Approaching Compliance Date for New IRS Safe Harbors for Private Use of Facilities Financed with Tax-Exempt Debt

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August 18, 2017 is the effective date for a new IRS safe harbor for "management contracts," including service contracts with physicians and others who provide services in hospital facilities financed with the proceeds of tax-exempt debt. The new safe harbor replaces the safe harbors previously in effect. To comply with the new safe harbor tax-exempt hospitals may need to make changes to contracts that they enter into, modify or extend with service providers after August 18. Hospitals can continue to use the existing safe harbors for contracts that were entered into before August 18 until these contracts are modified or extended.

The safe harbor implements a tax rule that no more than a minimal amount of the proceeds of a tax-exempt bond issue (generally, no more than 5% of the net proceeds) may be used for any private business use. Private business use that exceeds this threshold can result in loss of the exemption from federal tax for interest paid on the bonds. This means that hospitals must carefully restrict the private use of facilities that are financed with tax-exempt debt.

Health care providers that have tax-exempt debt should review their forms of physician contracts for compliance with the new safe harbor requirements. The new safe harbor is in some respects more flexible than the old ones, particularly in allowing contracts of longer terms than in the past. However, compliance with the safe harbor requires two specific provisions that may not be in current contracts:

- The exempt entity must approve rates charged by the service provider. The exempt entity can do this by expressly approving the rates, by approving a general description of the methodology for setting them, or by requiring that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (such as a medical insurance company).
- The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the exempt entity. The service provider should 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.

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What the IRS calls "management contracts" can result in private use. "Management contracts" include service contracts in which the service provider – such as a physician or medical group – provides services in facilities financed with the proceeds of tax-exempt bonds. Merely granting admitting privileges to a physician does not result in private use, as long as privileges are available to all qualified physicians. Leases to non-exempt persons, on the other hand, always result in private use, and there is no safe harbor for them. Management contracts – which include provider service agreements – may or may not result in private use, depending on the circumstances. A management contract (including a service agreement) that meets the requirements of the safe harbor will not be treated as involving private business use.

The new safe harbor was issued in February of 2017 (Rev. Proc. 2017-13). It supersedes prior guidance, including Revenue Procedure 97-13, which for many years set the standard, and typically limited contracts between hospitals and physicians to terms of two or three years, depending on the form of compensation. The new guidance also supersedes Notice 2014-67, which expanded the safe harbors to deal with financial arrangements in accountable care organizations, and to allow a broader range of compensation arrangements in contracts of up to five years, and it supersedes Rev. Proc. 2016-44, which generally permitted contracts of up to 30 years, as long as the compensation was reasonable for the services rendered, and did not include a share of net profits or net losses.

In order to meet the new safe harbor, a management contract must meet all of the following requirements:

(1) Compensation. The payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract. The contract may not allow the contractor to share in the net profits from the operation of the managed property, or require the contractor to bear a share of the net losses, or take account of both revenue and expenses from the operation of the property. However, incentive compensation is permitted if it is based on the service provider's meeting standards that measure quality of services, performance, or productivity, and the amount is reasonable and not contingent on profits. Compensation based on a capitation fee, a periodic fee or a unit of service is permitted.

(2) Term. The term of the contract, including all renewal options, must not be greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. This economic life calculation may be complex, but providers that want to enter into contracts for terms much longer than those currently permitted would be well advised to make it.

(3) Control over use of the managed property. The exempt entity must exercise a significant degree of control over the use of the managed property. The safe harbor focuses here on financial control. In the context of provider contracts, it says that the exempt entity must approve rates charged for the use of the exempt property, which presumably means rates charged to patients by the service provider. The IRS says that the exempt entity may show approval of rates by expressly approving them, or by approving a general description of the methodology for setting them, or by requiring that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (such as a medical insurance company).

(4) Risk of loss of the managed property. The exempt entity must bear the risk of loss upon damage or destruction of the managed property (for example, due to force majeure).

(5) No inconsistent tax position. The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the exempt entity. For example, the 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.

(6) No substantial limits on exercise of rights. The service provider must not have any role or relationship with the exempt entity that has the effect of substantially limiting the exempt entity's ability to exercise its rights under the contract, based on all the facts and circumstances. There is a safe harbor for this, too – a service provider is not treated as having a prohibited role or relationship if:

(a) No more than 20 percent of the voting power of the governing body of the exempt entity is vested in the directors, officers, shareholders, partners, members, and employees of the service provider, in the aggregate;

(b) The governing body of the exempt entity does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and

(c) The chief executive officer of the service provider is not the chief executive officer of the exempt entity or any of the exempt entity's related parties.

Hooper, Lundy & Bookman provides assistance to health care providers in tax-exempt financing, and in all aspects of physician contracting. For assistance, please contact Paul Smith, Steve Lipton or Ben Durie in San Francisco, David Henninger, Charles Oppenheim or Terri Cammarano in Los Angeles, Bob Roth in Washington, D.C., or Amy Joseph in Boston.

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