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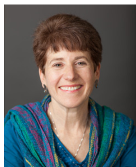
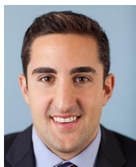
IRS Notice Liberalizes Private Use Rules Governing Bond-Financed Facilities





by Pamela S. Kaufmann & Payam A. Saljoughian

The IRS has issued interim guidance that liberalizes the private use rules governing tax-exempt organizations with tax-exempt bonds ("EO Borrowers"). Notice 2014-67, issued October 24, creates two new opportunities for EO Borrowers. First, it recognizes that participation by EO Borrowers in Medicare Shared Savings Programs ("MSSPs") through Accountable Care Organizations ("ACOs") is not private use if certain criteria are met. Second, it expands the permitted terms of five-year "management contracts" between EO Borrowers and non-exempt entities. The press to date on Notice 2014-67 (the "Notice") has focused largely on ACOs. However, we believe the second change (practically a postscript on page 14 of the Notice) is key because it creates more opportunities for a wider range of organizations. We therefore discuss this safe harbor first and the MSSP guidance second. First a few words on private use:

Private Use and Revenue Procedure 97-13

When EOs borrow tax-exempt funds, they must comply with strict limits on "private use" of their bond-financed property (that is, use by entities that are neither EOs nor governmental entities) as a condition of the financing. If they exceed these limits, they risk having the interest on the bonds become taxable.

It is quite common for EOs to engage private entities to enter their premises to provide "management services." This term encompasses much more than traditional management contracts. Depending on the EO, it might include dining contracts, physician contracts, or other contracts for on-site services by private entities. A key IRS ruling, Revenue Procedure 97-13, describes various "permissible arrangements" (based on contract term) that will **not** be deemed private use for these purposes. Such contracts must adhere to strict rules governing compensation, term, and in certain contracts, the borrower's right to terminate without cause or penalty at certain intervals. Arguably, this Revenue Procedure has not kept apace with business practices and is unduly restrictive.

New Rules for Five-Year Management Contracts

The Notice liberalizes five-year permitted arrangements, creating new opportunities for EO Borrowers and their management

companies. Under the new five-year rule, compensation can be based on any of the following: a stated amount, a periodic fixed fee (e.g., $x per day; $y per month), capitated fees, a per-unit fee (such as a fee per medical procedure), or a combination of these formulas. Compensation may also include a percentage of gross revenues, adjusted gross revenues (net of bad debt and allowances), or expenses. (It cannot be based on both revenues and expenses, as percentage of net revenue arrangements are **forbidden**.) Likewise, tiered productivity awards, used to achieve quality standards under an MSSP, are allowed (and treated as periodic fixed fees or stated amounts) if they meet certain criteria. The borrower need not be assured the right to terminate early without penalty or cause.

This is a great improvement over the former Rev. Proc. 97-13. Before the Notice, permitted five-year arrangements were limited to 50% periodic fixed fees, capitation fees, or hybrid fixed/capitation fees, and borrowers had a right to terminate without cause or penalty after three years. Unfortunately, certain “penalties” were prohibited even when they were desirable to borrowers. For example, a management company might fund purchases by the EO Borrower on the condition that the borrower repay a portion of the purchase price if it terminated the contract early. This is no longer an obstacle under thee new liberalized five-year contracts.

Participation in Medicare Shared Savings Programs

In an ACO, health care providers collaborate with suppliers to manage and coordinate care for Medicare fee-for-service patients. Their objective is to reduce costs while improving quality of care. To participate in an MSSP, ACOs must meet criteria contained in the Patient Protection and Affordable Care Act, passed in 2010. ACOs that are accepted into the MSSP are eligible for shared savings payments if they meet certain performance standards and achieve certain cost savings. Prior to the Notice, it was unclear whether such shared savings payments resulted in private use.

The Notice resolves this issue. It expressly states that participation by health care organization in a MSSP through the ACO will **not** result in private business use a bond-financed facility – if the following conditions are met:

- The terms of the health care organization's participation in the MSSP through the ACO (including its share of the MSSP payments or losses and expenses) are set forth in advance in a written agreement negotiated at arm’s length;
- The Centers for Medicare and Medicaid Services (“CMS”) has accepted the ACO into, and has not terminated the ACO from, the MSSP;
- The health care organization's share of economic benefits derived from the ACO (including its share of MSSP payments) is proportionate to the benefits or contributions the health care organization provides to the ACO, any ownership interest in the ACO received is proportionate and equal in value to the health care organization's capital contributions to the ACO, and all ACO returns of capital, allocations, and distributions are proportionate to ownership interests;
- The health care organization's share of ACO losses does not exceed the share of ACO economic benefits to which the health care organization is entitled;
- All contracts and transactions entered into by the health care organization with the ACO and its participants, and by the ACO with the ACOs participants and any other parties, are at fair market value; and
- The health care organization does not contribute or otherwise transfer the property financed with bonds to the ACO unless the ACO is a governmental entity or, in the case of qualified Section 501(c)(3) bonds, a governmental entity or Section 501(c)(3) organization.

This is a wonderful clarification for organizations that participate in MSSPs; however, as of May 2014, CMS reported that there were only 338 ACOs in MSSPs nationwide. For the rest of the EO Borrower community, the more exciting change will likely be the new liberalized rules governing five-year management contracts.

Timing

Both the MSSP guidance and the five-year management contract option are available for immediate implementation. (They will formally apply to bonds issued or management contracts entered into, materially modified, or extended as of January 22, 2015.) The new five-year contract standard should jump-start negotiations of contracts between EO Borrowers and their management companies.

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