AAHSA

Mission Ridge IRS Call

September 7, 2010

Mr. Steve Maag: What we're here to talk about is to give members an update on a very important tax matter affecting CCRCs across the country.

This is a four-year [inaudible] and bond audit in which the IRS is attempting to establish that the funds held by Mission Ridge, a CCRC as I mentioned, which are primarily their entrance fee deposits, but not exclusively those deposits, are being considered by the IRS to be replacement proceeds for the outstanding tax-exempt bonds and are thus what--turned what are yield restricted and subject to the arbitrage rules of the IRS.

As I mentioned, this has been going on for virtually four years through varied--a number of iterations. Many of you who have attended AAHSA conferences in the past have heard me or other staff speak of this. It is a matter of significance for CCRCs across the country and could have a significant impact on the financing and the structure, financial structure, of the CCRCs if the IRS position is sustained.

What we're going to do today, I'm going to have Kent Burgess, again, the CEO of St. John's, the operator of Mission

Ridge, talk a little bit about the history and what Mission Ridge is, what kind of CCRC they are and a little bit of the background.

And then, Brad Waterman, the tax counsel, as I mentioned, is going to spend half an hour or so going over a very long and torturous history of dealing with the IRS.

And then, we want to leave some time at the end for the written questions for you to submit that I'll read and have our speakers respond to.

So, with that, Kent, could you go ahead and give us some background?

Mr. Kent Burgess: Thanks, Steve, and I'm pleased that so many people have turned out for the call today.

Just a--I'll talk a little bit about who Mission Ridge is, how we're structured, and then talk a little bit about how this audit has unfolded.

Mission Ridge is a joint-venture operation between St. John's Lutheran Ministries and St. Vincent Healthcare. St. Vincent Healthcare is a Catholic tertiary care hospital located here in Billings, and it's a 50/50 joint venture in terms--the joint venture has hired St. John's to manage the project and pays a management fee for that. And the project is governed by a 10-person Board of Directors. The CEO of St. Vincent Healthcare and myself both have permanent seats on the Board.

And then, each of the sponsors appoint four additional Board members.

Mission Ridge is kind of freestanding with 122 independent living apartments and 60 assisted living apartments. Average deposit in IL is about $100,000. Basically, the plan is 90 percent refundable upon re-leasing of the apartment. We also provide an $18,000 long-term care benefit. And Mission Ridge opened in 1998 and has paid out over a million dollars in long-term care benefits so far.

From an accounting standpoint, it's probably important to note that while we do keep a running record and log of every resident deposit, how much their deposit was and when we received it, we operate with one checkbook. So, resident deposits are deposited into our checkbook, as well as depreciation funds, as well as any net income.

So, we're basically a one checkbook operation, but the--what we do identify individually, as all of you would as well, what the individual deposit was.

I offer that up because it's important that--initially that the agent who conducted this audit seemed to be able to point to this log of resident deposits and believe that that then said that we were retaining those resident deposits and tried to build a case that we're retaining the deposits so that--for the benefit of the creditors and that the money was assuredly would

be in the till if the creditors needed it, even though we believe none of our bond documents required anything other than the debt-service coverage ratio and days cash on hand covenants that we had.

As Steve mentioned, the audit was launched in April of 2007, and the agent believed strongly that the resident deposits that we have are held for the creditors and thus would consistent replacement proceeds and thus need to be yield restricted with no deposit of [inaudible].

Through the first several years of the audit, we received multiple information--requests for information and documents, with multiple, kind of, theories being proposed through each of those. Our attorney, Brad Waterman, has indicated that when he came onboard that the last information document request he'd received was number 15.

We responded to every request of the IRS, provided the information that they required, but honestly they didn't like our answers. And I felt through this entire period that when they didn't like our answers, we would be required to do vast amounts of homework.

In the second IDR request, the IRS told us that they'd be happy to entertain our settlement agreement on the proposal, even though at that point in time they had never presented a

legal case or reasoning as to what sin we had committed and what we had done wrong.

Further in the process when the IRS agent got, kind of, animated and upset with us, he threatened our entire tax-exempt status, which our attorneys indicated that for the tax-exempt bond division that he is in that that is not a question for him to question, and it is not under his scope of responsibilities.

So, again, we've had, kind of, multiple threats--I would really call it intimidation from periods of time. But, we continue to provide all the information.

At one point during the proceeds, we thought, "We ought to try to figure out what if we did lose? What's the impact here?" And that's difficult for us to calculate because we have resident deposits, we have interest earnings, we have depreciation funds, we have net income that makes up our--basically, our cash.

And we, honestly, could not tell you what percentage of that cash was resident deposits, did we spend a resident deposit dollar or did we spend a depreciation dollar or did we spend a net income dollar? So, we decided that we would [inaudible] the entire amount, every cash that we--all cash that we had over that four-year period in question and calculate if there was positive arbitrage what the impact would be.

