A Guide to Understanding Private Business Use (PBU) at The California Institute of Technology

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Introduction

- Caltech, as a non-profit organization, is able to utilize tax-exempt financing in its capital projects.
- Such financing involves the issuance of "qualified 501(c)(3) bonds," the interest on which is exempt from taxation.
- Tax-exempt debt often results in substantial savings in financing costs for the Institute.

A Benefit with Restrictions

- The benefit is provided to assist non-profits in advancing their charitable or educational missions, and not to aid Private Business Use (PBU).
- Property financed with the proceeds of tax-exempt debt must be owned by the exempt organization.
- No more than 5% of the direct or indirect use of that property may be PBU.

A Benefit with Restrictions - cont'd

- Should PBU activity occur, it must be closely monitored.
- In addition, payment out of the bond proceeds of the costs of the bond offering is deemed to be PBU, and such costs of issuance can run to 2% of the offering.

What is Private Business Use (PBU)?

- PBU is actual or beneficial use of tax-exempt financed property by any person or organization other than (1) a Section 501(c) (3) organization such as the borrower, or an affiliate, pursuing its exempt purposes or (2) a state or local government.
- Any direct or indirect use of tax-exempt financed property at Caltech, other than by Caltech (or another non-profit) for its exempt purposes, will result in PBU.
- There are limited exceptions for certain short term arrangements.

Why do we care?

- The Internal Revenue Service (IRS) imposes strict limits on the PBU of proceeds derived from the sale of tax-exempt bonds.
- PBU that exceeds these limits may cause the tax-exempt bonds to become taxable to the bond holder. Extreme cases could jeopardize the Institute's non-profit status.
- PBU of facilities and equipment financed with tax-exempt bonds requires monitoring procedures to ensure that the PBU stays within the allowable limitations.
- We must be ready with good records and detailed information in the event of an IRS audit where the exempt status of our bonds may be challenged.

Summary of PBU % by Bond Series

Bond Issue	Bond Proceeds	Comments	Private Use Status	FY2011 Cumulative PBU%
2011 Taxable Bonds	$ 350,000,000		No contribution	0.00%
* 2011 Bonds	246,000,000	New Money	No contribution	
* 1998 CEFA Bonds	54,000,000	Refunded by 2011 Bonds	No contribution after 12/2011	1.54%
* 1991 CEFA Bonds	30,000,000	Refunded by 1998 Bonds	No contribution after 12/2011	
* 1985 CEFA Bonds	20,000,000	Refunded by 1991 Bonds	No contribution after 12/2011	
2009 CEFA Bonds	$ 80,000,000	New Money	Contributes to PBU	1.23%
2006 CEFA Bonds	$ 165,000,000		Contributes to PBU	1.82%
* 2006 CEFA Bonds	95,000,000	New Money	Contributes to PBU	
* 2003 CEFA Bonds	70,000,000	Refunded by 2006 Bonds	Contributes to PBU	
1994 CEFA Bonds	$ 30,000,000	New Money	Contributes to PBU	1.97%
Total Outstanding Bonds	$625,000,000			

Note: The PBU % for CEFA Bonds used to refinance earlier bonds includes the PBU % contribution from the refunded bonds. The PBU % for the 1998 bonds is shown to provide insight into the levels Caltech' has experienced. After FY2012, the PBU from these bonds will no longer be relevant since they were refunded with taxable bonds.

Steps to Identify PBU

- Identify all tax-exempt bonds, new issues or still outstanding within a given fiscal year.
- Identify those buildings or projects that have benefited from exempt debt financing.
- For each building or project there must be an annual survey in order to determine PBU and qualified use activities.
- This is a continuous annual process in order to have the most accurate information available for calculating a required annual PBU percentage.

Examples of PBU at Caltech

- Use of tax-exempt financed property by Caltech in an unrelated trade or business such as allowing Movie or Television production companies to film on campus for a fee.
- Use by for-profit entities of property, such as laboratory space or equipment, built, improved or purchased with tax-exempt bond proceeds, whether such use is under a facilities use agreement or otherwise.
- Lease agreements such as for parking space or other use of space (even if the lessee is another 501(c)(3)).
- Engagement by Caltech in privately-sponsored research, under non-qualifying agreements (not for exempt purposes), utilizing equipment or facilities financed with tax-exempt debt.
- Improvements to Central Plant that benefit campus buildings that have private use activity.
- Agreements that permit the location of cellular towers, solar panels, or other structures on buildings that have benefitted from tax-exempt financing.

Measuring PBU

In order to measure PBU, the following must be considered:

- Determination of PBU done on an individual bond series basis.
- Each capital project receiving funding from the bond is identified to the space and specific building that benefits from the project.
- The use of equity (donor or general budget contributions), when available, reduces the percentage of PBU.

