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# Recent IRS guidance on tax-exempt bonds: management and physician contracts

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# Speakers

## Peter Smith, *Partner*

Peter Smith's practice focuses on the tax aspects of public finance transactions.  He also has significant experience in other facets of US federal tax law, including tax-exempt organizations and international tax matters, as well as on healthcare transactions.

Peter has served as tax counsel on a broad range of tax-exempt financings, including bonds issued by large cities, counties, state agencies, utilities, universities, hospital districts, and school districts. He has also worked on stadium financings and on many conduit financings for major healthcare systems and other tax-exempt organizations.

In addition to public finance transactions, Peter frequently advises exempt organizations with respect to their formation, operations, and transactions.

# Speakers

## Patrick O'Daniel, *Partner*

Patrick O'Daniel has served for many years as a trusted business and tax advisor to clients efficiently solving their legal problems as part of their business team. A large portion of his practice is dedicated to the tax and public law aspects of municipal finance and structured and project finance.

He advises on a wide variety of international and domestic issues concerning the formation, operation, acquisition, merger, combination, liquidation and disposition of partnerships, limited liability companies and corporations, as well as various funding structures.

Patrick served as a clerk for US Supreme Court Justice Clarence Thomas and US Court of Appeals for the Fifth Circuit Judge Will Garwood.



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# Speakers

## Adam Harden, *Associate*

Adam primarily focuses his practice on municipal finance tax and nonprofit corporation tax matters.  He provides tax advice in connection with tax-exempt financing transactions for cities, counties, school districts, charter schools, higher education authorities, state agencies, housing authorities, foundations, colleges and universities, hospital systems, Native American tribes, and other tax-exempt organizations.

In addition to public finance, Adam routinely creates corporate entities and advises on the application process for tax-exempt status recognition. He has advised on certain tax consequences of domestic and international corporate reorganizations, mergers and acquisitions in the healthcare field, and on compliance, regulatory, and legislative matters affecting 501(c)(3), 501(c)(4), and (c)(6) organizations.

# Continuing education information

We have applied for 1.0 hour of California and Texas CLE credit and 1.0 hour of New York transitional CLE credit. For attendees outside of these states, we will supply a certificate of attendance which may be used to apply for CLE credit in the applicable bar or other accrediting agencies.

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# Administrative information

- Today's program will be conducted in a listen-only mode. To ask an online question at any time throughout the program, click on the question mark icon located on the toolbar in the bottom right side of your screen.  Time permitting, we will answer your question during the session.
- Everything we say today is opinion.  We are not dispensing legal advice, and listening does not establish an attorney-client relationship.  This discussion is off the record.  You may not quote the speakers without our express written permission.  If the press is listening, you may contact us, and we may be able to speak on the record.

# Overview of Topics

- Private Business Use in General
- Management Contracts
- Recent Guidance
- Open Issues
- Compliance

# I. Private Business Use in General

# Tax-exempt bonds: types of issues

- Governmental Bonds
  - Issued by a political subdivision, generally to finance property owned and operated by that political subdivision
  - For example, bonds issued by a county hospital district to finance a governmentally-owned hospital
- Qualified 501(c)(3) Bonds
  - Issued by a political subdivision which serves as a conduit issuer and loans the proceeds to a 501(c)(3) borrower to finance property owned and operated by the 501(c)(3) borrower
  - For example, bonds issued for the benefit of a nonprofit healthcare system

# Tax-exempt bonds: benefits and restrictions

- By issuing tax-exempt bonds, governmental issuers (and 501(c)(3) borrowers) receive a benefit from the federal government
  - Bondholders do not pay federal income tax on the interest they receive
  - As a result, bondholders are willing to accept a lower interest rate
- In exchange for the lower cost of borrowing, a number of restrictions apply to tax-exempt bonds
  - Restrictions on investment of bond proceeds (yield restriction, rebate requirements)
  - Private Activity Restrictions (private business use, private security, private payments, private loans)

# Restrictions on private business use

- No more than a “de minimis” amount of private business use permitted
  - For governmental bonds, limit is lesser of 10% of the proceeds or $15MM
    - Private business use is use by any entity other than a state or local governmental unit
      - Use by nonprofits or the federal government counts as private business use
  - For 501(c)(3) bonds, limit is lesser of 5% of the proceeds (less up to 2% used for costs of issuance) or $15MM
    - Private business use is use by any entity other than a state or local governmental unit or a 501(c)(3) entity
    - Use by a 501(c)(3) entity in an unrelated trade or business (i.e., an activity not substantially related to the entity’s exempt purpose) is also private business use
    - In addition to the lower private business use limitation, also a 100% ownership requirement