And, basically, on every nickel that Mission Ridge had during that four-year period of time, the actual impact to us would have been less than $252 if we had lost that.

[Inaudible] from the beginning, we had that log that reflects $12 million in resident deposits, again, about 122 IL apartments with a median deposit of around $100,000. We only have $8 million in cash, thus we obviously have spent resident deposits as well as other dollars.

We went through a pretty significant argument that we were being forced to hold onto those resident deposits because we had to refund to those residents, therefore that money would always be in a [inaudible]. Bit of an education to them on what the refundable deposit looks like based on re-leasing. The first deposit constitutes income as amortized over the life of that resident in that apartment.

So, $12 million of resident deposits on the books, $8 million in cash--we've obviously spent dollars. To this point, our legal bills have exceeded $300,000 or what the impact of the potential arbitrage impact would be. And we believe that, ultimately, that if we were somehow to figure out a formula that says over this 12-year period of time we've generated these many depreciation dollars, these many net income dollars, these many resident deposits, came up with a ratio, and then calculated

that and presented that as a settlement agreement, our settlement agreement would probably be less than $150,000.

It was at this point--initially, Ziegler, who was our bond underwriter, the Montana Health Facilities Authority, who issued the bonds, and Mission Ridge each contributed $30,000 to the initial legal expenses before--while we worked with, fundamentally, our internal team, our bond counsel.

After we'd expended those dollars and were in probably about the fifth--fourth or fifth request for information, was when we realized we needed to get more legal help in this area and therefore retained Brad Waterman, who is our lead attorney.

Would also want to point out that Brad is being assisted by Milt Wakschlag of the Katten Muchin firm, that--and that Ziegler is supporting Milt in that effort as we continue.

Once we'd gone through multiple IDRs, we finally brought the case to some sense of resolution in that our goal was to get it out of the agent's hands. The agent wrote his final report. We submitted our report or response, which we think refuted everything the agent had to say. And then, we basically requested that we go to appeals. We needed to get to another set of voices that made more sense to us.

Prior to the moving to appeals, we requested a sit-down meeting with the agent, the agent's boss from Chicago--the agent

is based in Helena, Montana. His boss is based in Chicago, and her boss is based in New York.

We requested a face-to-face meeting with the agent and the boss and the boss's boss, and we held that meeting in Chicago. I was present, our local counsel was present, the Executive Director of the Montana Health Facilities was present, as well as the--our attorney, Brad Waterman and Milt from--representing Ziegler at the time.

Our goal in going into that meeting was to have the boss's boss walk out of that meeting scratching his head saying, you know, "What's going on here, and is there anything to constitute this agent's claim?"

In the last call, we covered that meeting in depth, so I won't cover it again other than to say that, honestly, in the midst of that meeting, the agent was quite embarrassing. At the very end when this meeting was over, the boss's boss ultimately called Brad Waterman, our attorney, and said that he was going to request a step called technical advice, which was a step that was available for us.

So, we could have said, "Hey, there's a question here. We need to take this to another division of the IRS, and we need to receive technical advice." We decided we didn't need any technical advice. It was not a step that we wanted to take. It would take more time, cost more dollars. But, the boss's boss

then indicated that he, representing the IRS, was going to request technical advice.

When that request was made--well, I guess, internally, we felt that we had left the boss's boss leaving that meeting scratching his head saying [inaudible].

When we went into--so, the technical advice, and Brad can talk more about this, but it got shifted into another division of the [inaudible] we sat. We sat for a long period of time, and then the IRS agent's argument, which was new to us--now three and a half years into the process, we're told that the reason that we have to retain resident deposits is because GAAP accounting requires us to do so.

So, that was the question going into this technical advice. And we honestly felt quite confident that, one, that was a weak argument. That, two, GAAP accounting does not address how we can and can't spend our dollars. That'd really help us a lot [inaudible] what the credit agreement were prior to us entering into this conference.

So, they cited about four sections of the letter of credit agreement. We zeroed in on the letter of credit agreement. We saw nothing in there that required us to retain resident deposits for the letter of credit bank.

It happened that our representative at the letter of credit bank happened to be visiting three weeks ago prior to our

meeting with the IRS in DC. And so, I walked the representative through our financials, through the letter of credit agreement, and her understanding and my understanding of our letter of credit agreement is exactly the same, that there's nothing in there--as the letter of credit banker said, "If we wanted those resident deposits, we'd have put a lockbox on those and kept them segregated."

So, we went to our meeting in Washington, DC--this was now two weeks ago--with this new division, new attorneys to me, we--they introduced the meeting, and then we introduced our case, reviewed the case with them.

