IRS Provides Increased Flexibility on Management Contracts for Tax-Exempt Bond-Financed Property

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On October 24, 2014, the Internal Revenue Service issued Notice 2014-67 (the "Notice"), which provides important guidance and increased flexibility for issuers and conduit borrowers of tax-exempt bonds regarding contracting with private parties in a manner that avoids "private use" by such parties of bond-financed facilities. The Internal Revenue Code restricts private use of facilities financed by certain categories of tax-exempt bonds, including governmental bonds and bonds issued for the benefit of hospitals and other organizations that are tax-exempt under Section 501(c)(3) of the Internal Revenue Code. The Notice addresses so-called "management contracts", i.e. contracts (other than leases) with private parties that provide services with respect to bond-financed property, and, as discussed below, states that no private use will be deemed to arise from such contracts provided their term does not exceed five years and the compensation methodologies adhere to an expanded menu of permissible arrangements.

The Notice also addresses the treatment, for private use purposes, of Accountable Care Organizations (ACOs) established under the Affordable Care Act, and provides helpful guidance for participation in such organizations without creating "private use."

The New 5-Year Safe Harbor

The Notice "amplifies" Revenue Procedure 97-13, which provides various safe harbors under which management contracts will not be treated as causing private use of bond-financed facilities. Both the National Association of Bond Lawyers and the American Bar Association have urged that this 1997 Revenue Procedure be updated to reflect substantial changes since its publication in the sorts of arrangements being proposed or used in connection with bond-financed facilities, including the use of ACOs.

The Notice's new safe harbor for contracts with a term not exceeding five years improves on the existing safe harbor for contracts of similar length in several respects:

The new 5-year safe harbor permits a binding contract for the full 5-year term. The existing one required that the contract be terminable without penalty by the issuer or conduit borrower at any earlier date than their full term.

The existing 5-year safe harbor required that at least 50% of the compensation payable to the private party under the contract be fixed. The new 5-year safe harbor, as confirmed by informal conversations with the IRS, permits any combination of the permissible compensation methods outlined in the 1997 Revenue Procedure, including a 100% variable compensation methodology based on a percentage of revenues or a percentage of expenses (but not both, since that would be considered a proxy for participation by the private party in the bond-financed facility's net profits, which is a third rail for "private use" purposes.)

While Revenue Procedure 97-13 allowed an annual "productivity award" based on achievement of revenue or expense goals, the Notice permits a new type of annual incentive payment keyed to satisfying quality performance standards.

IRS private letter rulings approving management contracts outside the safe harbors for some time have focused principally on the absence of an interest in net profits. The new safe harbor established under the Notice does the same, eliminating most of the detailed compensation rules under the existing 5-year and

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shorter safe harbors. The IRS can be expected at some point to promulgate a new Revenue Procedure which will eliminate those no longer necessary provisions.

While the Notice has a January 22, 2015 effective date, it specifically allows application to earlier bonds or contracts. Accordingly, the enhanced flexibility in compensation methodologies can be built into new contracts, and existing contracts can be amended if desired to take advantage of the new flexibility without jeopardizing tax-exemption of outstanding bonds.

Treatment of ACOs

The Notice also clarifies that hospitals or other health care organizations will not be treated as creating private use of bond-financed facilities through their participation in ACOs mandated by the Medicare Shared Savings Program under the Affordable Care Act. The United States Treasury and the IRS have been focused on ensuring that federal tax policy not be inconsistent with federal health care policy, which has increasingly encouraged and in some cases mandated collaboration between tax-exempt 501(c)(3) organizations and for-profit entities. ACOs are a prime example. The IRS previously, in Notice 2011-20, provided favorable guidance on the effect of ACO participation on the tax-exempt status of such charitable organizations.

While an argument could be made that ACO arrangements are just a variation on third party payment arrangements, and third party payers have never been treated by bond counsel as "users" of bond-financed facilities, the need for this guidance arises, first, from the fact that ACOs must be distinct legal entities, frequently partnerships, which are separate from the health care provider and separate from insurers, and, second, from the fact that these arrangements provide for financial sharing between the exempt and non-exempt participants which might be viewed as problematic for the private use analysis. Under the Notice, upon satisfying multiple stated requirements, ACOs will not be treated as creating an impermissible net profits interest by the ACO or its private participants (such as doctors' organizations) and therefore will not be treated as private use. This guidance is consistent with recommendations made by industry groups, including the National Association of Bond Lawyers. The major shortcoming of those recommendations and this guidance is the failure to deal with ACOs other than those which are created under the Affordable Care Act. In fact, health care providers are under increasing pressure to participate in ACOs to deal with other third party payers, and such ACOs may include features which are not blessed under the Notice.

If you have any questions about this topic, please contact the author or your principal Mintz Levin attorney.

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