# Private business use: measurement

- Generally, private business use (other than ownership) is averaged over the "measurement period"
  - Begins on later of issue date and placed in service date
  - Ends on earlier of final maturity or expiration of expected economic life of financed property
  - Ex: 8 year measurement period, hospital enters into management contract that results in private business use of entire facility for 1 year: 12.5% PBU
- Discrete property: PBU measurement based on space used for private business use
  - Ex: 10 floor hospital, 1 floor is subject to a lease or management contract that results in private business use: 10% PBU
- Use at different times: PBU measurement based on percentage of time facility is used for private business use
  - Ex: Facility is used for private business use 2 out of every 7 days: 28.57% PBU
- Simultaneous governmental and private business use: entire facility is treated as used for private business use
  - Ex: An entire hospital is subject to a management contract that results in private business use. Despite simultaneous governmental or nonprofit use of the hospital, the entire hospital is considered to be used for private business use: 100% PBU

# Private business use: allocations

- Issuers or 501(c)(3) borrowers may finance projects with both proceeds of tax-exempt bonds and other money (such as funds on hand or taxable bond proceeds)
- Allocations can be used to reduce private business use
  - Until recently, different sources of funds needed to be allocated to specific discrete portions of financed property
    - For example, might allocate equity to a specific floor of a hospital where private business use was anticipated
    - Sometimes difficult to guess where private business use would arise
  - New allocation rules issued last year are much more flexible – allow for “floating allocations”
    - Generally equity spent on project prior to placed in service date is allocated to private business use wherever it arises
    - For example, a 10 floor hospital is financed with $90MM tax-exempt bonds and $10MM equity; the hospital later enters into a lease or nonqualifying management contract for one of the floors: 0% PBU regardless of which floor.
  - Examples of private business use to which equity may be allocated
    - Privately operated retail locations; research labs; medical office buildings; for-profit pharmacies

# Private business use: types

- Private business use may include the following non-governmental business uses:
  - Ownership (0% limit for 501(c)(3) bonds)
  - Leases (some exceptions for short-term leases)
  - Management Contracts
  - Sponsored Research Agreements
    - Safe harbors if meet certain requirements, generally based on licensing provisions and publication rights
  - Naming Rights
    - Naming a facility after a business can result in private business use, but naming after an individual donor is generally OK
  - Other special entitlements to use the facility

# Private business use: joint ventures

- Joint Ventures can result in private business use
  - For example, facility owned and operated by a joint venture between a hospital and physicians
- Previously such facilities could not be financed with tax-exempt bonds
  - New allocation regulations that took effect last year allow for greater flexibility
    - Can finance the governmental (or 501(c)(3)) share of the facility based on share of partnership income and loss
    - Ex: 501(c)(3) healthcare system owns 51% of partnership, physicians own 49%; partnership owns and operates a specialty hospital. Can now use tax-exempt bonds to finance 51% of the hospital (with the other 49% financed with equity or taxable bonds).
    - Not used much yet but may present opportunities in the future for healthcare systems that engage in joint ventures

# II. Management Contracts

# Management contracts: definition

- Management contracts, which can result in private business use, are very broadly defined under the Treasury regulations
- A management, service, or incentive payment contract between a governmental person (or 501(c)(3) entity) and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility
- Each of the following are examples of management contracts:
  - a contract for management services for an entire hospital
  - a contract for management services for a specific department of a hospital
  - an incentive payment contract for physician services to patients of a hospital
- The following are generally not treated as management contracts that could give rise to private business use:
  - The granting of admitting privileges by a hospital to a doctor if such privileges are available to all qualified physicians in the area
  - Contracts for services solely incidental to the governmental function of a financed facility (e.g., janitorial services or hospital billing)
    - But food services contracts at a hospital are generally treated as management contracts due to the close relationship between nutritional services and patient care

# Management contracts: facts and circumstances test

- Whether a management contract constitutes private business use is generally determined under a facts and circumstances test
  - Regulations provide that generally a management contract will result in private business use if the contract provides for compensation for services rendered with compensation based on a share of *net profits* from the operation of the financed facility
  - Also may have private business use if the service provider is treated as a lessee or owner of the financed property for federal income tax purposes
- Can be dangerous to rely on a facts and circumstances test
  - Tax-exempt status of bonds may depend on management contract not resulting in private business use
  - To alleviate some of the concerns of relying on a facts and circumstances test, the IRS has historically provided safe harbors under which management contracts will not result in private business use