But, at one point, as I was speaking to the more senior attorney in the room, I indicated that I thought we were at technical advice because GAAP accounting. And that was why we were there is that GAAP accounting required us. And here I was now back in Washington, DC, hearing the seventh theory, and no one mentioned the word GAAP accounting. It never immersed.

And I said--all of a sudden, I go into technical advice, GAAP accounting. Three and half years later, I hear the GAAP accounting. Now, three and three-quarters years later, I hear a letter of credit agreement is the problem.

The more senior attorney indicated that while numerous theories had been thrown at us, ultimately the issue here was

whether resident deposits constitute replacement proceeds and thus need to be yield restricted.

And I think for those of us who rely on interest earnings from our resident deposits to keep our monthly fees lower, you know, obviously that would drive up the cost of healthcare in our CCRCs and, ultimately, isn't what we think the goal of the IRS should be nor do we believe that this is a way to make public policy.

There have been several other additional audits that have been opened looking at deposits. Some have been closed, could be reopened depending on the status of ours. But, our feeling is that the IRS has, kind of, staked their claim to our case. And win it or lose--obviously, if we lose, it will have a significant impact on the industry and other CCRCs that are structured pretty identical to how ours is as well.

With that, I'm going to introduce Brad Waterman who can talk to you about more of the, kind of, legal view and position of the IRS and our position in turn.

So, I'll turn it over to you, Brad.

Mr. Brad Waterman: Thank you, Kent.

I think I'm going to start by fielding a question that came in already. And the question is, "Bottom line, can you see where this is going to end up or is it still too early in the process to predict likely outcomes?"

Well, I thought I knew where it was going to end up at the moment that I was brought onto the case. I never anticipated that the tax-exempt bond group of the IRS would toss theory after theory after theory against the wall in the hope that one would stick. And we felt very confident, but we have not been able to persuade them to back off. I thought that we made excellent arguments at the meeting that Kent referred to a couple of minutes ago. I'll talk about that in a little while.

But, they keep coming, and it reminds me of the movie Caddyshack. For those of you who are golfers, you'll recall that the groundskeeper, who's played by Bill Murray, every time he thinks he's got the gopher, the gopher pops up someplace else. That has been our experience. This has been a very hard-fought and nasty battle.

I would just like to say, as Kent said, that, you know, we are the guinea pig here. There's no doubt whatsoever that lots of people within the IRS are watching this case. That meeting that Kent referred to that took place in Chicago, the revenue agent would not meet with us. The group manager, his immediate supervisor, would not meet with us. We had to go up top to the Director of Field Operations, the person who runs the audit function for the tax-exempt bond group, to get the meeting.

And they came in very confident and, as Kent mentioned, walked out scratching their heads. Articulated two new theories

after that, which I'll get into in a few minutes. We beat them both down, and now we find we're dealing with something completely different, but for a different group of folks.

So, I'd like to tell you that it should have been over a long time ago, but they keep coming. The issue has been raised in several other examinations. I'm aware that a couple of them have been closed, but you can't walk away with a good feeling about that because the IRS can always come back. It's clear we're the guinea pig, and there's just no way to predict how much longer this thing is going to go and where they are going to wind up.

We're going to keep fighting, obviously, on the examination side, on the controversy front, but at the end of the day, there may be--it may be necessary to go the legislative route to get a fix.

But, having said all of that, let me just give you a very brief introduction into the problem here, into the issue, and that is arbitrage. Generally speaking, the price of tax-exempt financing is that you're required to build things or buy things. You're not allowed to borrow at a tax-exempt rate and turn around and invest at a taxable rate and keep the arbitrage profits that result from that.

There are circumstances in which other money, not bond proceeds themselves, but other funds are treated as bond

proceeds. The technical term is replacement proceeds. And if you have replacement proceeds, you're required to follow the rules that are applicable to bond proceeds. Generally speaking, you're not allowed to invest at a materially higher yield than the bond yield. And if you are entitled to invest under the Internal Revenue Code, than you have to pay the profit over to the IRS. It's 100 percent tax.

And the question is, well, what creates replacement proceeds? And the answer is that there has to be some connection or nexus to the bond deal. And one way that is supplied is through a pledge. If you pledge collateral to the bondholders to secure your obligation to pay debt service, then generally speaking, that collateral will be regarded as replacement proceeds, and that's what we're talking about here. And you are required to yield restrict, you're not--in other words, you're not permitted to earn arbitrage profit on the investment of that collateral.

But, there's another rule that's very important, and that is that if the borrower has discretion to defeat the collateral--I'm sorry, to defeat the pledge by dissipating the collateral, then there's no replacement proceeds problem. In other words, if you can spend the collateral, if you're not subject to any restrictions or limitations on the dissipation of the

collateral, and you therefore have discretion to spend it all, then the pledge is defeated.