PBU Measurement Expressed as a Mathematical Model

Activity Ratio	Space Ratio	Use of Proceeds Ratio	Debt Ratio

$$\frac{\text{Activity}}{\text{Total Activity}} \times \frac{\text{Space}}{\text{Total Space}} \times \frac{\text{Project Bond \$}}{\text{Total Bond \$}} \times \frac{\text{Debt}}{\text{Total Funding}} = \text{Total Private Business Use}$$

Activity Ratio: measures portion of activities in the space that is PBU

Space Ratio: measures portion of space used to perform PBU activities

Use of Proceeds Ratio: measures portion of the total bond proceeds used to fund the space where PBU activities are performed

Debt Ratio: measures portion of the space that was bond funded (total funding includes debt portion plus any equity contribution)

It is important to note that the percentage of calculated PBU will be lower when equity funding (donor or general budget contributions) is used as part of the total project funding.

Specific Examples of Ratio Application to Measure PBU
Example #1
Calculating PBU (Service Centers)
No Equity Contributions

2006 Bond: ARMs/ GPS Division Analytical Facility (DAF) Service Center								
Activity Ratio		Space Ratio		Use of Proceeds Ratio		Debt Ratio		
Income from PBU ($) / Total Income ($)	X	Total project private use (Sq.Ft.) / Total Project Size (Sq.Ft.)	X	Bond Project Proceeds ($) / Total Bond Proceeds ($)	X	Bond Funding on Project ($) / Total Project Funding	=	Total Private Business Use
Activity Ratio		Space Ratio		Use of Proceeds Ratio		Debt Ratio		
$ 24,733 / $ 174,333	X	746 / 47,332	X	$ 481,069 / $ 170,500,611	X	$ 481,069 / $ 481,069	=	Total Private Business Use
14.19%	X	1.58%	X	0.28%	X	100.00%	=	0.0006%
								before equity adjustment

0.00%	Equity Contribution
47,332	Total Space
-	sq ft of space exempt from PBU
746	less PBU Space
(746)	sq ft of remaining space exempt from PBU
0.0006%	PBU after adjusting for equity

Example #2
Calculating PBU (Solar Panels on Buildings)
With Equity Contribution

2006 Bond: Cahill-Solar Panel T-mobile Model								
Activity Ratio		Space Ratio		Use of Proceeds Ratio		Debt Ratio		
PBU Days / 365 days	X	Total project private use (Sq.Ft.) / Total Project Size (Sq.Ft.)	X	Bond Project Proceeds ($) / Total Bond Proceeds ($)	X	Bond Funding on Project ($) / Total Project Funding	=	Total Private Business Use
Activity Ratio		Space Ratio		Use of Proceeds Ratio		Debt Ratio		
365 / 365	X	2232 / 102,232	X	$ 22,977,933 / $ 170,500,611	X	$ 22,977,933 / $ 52,700,000	=	Total Private Business Use
100.00%	X	2.18%	X	13.48%	X	43.60%	=	0.1283%

before equity adjustment

Roof Space (SF)	25,980
Interior Space Factor	11.64
PBU Space (SF)	2,232
Interior Space (SF)	100,000
Total Space (SF)	102,232

56.40%	Equity Contribution
102,232	Total Space
57,657	sq ft of space exempt from PBU
2232	less PBU Space
-	sq ft of remaining space exempt from PBU
0.0000%	PBU after adjusting for equity

Calculating PBU for Corporate Sponsored Research (CSR)

The are two methodologies for calculating PBU for CSR projects:

- A detailed calculation for CSR projects financed by bonds issued prior to the Series 2003 CEFA bonds.
- A high level methodology for CSR projects financed by Series 2003 CEFA bonds and/or later issues, including an 8% holdback.

CSR Example 1

Calculating PBU for CSR projects funded by bonds issued prior to Series 2003 CEFA bonds, no equity contribution, and no 8% holdback

PBU in the Business Services Building.

1998 Bond: Business Services (Corporate Sponsored Research)								
Activity Ratio		Space Ratio		Use of Proceeds Ratio		Debt Ratio		
Sum of CSR Dollars ($) / Sum of FY11 Expenses ($)	X	Total project private use (Sq.Ft.) / Total Project Size (Sq.Ft.)	X	Bond Project Proceeds ($) / Total Bond Proceeds ($)	X	Bond Funding on Project ($) / Total Project Funding	=	Total Private Business Use
Activity Ratio		Space Ratio		Use of Proceeds Ratio		Debt Ratio		
$ 83,634 / $ 1,347,133	X	1055 / 63,759	X	$ 3,705,538 / $ 97,520,308	X	$ 3,705,538 / $ 3,705,538	=	Total Private Business Use
6.21%	X	1.65%	X	3.80%	X	100.00%	=	0.004%

Bonds with 8% Equity Contribution
(Series 2003 CEFA bonds and later)

- Beginning with the Series 2003 CEFA bonds, capital improvement projects on academic and research space, as well as projects that serve such space (such as central plant), were deliberately funded with equity in the amount of 8% or greater of the project cost.
- So long as the overall corporate sponsored research calculated is less than 8%, corporate sponsored research activity may be excluded from the PBU calculation for the particular bond. That is, the calculation displayed on CSR Example 1 is not required.