# Management contracts: Rev. Proc. 97-13

- For the past 20 years, safe harbors have been set forth under IRS Revenue Procedure 97-13
  - No part of the compensation could be based on net profits
    - Compensation could be based on either a percentage of gross revenues *or* a percentage of expenses, but not on both
  - Needed to fall within certain specified categories based on contract term and method of compensation. For example:
    - If 95% of the compensation was based on a periodic fixed fee (such as $X per month), the term could be 15 years
    - If 80% based on periodic fixed fee, term could be 10 years
    - If 50% based on periodic fixed fee, term could be 5 years
    - If all of the compensation was based on a combination of a periodic fixed fee and a per unit fee (such as $X per procedure), term could be 3 years
    - If all of the compensation was based on a percentage of fees charges (such as physician fees charged to patients), a per unit fee, or a percentage of revenues or expenses, the term could be 2 years
  - Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties was not treated as compensation
    - Rulings provided that employees of the service provider were considered “unrelated” for these purposes

# Management contracts: Notice 2014-67

- The categories under Rev. Proc. 97-13 were fairly rigid
  - For example, if wanted to use variable incentive compensation, generally needed to use a 5 year contract and limit the variable compensation to 50%, with the remainder based on a periodic fixed fee
- In 2014, the IRS introduced an additional, more flexible safe harbor
  - No part of the compensation could be based on net profits
  - Term could not exceed 5 years
  - All of the compensation for services based on a combination of stated amount; periodic fixed fee; percentage of gross revenues (or adjusted gross revenues) or expenses of the facility (but not both); a capitation fee; a per-unit fee; or a combination of the preceding
- Basically allowed for any management contract with a term of 5 years or less to qualify for safe harbor as long as compensation was not based both on revenues and expenses of the facility
  - Great for healthcare systems, which mostly enter into contracts less than 5 years anyway

# III. Recent Guidance

# Recent guidance on management contracts

- On August 22, 2016, the IRS issued a new Revenue Procedure (2016-44) that superseded the prior guidance on safe harbors
- On January 17, 2017, the IRS issued Revenue Procedure 2017-13, which supersedes Rev. Proc. 2016-44
  - End result is that we will have one safe harbor under Rev. Proc. 2017-13, with all prior management contract safe harbor guidance having been superseded
- Narrow safe harbors abandoned in favor of a broad and generally more inclusive set of principles
- Idea is to allow for longer contracts that do not need to meet the rigid compensation structures required by prior safe harbors
  - Allows for long-term arrangements with variable compensation
  - Intended to allow for tax-exempt financings of projects involving long-term P3 arrangements, including infrastructure projects

# Recent guidance on management contracts

- The new guidance applies a principles-based approach focusing mainly on:
  - Extent of governmental control over the financed project
  - Extent to which the service provider does or does not bear risk of loss or share in profits with respect to the financed project
  - The term of the arrangement in comparison to the economic life of the financed project
  - Consistency of the tax positions taken by the service provider and the governmental unit
- Aligns closely to the criteria that would be analyzed in a review of aspects of traditional tax ownership
- Generally, 8 conditions that must be satisfied in order to qualify for the safe harbor

# Revenue Procedure 2017-13: eight conditions

1) Compensation under the contract must be reasonable

- There was a similar requirement under the prior safe harbors
  - However, unlike in the past, compensation for such purposes is now defined to include the reimbursement of actual and direct expenses paid by the service provider and the reimbursement of related administrative overhead expenses of the service provider
- 501(c)(3) healthcare systems are generally already subject to such restrictions, as unreasonable compensation may result in impermissible private inurement or private benefit
- It is unclear what type of evidence will be needed to establish reasonableness of physician and practice group contracts

# Revenue Procedure 2017-13: eight conditions

2) Must not provide the service provider with a share of net profits from the operation of the managed property

- Not treated as a net profits arrangement if no element of the compensation takes into account or is contingent upon the property's net profits or both the managed property's revenues *and* expenses
  - Elements of compensation are eligibility, amount, and timing
  - Reimbursement of direct and actual expenses paid by the service provider to *unrelated* third parties is disregarded
    - "Unrelated parties" does not include a service provider's own employees
- It is important to remember that although the new safe harbor provides more flexibility in length of contract and ability to use variable compensation, an arrangement with compensation based both on revenues and expenses of the facility may still result in private business use



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# Revenue Procedure 2017-13: eight conditions