And the reason is that there's got to be a reasonable assurance that money will be in the till, that the collateral will be in the till even if the borrower encounters financial difficulty. And if you can spend it all, obviously the borrower--I'm sorry, the lender, can't have the requisite reasonable assurance.

That is the--that's, sort of, arbitrage 101 as it relates to replacement proceeds. It's all about the question of whether the lender has the requisite reasonable assurance that the collateral's going to be in the till. And the rule is that if the borrower can spend the collateral, then you can't--the lender doesn't have the requisite reasonable assurance and all these tough rules don't apply.

Now, with regard to Mission Ridge itself, Kent has reviewed the salient facts. Let me just hit a couple of other points. Mission Ridge granted a security interest in its revenue, also known as a general revenue pledge, to the bondholders.

And so, you'd think hearing pledge and that sort of thing that we're in bad shape. But, there's a little more to the story, and the rest of the story is that there's absolutely no question that Missions United is entitled to spend that revenue as it sees fit in connection with the operation of Mission

Ridge, including for capital expenditures. There are no restrictions or limitations on the expenditure of the revenue, including the resident deposits.

Kent actually spends the resident deposits. There's no question about it. As he mentioned, he's got one checkbook. All the cash flows in, and if he's got to spend money, he spends it without regard to whether it came from operating revenue, in other words tenant fees, or investment income or resident deposits.

Couple of other general observations. The purpose of a general revenue pledge is to enable the lender to intercept revenue before it reaches the borrower if there is trouble. In other words, it's forward looking. And if that happens, there could be some--what I refer to as "old and cold revenue" still in the till. And if there is, so be it, but there's no promise on the part of the borrower to maintain revenue, including resident deposits, for the benefit of the bondholders. And, indeed, how could there be because a business has got to spend its revenue in order to operate.

So, the whole idea here is this is nothing more than an intercept mechanism. And, you know, it is forward looking. If there's trouble, the lender says to third parties, "You know, that guy hasn't paid his debt service. You start paying me the

revenue that you do--that you owe him. I want to control it instead of paying him."

But, until that happens, generally speaking and in particular in this instance, there's no intention on the part of the lender to in any way interfere with the ongoing operations of Mission Ridge or the business otherwise, no restrictions, no limitations on the dissipation of the revenue, including the resident deposits.

As Kent mentioned, he gets the cash, he spends it. The letter of credit provider has never had a beef, the trustee has never had a beef because he's entitled to spend it, and that's really the bottom line.

Now, with regard to the examination--the examination, as Kent mentioned, started several years ago. And it has been characterized by threats, threat to 501(c)(3) status, curious inquiries into substantial donors and advice given by Mission Ridge to its tenants regarding the [inaudible] some of the monthly fees as medical expenses. All kinds of crazy stuff like that.

And they have tossed against the wall theory after theory after theory. And I will give you a little review of what they've done. The first theory was that the revenue--resident deposits, and more generally the revenue, constitutes replacement proceeds solely because of the pledge.

And our answer to that was, "Well, you didn't look deeply enough. There's more to the inquiry." You know, the second part of the inquiry is whether Missions United is entitled to dissipate the collateral. It clearly is, so the mere fact that it has pledged its revenue doesn't mean that they are replacement proceeds. That was theory number one.

Theory number two was that the resident deposits constitute replacement proceeds because Missions United expected to use resident deposits to cover anticipated shortfalls in the cash required for debt service in the first few years of the operation of the expansion that was financed by the bonds.

Well, the answer to that one was, "No we didn't." You take a look at the projections, and three out of the five years we expected operating revenue to fully cover all of the expenses, including debt service. And with respect to the other two years, we knew that we would have to dip into resident deposits, but those were resident deposits that were remitted in the year at issue. In other words, not accumulated resident deposits, but current resident deposits. And in dipping into them, we were just spending our revenue.

Theory number three, the IRS, the tax-exempt bond group, conceded that were contractually entitled to dissipate, but it said that we had to preserve them so that we could make refunds to tenants as they vacate. And we said, "No we don't. If you

look at the agreements, you would see that a vacating tenant is entitled to the refund of the deposit when the next tenant moves in and makes his or her deposit."

Theory number four was that sound business practice requires Missions United to preserve resident deposits. Our response was, "Sound business practice? What do you guys know about sound business practice as it relates to CCRCs? And furthermore, every business needs to spend its revenue when it's operating, in its operations." You know, everybody understood that, every party to this deal understood that, and more particularly the lender, the trustee acting on behalf of the bondholder, obviously thought that sound business practice, kind of an amorphous concept, dictated that Missions United spend its revenue, not preserve its revenue. How could it operate otherwise?

Theory number five, again, the tax-exempt bond group conceded that we are contractually entitled to dissipate. It said that we had to save the resident deposits so that we would be able to make refunds to the last tenants who occupy Mission Ridge, in other words, the folks who turn out the lights.