Calculating PBU for CSR
Example II
A high-level calculation is performed for Series 2003 CEFA bonds (or later) receiving 8% holdback (equity contribution) as shown below

Analysis of Corporate Sponsored Research
FY2011 and FY2010
(dollars in thousands)

TIES TO FINANCIAL STATEMENTS & PREVIOUS CONTINUING CEFA DISCLOSURES			
Revenue	Notes	**FY2011**	**FY2010**
Direct Federal Government Sponsored Research	Note 1	$ 240,620	$ 227,014
Facilities and Administrative Recovery	Note 2	$ 79,628	$ 81,430
Less: Off-Campus Direct Federal Government Sponsored Research and related Off-Campus Facilities and Administrative Recovery	Note 3	$ (18,721)	$ (16,797)
Direct Non-Federal Government Sponsored Research	Note 1	$ 18,397	$ 20,726
		$ 319,924	$ 312,373
Corporate Sponsored Research (with potential private use)	Note 4	$ 9,089	$ 8,396
% of total above		2.8%	2.7%

NOTES:

Note 1 From the FY11 Year-end Financial Statement

Note 2 From the FY11 Incurred Cost Proposal, Indirect Cost Chart of Account File, Object Code 6902 Total, or the Year-end Trial Balance

Note 3 From the FY11 ICP COA Detail File for off-campus awards excluding non-federal (non-17XXX) and JPL IA (1723XXX)

Note 4 From the FY11 Incurred Cost Proposal, Indirect Cost Chart of Account File, Funding Source 15XXXX, then mapped awards as "Safe Harbor" or "Potential Private Use"

Safe Harbors for Research Contracts

- Some research contracts can be excluded from the calculation of PBU so long as they include what are known as "Safe Harbor" conditions.
- IRS Revenue Procedure 2007-47, Qualified Research Contracts, sets forth these conditions under which a research contract does not result in private business use.
- The guidance addresses basic research, which is original investigation for the advancement of scientific knowledge not having a specific commercial objective.

Safe Harbors for Research Contracts – cont'd

The contract will be "qualified" if:

- Any license of the resulting technology to the sponsor is permitted only on the same terms as the institution would permit use by an unrelated, non-sponsoring party.
- The price paid for the use is determined at the time the license or the other resulting technology is available for use.
- Persons other than the sponsor need not be permitted to use the technology however; the price paid by the sponsor must be fair market value.

Record Keeping

- Current IRS policy requires that all records relating to tax-exempt debt shall be maintained for the life of the debt (or, in the event the debt issue is refunded by a subsequent issue, for the life of the subsequent issue) plus three years.
- This includes, but is not limited to all investment records, requisitions, information concerning PBU such as commercial sponsored research agreements, leases, and management agreements.

Record Keeping – cont'd

Records common to most tax-exempt bond transactions include:

- Basic records relating to the bond transaction (including the trust indenture, loan agreements, and bond counsel opinion)
- Documentation evidencing expenditure of bond proceeds
- Documentation evidencing use of bond-financed property by public and private sources (i.e., copies of management contracts and research agreements)
- Documentation evidencing all sources of payment or security for the bonds
- Documentation pertaining to any investment of bond proceeds (including the purchase and sale of securities, SLGs subscriptions, yield calculations for each class of investments, actual investment income received the investment of proceeds, guaranteed investment contracts, and rebate calculations)
- Records of buildings and projects that benefited from tax exempt debt
- Records and calculations used to determine the percentage of Private Business Use for each debt financed building or project

It will be the responsibility of the Controller's/Tax office for coordination of the maintenance of all necessary records to ensure compliance.

Reporting

Annual Information Return Form 990, Schedule K:

The purpose of schedule K is to provide the IRS information on an exempt organization's tax-exempt bonds issued after December 31, 2002, with an outstanding balance of $100,000 or more. Required information includes, a listing of outstanding bonds, information on the proceeds, PBU related to the bonds, and information on related arbitrage. Schedule K is a part of an exempt organization's annual 990 tax return.

Annual Bond Equity Allocation Certification:

This is an annual listing of the dollar amounts of debt financing and equity applied (from donor or general budget contributions) to the various projects receiving benefit from tax-exempt bonds.

It will be the responsibility of the Controller's/Tax Office for completion of the form 990, Schedule K and the Annual certification. This includes coordination with other Caltech offices that contribute necessary data and analysis, outside counsel, and post compliance services.

Process Participants

- Controller's Office
    A. Tax
    B. Accounting & Reporting
- Treasury Services
- Cost Studies
- General Counsel
- Campus Facilities
- Outside Counsel and Post Compliance Services (BLX)

In the future the Office of Technology Transfer (OTT) and Corporate Sponsored Research (CSR) will participate in the process using a template developed by the Office of The General Counsel (OGC) that will help them determine if PBU is present in their agreements and contracts.