3) Must not impose on the service provider the burden of bearing any share of net losses from the operation of the managed property

- Not treated as bearing net losses if the amount of compensation and the amount of unreimbursed expenses paid by the service provider do not take into account the property's net losses or both the property's revenues and expenses, and the timing of compensation is not contingent on the property's net losses
  - For example, a reduction of compensation by a stated dollar amount for failure to keep expenses below a stated target is not treated as bearing a share of net losses

# Revenue Procedure 2017-13: eight conditions

- Certain types of compensation are not in and of themselves considered a share of net profits or net losses regardless of whether the service provider pays expenses without reimbursement
  - Capitation fee (*e.g.*, $X per patient)
  - Periodic fixed fee (*e.g.*, $X per month)
  - Per unit fee (*e.g.*, $X per procedure; separate billing arrangements between hospitals and physicians)
  - Incentive compensation with eligibility based on meeting standards of quality, performance, or productivity, as long as the amount and timing is not based on net profits or both revenues and expenses

# Revenue Procedure 2017-13: eight conditions

- Both the net profits rule and the net losses rule reference timing of payments
  - Safe harbor allows for deferrals due to insufficient net cashflow from the operation of the managed property if:
    - Compensation is payable at least annually
    - The qualified user (*i.e.*, the governmental unit or 501(c)(3) entity) is subject to reasonable interest payments or late fees for deferred payments
    - Deferred compensation is paid no later than 5 years after original due date

# Revenue Procedure 2017-13: eight conditions

4) Term of the contract must not exceed lesser of 30 years or 80% of the reasonably expected economic life of the managed property

- Includes renewal options under which either party has a legally enforceable right to renew, but not renewal options that both parties must agree to
- To determine economic life of property, use same guidelines as for other bond-related tests (*e.g.*, new construction usually has a 40 yr life)
  - Land is disregarded in the calculation unless more than 25% of the proceeds were used to finance land, in which case land is assigned a 30 yr life
- These lengthened terms are a great benefit for many industries, but it may have limited effect for healthcare management contracts, which for commercial reasons are generally much shorter
  - The short-term nature of these contracts (such as contracts with physician groups) means more frequent testing dates, so care must be taken toward the end of the economic life of property to ensure the term of a newly entered into contract meets the 80% limitation

# Revenue Procedure 2017-13: eight conditions

5) The qualified user (*i.e.*, governmental unit or 501(c)(3) borrower) must exercise a significant degree of control over the use of the managed property

- Qualified user should approve the annual budget, capital expenditures, dispositions of property, and nature and type of use
- Qualified user should approve the rates charged for the use of the managed property
  - Concern was raised by the healthcare industry and others about this requirement (for example, it is rare for hospitals to control the rates charged by physicians in separate billing arrangements)
  - In response, the IRS updated the safe harbor to allow for a qualified user to approve a *general description of the methodology* used to set rates, or to require that the service provider charge reasonable and customary rates as determined by or negotiated with an independent third party (such as a medical insurance company)

# Revenue Procedure 2017-13: eight conditions

6) The qualified user (*i.e.*, governmental unit or 501(c)(3) borrower) must bear the risk of loss upon damage or destruction of the managed property

- It is OK for the qualified user to shift this risk of loss through an insurance policy with a third party
- It is OK for the qualified user to impose a penalty on the service provider for failure to operate in accordance with standards set forth in the contract

# Revenue Procedure 2017-13: eight conditions

7) The service provider must agree that it is not entitled to and will not take any tax position inconsistent with being a service provider

- Service provider must agree not to claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the managed property
- Express language to this effect will need to be added to management contracts going forward



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# Revenue Procedure 2017-13: eight conditions

8) The service provider must not have any role or relationship with the qualified user that would restrict the exercise by the qualified user of its rights under the contract

- Safe harbor under which a relationship will be disregarded for purposes of this test:
  - No more than 20% of the voting power of the qualified user is vested in the directors, officers, shareholders, and employees of the service provider
  - The governing body of the qualified user does not include the CEO or chairperson of the service provider
  - The CEO of the service provider is not the CEO of the qualified user or its affiliate

# Revenue Procedure 2017-13: expense reimbursement arrangement

- Management contracts under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable administrative overhead expenses of the service provider do not result in private business use
  - Again, “unrelated parties” does not include the service provider’s own employees

# IV. Open Issues

# Revenue Procedure 2017-13: open issues

- Reimbursement of employee salaries
  - Under prior guidance, employees of the service provider were considered "unrelated," such that reimbursement of a service provider's costs of onsite employees was not treated as compensation under prior safe harbors
  - Rev. Proc. 2017-13 specifically notes that employees are not "unrelated," reversing the prior rule
    - It is unclear how reimbursement of onsite employees will be treated under the new safe harbor. For example, if a management contract includes a per unit fee plus reimbursement of expenses including employee salaries, is this within the safe harbor?