Our response to that was, "We don't ever expect to turn out the lights. And in any event, if it happens, it's going to happen long after these bonds have come off the market. And the argument, therefore, is irrelevant."

Theory number six was that the bondholders have the requisite reasonable assurance that the money will be in the till, even though Missions United is entitled to spend it, merely because it has money in the till today. In other words, if you've got cash in your bank account today, that and that alone provides a reasonable assurance that the money will be there if there's an event of default.

And our response to that was that we have already expended [inaudible] resident deposits, and that is based upon assumptions that are extraordinarily favorable to the government, assumptions that are unreasonable. And, you know, let's be realistic. The fact that you've got cash in the bank today doesn't mean it's going to be there tomorrow.

And then, finally, theory number seven, which is the theory that was the basis of their request for technical advice, was that conformity with GAAP precludes dissipation of the resident deposits. And as Kent mentioned, we asked LarsonAllen and Dixon Hughes for opinions, and they said, in effect, that the IRS has no clue what they're talking about, that GAAP dictates how you report things, not how you run your business, and in particular, how you spend your money.

As Kent mentioned, at the conclusion of this meeting or shortly after the conclusion of the meeting that we had with the big boss in Chicago in April of last year, he called to say that

they wanted to request technical advice. Technical advice is a process that is used in examinations when the field needs guidance from the National Office with respect to difficult or complex issues.

And in this case, in the bond area, technical advice is provided by the Office of Chief Counsel, and specifically the bond branch, which is a group of tax-exempt bond experts who sit within the Office of Chief Counsel.

What happens is, in the technical advice process, if the National Office determines that it is tentatively adverse to the tax payer, the tax payer's offered a conference of right. It's your opportunity to come in and make your pitch, try to turn them around, and that's what happened to us.

We got a call a few weeks ago from the bond branch saying they were tentatively adverse, inviting us into a conference. They didn't want to tell us why they were tentatively adverse and we insisted. We said, "What's the point of coming to a conference unprepared? If you told us what's going on, what you're thinking about, we could be ready for the conference, and then it would be much more meaningful for all of us."

And they told us for the very first time that there's actually now theory number eight, which is that the letter of credit agreement imposes restrictions on the expenditure of revenue, including resident deposits. And prior to the meeting,

they cited to us chapter and verse of the provisions that they contend support this.

We met, as Kent mentioned, with representatives of the bond branch a few weeks ago--a couple of weeks ago. And it was evident that they had completely thrown away the GAAP argument that had been advanced by the tax-exempt bond folks, the examination folks, and were now focused on the letter of credit agreement.

And after we conducted a thorough review of the legal landscape as it relates to replacement proceeds in general and pledges in particular, the history of the examination, life in the real world in so far as general revenue pledges are concerned--life in the real world in so far as Kent's operation is concerned, and life in the real world in so far as Montana is concerned--Montana law is concerned.

We addressed each one of the specific provisions of the letter of credit agreement that they cited, and we said, "This one doesn't say anything about restrictions or limitations, and this one doesn't say anything about it," so on and so forth.

The bottom line is that the provisions they cited basically said things like, "Missions United hereby grants a security interest in its revenue. Missions United agrees to cooperate with the letter of credit provider to do whatever is necessary to evidence the security interest it's been granted. Missions

United has the authority to grant the security interest," et cetera, et cetera.

Nowhere in any of those provisions did it say that there are any restrictions or limitations on the dissipation of the revenue. And we point--we called their attention to two other provisions in the letter of credit agreement. One of them says you're allowed to spend the revenue, and the other one says you've got to spend your revenue in order to conduct operations, maintain your business and maintain your assets.

They did not say a word in response to our comments on their position. They asked us to provide a summary of our arguments, which I did last week. They also asked our Montana counsel, John Jones, to provide a summary of how Montana law would work. He did that last week as well. And now, we're waiting to hear.

Well, what's next? Well, at this point the ball is in the bond branch's court. If they issue technical advice that exports the tax-exempt bond group's position, then we'll take the case to IRS appeals. Appeals' mission is to take a fresh look at cases. It's independent of the examination functions. It settles cases based on the likely outcome of litigation, and they do a good job. They generally give you a fair shake, but, you know, when you're going in there with a technical advice

that supports the IRS's position, that obviously influences the dynamic and not in a good way.

If the bond branch issues technical advice that is favorable to us, we're hoping, but there's really no way to know for sure, that that will be the end of it.

So, I guess with a couple other comments, and then we'll open it to questions. There--as I mentioned before, and forgive me for repeating this, but I think it bears repeating. There's simply no doubt that this is a test case.

The big cheese from New York told us that his folks throughout the tax-exempt bond group are generally aware of the replacement proceeds issue. As we mentioned, it's popped up in a few audits.

