruling 2004-51 should be helpful in determining when a nonprofit organization may be a Qualified User for purposes of applying the safe harbors established by Rev. Proc. 97-14. In addition, the release of the ruling may suggest a possible evolution in the IRS's views during the seven years since release of Rev. Proc. 97-14.

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Note: Karen Endres, an associate with the firm, and Russell A. Miller, a firm partner, contributed to this article.

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