# Revenue Procedure 2017-13: open issues

- Compensation based on gross revenues
  - Compensation based on gross revenues is not included in the list of compensation types which will not be treated as a net profits interest without regard to whether expenses are reimbursed
  - If a contract provides for compensation based on gross revenues and the service provider is not reimbursed for expenses, might it be viewed as sharing in net profits? Is there a distinction between a service provider paying facility expenses as compared to its own internal operating expenses?
  - If a contract provides for compensation based on gross revenues and the service provider is reimbursed for onsite employee salaries, is the service provider receiving compensation based both on revenues and expenses?
  - Treatment of separate billing arrangements with physicians

# Revenue Procedure 2017-13: open issues

- Calculation of maximum term of contract
  - Management contracts at end of useful life
    - Management contract cannot exceed 80% of useful life of property
    - At end of useful life, allowable contract term will shrink
    - Do changed circumstances (such as the condition of the building) at the time the contract is entered into allow for longer term contracts? What about property that has deteriorated faster than anticipated?
  - Does this limitation apply on an bond issue by bond issue basis (based on what property was financed with a particular issue) or is it applied based on the entirety of the managed property?
    - For example, if a management contract relates to short-lived equipment financed by one bond issue and long-lived property (e.g., a building) financed by another bond issue, is the maximum contract term determined on a combined or separate basis? Does it take into account portions of the managed property not financed with tax-exempt bond proceeds?

# Revenue Procedure 2017-13: open issues

- For open issues such as these, we may need further guidance from the IRS or may need to rely on the facts and circumstances test to show the service provider is not sharing in net profits of the facility
  - While the new guidance provides increased flexibility, the prior guidance benefited from 20 years of practice and rulings


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# V. Compliance

# Revenue Procedure 2017-13: effective date

- Issuers and 501(c)(3) borrowers may rely on the new safe harbor guidance for any contract that was entered into on or after August 22, 2016
- However, until August 18, 2017, issuers and 501(c)(3) borrowers may also continue to rely on the prior guidance
- For any contracts entered into or materially modified on or after August 18, 2017, issuers and 501(c)(3) borrowers may only rely on the new safe harbor guidance
  - Care needs to be taken with respect to extensions of prior contracts after such date, to ensure they comply with the new rules

# Revenue Procedure 2017-13: next steps

- Healthcare systems may need to update their standard contract forms (including physician compensation arrangements) to include new required language (e.g., provisions on approvals of budgets and rates, and provisions on consistency of tax positions)
- For management and service contracts to be entered into, materially modified, or extended on or after August 18, 2017, such contracts need to be reviewed to ensure compliance with the new guidance
  - Check with counsel when negotiating new contracts

# Post-issuance compliance

- Issuers and 501(c)(3) borrowers are responsible for continuing to comply with the tax requirements after issuance of tax-exempt bonds
- Private activity bond status is generally tested as of the issue date
  - Whether the issuer *reasonably expects* that the issue will meet the private business use test
- However, bonds can later become private activity bonds if, subsequent to the issue date, the issuer takes a *deliberate action* that causes the issue to meet the private activity tests
  - A deliberate action is generally defined as any action within the issuer's control
  - Entering into a new contract (such as a management contract) generally constitutes a deliberate action
    - Similarly, revising a contract may also be treated as a deliberate action, requiring retesting to see if the contract results in private business use


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# Post-issuance compliance

- Important to have processes and policies in place to ensure that management contracts entered into with respect to financed property meet a safe harbor or otherwise do not give rise to private business use
- In addition, IRS may be more lenient with issuers who have adopted written post-issuance compliance procedures, containing the following key elements:
  - Periodic (at least annual) review
  - Specific officers responsible for compliance
  - Appropriate training
  - Record retention
  - Procedures to timely identify noncompliance and to take steps to correct



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# Corrective action

- If excessive private business use occurs as a result of a deliberate action, may be able to cure with certain "remedial actions" if corrected within certain timeframes
  - Includes defeasance of all or a portion of the bonds
  - Includes alternative use of disposition proceeds
- If remedial action is not available, IRS offers Voluntary Closing Agreement Program (VCAP)

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