And I would say that the significance of this examination was evidenced by the number of people who attended our conference with the bond branch in Washington last week. Every person in the bond branch who was in town was in that meeting, including the Deputy Branch Chief, two senior technician reviewers, as well as the attorney who's handling the case. They're obviously very focused on this, and they're focused because they know that it affects CCRCs throughout the country, and perhaps even other borrowers.

And just to reiterate my response to the question that was post at the outset, we'd like [inaudible] victory's right around the corner, but we know better.

We know better because the tax-exempt bond group has been relentless in its pursuit of Mission Ridge. It has repeatedly tossed poorly-developed and what I refer to as intellectually corrupt arguments against the wall in the hope that one might stick.

Its last argument before it turned the case over to the National Office, the argument that conformity with GAAP precludes dissipation, perhaps was the silliest of them all. Not to give undue credence to the other ones, but that one was truly ridiculous.

And the continued discomfort that we're experiencing is attributable not only to what's happened thus far, but the fact that the bond branch easily could have tossed the case based on the issue that was presented to it whether conformity with GAAP precludes dissipation. And instead it tossed the argument and came up with an entirely new argument, namely the argument that the letter of credit agreement precludes dissipation. But, from where we sit, that argument has--doesn't have any more traction than the seven arguments that preceded it.

But, you know, we're back to Caddyshack. Every time we think we've got the gopher, it pops up again. So, it's just

impossible to predict when this thing is going to end and what the outcome will be. And just to emphasize again, the potential impact for all CCRCs that use this financing model is enormous.

You know, as Kent mentioned, you know, if the IRS prevails in this, it'll mean that you cannot earn arbitrage profit off the investment of your resident deposits, perhaps off the investment of your revenue generally, and that means one of two things, neither of which is good. Either you've got to cut services for the seniors who occupy your facilities or you have to raise their rates if you want to provide the same services. So, it's a very tough situation.

And with that, I'll turn it back to Steve for questions.

Mr. Steve Maag: Great. Thank you, Brad.

First of all, I'm going to--one quick question for Kent. And we actually had a couple of questions along the same lines that basically say, "Why Mission Ridge? How did you get on the IRS's radar?"

Mr. Kent Burgess: You know, we honestly don't know the answer to that question. We were told that it was purely a random audit.

A couple of things occurred, though, prior to us being notified of the impending IRS, was the IRS opened up an--prior to this time, they did not have an agent in Montana. They

opened up a new office with this agent in Helena, Montana--that's our state capital.

And the Health Facilities Authority who issued our bonds had already been given some notice that the IRS was opening in this office, expect an increase in the number of audits of your tax-exempt bond issues. So, the Health Facilities Authority was somewhat aware of it going in. We received, basically, a form letter that said we'd been randomly selected.

And as I'd shared in an earlier call, I can kind of remember the whole date being April of 2007 because in April of 2007, I had back surgery. And so, when the IRS agent showed up on campus, I was actually in surgery. The good news is that I recovered from my back surgery.

Mr. Steve Maag: Thanks, Kent.

Just as a reminder, you can e-mail questions into questions@aahsa.org.

With that, next couple of questions that have been along the same theme of, "Have we contacted elected officials? Have we contacted Senator Barkus?"

Larry Minnix is here. We have discussed that strategy, but for a variety of reasons we haven't pulled the trigger on that. But, I'll ask Larry to speak briefly to that.

Mr. Larry Minnix: Sure.

What we hope we can do is have this thing killed at the Mission Ridge level. But, so far, it will not [inaudible].

And so, what--we have been raising money from amongst our members and some of our business friends to get this appeal done because if Kent does not get the right kind of ruling, I think you can do your own calculations and begin to see the impact this could have on your financing and the way that people that buy tax-exempt bonds might be--see all of this has huge implications.

Kent could have settled a long time ago, and we discussed that possibility. But, if he settled, that meant there was a precedent there for everyone else and would make it considerably more difficult to finance CCRC projects.

So, we have quietly raised a couple hundred thousand dollars on the legal fees. We need another, we think, 250,000 to get through what we think will be an appeal process. And I'd like for everyone on the call to know that if you haven't been asked for financial support for that, you will be. Financial support is ranged anywhere from 1,000 to $10,000, and all of that is passed through to Kent because it's one of those issues that comes along from time to time that affects everyone.

In the meantime, and we'll meet again at LA to bring everyone up to date, when we get past this election, we will be working with members of [inaudible] fixed to this, similar to

what we did with the imputed interest. You'll recall that was one other way that's--we had from time to time, and we have some reason to believe that there will be members of congress that would want to help with this.

So, that will be a long-term strategy that we'll work on while we're helping Kent to resolve this particular issue because we believe that even if it resolves in Kent's favor, there's--there are people out there that are looking for ways to tax us. And we all know that the financial model of CCRCs is not built around the arbitrary rules that they have thrown at it.

So, we're going to ask your help initially with covering these legal fees through the appeals. And then, secondly, when we get far enough with congress after the election, we're going to want everyone's help here in approaching your member of congress, especially those on the appropriate committees, to help us get this fixed permanently through some piece of legislation.

Mr. Steve Maag: Thanks, Larry.

A couple of--one quick question on what the other CCRCs--I think, both Brad and Kent mentioned, we do know of four other CCRCs where this has been specifically raised in tax-exempt bond audits. One called Dow Rummel in South Dakota which is being done by the same agent that was handling the Mission Ridge and

occurred sometime shortly after Mission Ridge. And to the best of our knowledge, it's a non-AAHSA member. It's still pending the outcome of Mission Ridge.

There's a community in Norfolk, Virginia where this issue was raised and in a community in the state of Oregon where this issue has been raised. So, we do know that--and those are all part of the tax-exempt bond audit.

Question came in, and we'll have Brad respond to this after I do. It's as follows. "We're a state-regulatory system, but not any lender or GAAP requires the CCRC to build a reserve fund down in escrow to fund refunds of entrance fees. Would IRS treat that as replacement proceeds under its position in the Mission Ridge audit?"

My initial response is I don't think so because I believe that they'd have to act under IRS principles. I think what they're--you know, clearly, what the question is talking about is some of the state regulatory requirements that set some reserves as part of their CCRC regulatory environment. But, I don't think that would be subject to the IRS.

But, Brad, any thoughts?

Mr. Brad Waterman: Yes. The--I think the mere fact that the state says that you have to hold funds in reserve, presumably to protect the residents, that in and of itself

doesn't create the problem. The problem is created by the pledge of those resident deposits.

And I don't know the landscape in its entirety, but--and forgive me if I make a mistake here, but it seems to me that if a state says that you've got to sit on your resident deposits that that means that you can't pledge resident deposits, and therefore there's no connection to the bond issue. It's a standalone requirement for the benefit of the bondholders.

But, the question is a very good question because it kind of hints at something else which I alluded to before, and that is, does the reasonable assurance that the money's going to be in the till if there's trouble down the road have to--does that have to flow from the pledge arrangement or can it flow from elsewhere?

And we have a case where--at least until we ran into the technical advice process, the IRS did not take issue with our contention that we were free to dissipate those revenues, including resident deposits. They claimed that the reasonable assurance was provided by something else, some other factor outside of the security arrangement. And you'll recall I mentioned a couple of them. One was that you've got to sit on the money in order to be able to make refunds to tenants when they depart.

And our answer to that--in addition to addressing the specific argument that's raised, our more general answer is, "Think about what you're saying." If a lender wants to be assured that collateral is going to be in the till, it's not going to say, "Spend it all on your operation if you want to," and hope that it won't. Instead, it's going to say, "You can't spend it." In other words, it's going to wrap its arms around that revenue instead of allowing you to spend it and hope that you won't.

And I happen to believe that the reasonable assurance has got to flow from the pledge. And for that reason I believe all these arguments that the IRS has tossed up against the wall, that the reasonable assurance can flow from elsewhere--like the argument that you can't spend resident deposits, you've got to sit on them in order to be able to make refunds. I don't think those arguments are good enough simply because of the way that the rules read and the way world works, no creditor is going to say, "Spend it all," and hope that you won't that wants to be assured that there'll be money in the till if there's trouble.

And I think with respect--back to the question, bottom line is the mere fact that the state says that you have to sit on resident deposits, assuming that's to protect the tenants, that in and of itself doesn't create a problem. The problem would be created if those deposits are pledged to secure the payment of

debt service. But, it doesn't seem to me that if a state says sit on it, it's going to allow you to pledge it.

Mr. Steve Maag: Thanks, Brad.

Before we go to the next question, I want to let listeners know that--you heard Larry mention a meeting--an annual meeting regarding this. We do have a time set for this on Sunday morning at 10:30 October 31st. We have not yet determined the exact room. It will be on the advanced schedule--the site schedule when you get there, so that will be a time where you'll get the update. We hope, obviously, by then to have more specifics on whether the technical advice remains to be adverse or what will happen after that.

You also will receive some follow information on fundraising and methods that you can support AAHSA in supporting Mission Ridge.

Next question is for Kent. "Does Montana have additional rules through its departments of insurance or other agencies on CCRC-type providers that play a part or not in how Mission Ridge has practiced their way of doing operations?"

Kent?

Mr. Kent Burgess: The answer would be no.

We're not aware of any regulations or requirements that Montana has for CCRCs. My, kind of, understanding in researching this is that there are, I believe, 18 states in the

United States that have some type of CCRC regulations, but Montana is not one of them.

Mr. Steve Maag: Okay.

That also answers another question on escrow fees that are triggered to regarding sales of contracts, which you don't have in Montana, correct?

Mr. Kent Burgess: That's correct.

So--but, if I'm reading that question correctly, based on what I have gone through, if I was in a state that required that we escrow those entrance fees, I think that the IRS's case would have been stronger. And Brad can weigh in on that, but I think that's exactly what they were trying to say we were doing when, in fact, we weren't.

Mr. Steve Maag: I see--.

Mr. Kent Burgess: --So, Brad, would that not run a greater risk if you escrowed your entrance fees separately?

Mr. Brad Waterman: Well, again, it depends on whether you--you know, whether they were pledged or not.

I mean, as I mentioned before, it seems to me that if you're required to put them aside, then the state is not going to allow you to pledge them. That would be contrary to the purpose in allowing you to put them aside.

And--but, Kent makes an excellent point. I--you know, I've thought long and hard, and we all have, about why the IRS is so

aggressive here. And the only thing that we can come up with is that it sees that Mission Ridge and other CCRCs are [inaudible] and not yield restricting the investment of that cash. And they see that, you know, the cash is pledged. I mean, that's the revenue we're talking about. It's cash. And it just drives them crazy.

They think there's something wrong there, and they seem to be incapable of dealing with the second part of the analysis, which is asking whether or not you're entitled to spend your cash because if you're entitled to spend it, then you can invest it in whatever [inaudible]. It isn't replacement proceeds, and it doesn't have to be yield restricted.

But, you know, early on--or not early on, but in the first conversation that I had with the bond branch lawyer who's the, sort of, senior guy on this, he said, you know, "Let's be realistic here. Resident deposits in the real world are treated differently from other revenue. They are set aside, and people just have a warm and fuzzy feeling about them being there. And that's what we're really dealing with."

And our answer to that, both on the phone and at the meeting, a very effective rebuttal by Kent, was that, "We have no idea what you're talking about." You know, "We have three sources of revenue, investment earnings, monthly fees, resident deposits. We have one checkbook. Cash is cash. The money

comes in. We have no idea the source of the dollar that we're spending on any particular expenditure. And in determining how much cash we want to have around at any given time, we make the call without reference to our resident deposit liability. It's absolutely irrelevant. We make the call based on what we think is in the best interest of the organization and our residents. It's got nothing to do with our resident deposits. It is simply a business decision that seems--it's right to us at the time, and you cannot make any link between the fact that we have resident deposits, and we have cash sitting around. There's simply no link to be made."

And he did not say a word about that at the meeting, which we took as a step in the right direction.

Mr. Steve Maag: Great.

Well, that concludes our hour. We don't have any further questions.

We appreciate everybody's attention. Again, a reminder that you can view this or hear this on the AAHSA website starting tomorrow.

Also, a reminder that we are continuing to raise funds to support Mission Ridge, and you'll be hearing more about that.

And lastly, a reminder that if at the annual meeting on October 31st at 10:30 in the morning on that Sunday, we will be

having a further update on this to give you the latest developments.

And with that, I thank Brad and Kent for their time, and thank you all for participating.

And obviously, if you have any questions and follow up, please feel free to contact me either by phone or through e-mail.

Kent, do you have any last completing remarks?

Mr. Kent Burgess: Yeah, I do, Steve.

As an operator, if I was sitting on this call, I might ask a question--is, "Kent, throughout this whole process," you know, "what is it that's maybe confused you the most?"

And it would simply be this. I understand the IRS's position that says, "You've got cash, and we don't think you should be making money on that cash because some of it came from tax-exempt bond proceeds."

And as I kept looking at this, and I looked at the letter of credit agreement and I looked at everything I thought, if I was the IRS, I would make this argument. I would say, "Kent, you have a days cash on hand requirement," which at Missions United, it's 350 days cash on hand.

So, we have--in our letter of credit agreement, it has a requirement to have 350 days cash on hand. If I was the IRS, I'd be arguing that that 350 days cash on hand is an assurance

that the money will be in the till, and that I shouldn't be able to positively arbitrage any days cash on hand.

That made perfect sense to me. But, our attorney and Brad explained to me that [inaudible] days cash on hand has a safe harbor as long as it's tested just twice a year. So, our letter of credit agreement requires that we [inaudible] 12/31. We demonstrate on those days that, you know, we have 350 days cash on hand, and then we can spend it all the next [inaudible]. But, you and I know that I'm not going to do that.

So, I want to make [inaudible] I can understand from an IRS perspective is that days cash on hand covenant and our--and there's a safe harbor there as long as you have your days cash on hand agreement structured correctly, so.

Well, I'd just end with that, Steve.

Mr. Steve Maag: Okay, great.

Thanks, everybody. And you'll be hearing further from us as this issue continues to develop. Thank you for your time.

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