

# **Bond Case Briefs**

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## **IRS Issues Guidance on Facilities Financed With Tax-Exempt Bonds.**

The IRS has provided guidance (Notice 2014-67) for determining whether a state or local government entity or an exempt organization that benefits from tax-exempt bond financing will be considered to make private business use of its bond-financed facilities as a result of participating in the Medicare shared savings program through an accountable care organization (ACO).

Section 103 provides that gross income generally does not include interest on any state or local bond, but the exclusion does not apply to any private activity bond that is not a qualified bond. A private activity bond is defined in section 141(a) as any bond issued as part of an issue (1) that meets the private business use test and private security or payment test, or (2) that meets the private loan financing test. A bond issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use.

An ACO is a legal entity established by two or more healthcare providers or suppliers to coordinate and improve care for some Medicare beneficiaries and reduce costs. Under the Medicare shared savings program, an ACO that meets quality performance standards and satisfies specified cost savings benchmarks is eligible to receive payment of a portion of the total savings generated. Both for-profit entities and organizations exempt from tax under section 501(c)(3) may participate in an ACO. Notice 2014-67 is in part a response to governmental entities and tax-exempt hospitals that asked whether participating in an ACO with a for-profit entity will result in private business use of facilities financed with tax-exempt bonds.

According to Notice 2014-67, participation by a user of a healthcare facility financed with tax-exempt bonds in the shared savings program through an ACO that includes participants that are nongovernmental persons must be structured to not result in private business use of the facility. Also, any section 501(c)(3) organization using a facility financed with tax-exempt bonds must structure its participation in an ACO so that it neither jeopardizes its exempt status nor causes it to be engaged in an unrelated trade or business under section 513(a). Notice 2014-67 specifies six conditions under which the participation of a qualified user in the shared savings program through an ACO in itself will not result in private business use of the bond-financed facility.

Similarly, Notice 2014-67 provides that management contracts between qualified users of hospitals or other healthcare facilities that are financed with tax-exempt bonds and nongovernmental persons to provide healthcare services at the facilities must be structured to avoid private business use. Notice 2014-67 amplifies the permitted productivity rewards and the types of permissible arrangements described in Rev. Proc. 97-13 that do not result in private business use, provided all other requirements of the revenue procedure are met. The notice also solicits public comments on further guidance needed to facilitate participation in the shared savings program.

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## Private business use of tax-exempt bond financed facilities

### Part III — Administrative, Procedural, and Miscellaneous

#### SECTION 1. INTRODUCTION

The Internal Revenue Service (IRS) is considering the application of the provisions of the Internal Revenue Code (Code) governing tax-exempt bonds to arrangements entered into by hospitals or other health care organizations participating in the Medicare Shared Savings Program (Shared Savings Program) described in §§ 3022 and 10307 of the Patient Protection and Affordable Care Act, Pub. L. 111-148, 124 Stat. 119 (Affordable Care Act), enacted March 23, 2010. This notice provides interim guidance for determining whether a State or local government entity or an organization described in § 501(c)(3) of the Code that benefits from tax-exempt bond financing will be considered to have private business use of its bond-financed facilities under § 141 or § 145(a)(2)(B) of the Code as a result of its participation in the Shared Savings Program through an “accountable care organization” (ACO). In addition, this notice amplifies Rev. Proc. 97-13, 1997-1 C.B. 632, as amended by Rev. Proc. 2001-39, 2001-2 C.B. 38 (cited herein as “Rev. Proc. 97-13”), regarding certain management contracts that do not result in private business use. This notice also solicits public comments on this interim guidance and on further guidance needed to facilitate participation in the Shared Savings Program.

#### SECTION 2. BACKGROUND

##### ACOs and the Shared Savings Program

Section 3022 of the Affordable Care Act amended Title XVIII of the Social Security Act (SSA) (42 U.S.C. 1395 et seq.) by adding a new § 1899, which directs the Secretary of the Department of Health and Human Services (HHS) to establish a Medicare shared savings program that promotes accountability for care of Medicare beneficiaries, improves the coordination of Medicare fee-for-service items and services, and encourages investment in infrastructure and redesigned care processes for high quality and efficient service delivery. Under § 1899(b)(1) of the SSA, groups of health care service providers and suppliers that have established a mechanism for shared governance and that meet criteria specified by HHS are eligible to participate as ACOs under the program.

Section 1899(b)(1) of the SSA provides examples of groups of service providers and suppliers that may form an ACO, including (i) physicians and other health care practitioners (ACO professionals) in a group practice, (ii) a network of individual practices, (iii) a partnership or joint venture arrangement between hospitals and ACO professionals, and (iv) a hospital employing ACO professionals. ACOs eligible to participate in the Shared Savings Program will manage and coordinate care for their assigned Medicare fee-for-service beneficiaries. Health care service providers and suppliers participating in an ACO will continue to receive Medicare fee-for-service payments in the same manner as such payments would otherwise be made. In addition, an ACO that meets quality performance standards established by HHS and demonstrates that it has achieved savings against an appropriate benchmark of expected average per capita Medicare fee-for-service expenditures will be eligible to receive payments for Medicare shared savings (Shared Savings Program payments) under § 1899(d)(2) of the SSA. Section 1899(i) of the SSA also authorizes the use of other payment models that the HHS Secretary determines will improve the quality and efficiency of items and services for Medicare.

Section 1899(b)(2) of the SSA establishes the following requirements for an ACO to participate in the Shared Savings Program:

- (1) The ACO shall be willing to become accountable for the quality, cost, and overall care of the Medicare fee-for-service beneficiaries assigned to it.
- (2) The ACO shall enter into an agreement with the HHS Secretary to participate in the Shared Savings Program for not less than a 3-year period.
- (3) The ACO shall have a formal legal structure that would allow the organization to receive and distribute Shared Savings Program payments to participating providers of services and suppliers.
- (4) The ACO shall include primary care ACO professionals that are sufficient for the number of Medicare fee-for-service beneficiaries assigned to the ACO under § 1899(c). At a minimum, the ACO shall have at least 5,000 such beneficiaries assigned to it under § 1899(c) to be eligible to participate in the Shared Savings Program.
- (5) The ACO shall provide the HHS Secretary with such information regarding ACO professionals participating in the ACO as the Secretary determines necessary to support the assignment of Medicare fee-for-service beneficiaries to an ACO, the implementation of quality and the other reporting requirements under § 1899(b)(3), and the determination of Shared Savings Program payments.
- (6) The ACO shall have in place a leadership and management structure that includes clinical and administrative systems.
- (7) The ACO shall define processes to promote evidence-based medicine and patient engagement, report on quality and cost measures, and coordinate care, such as through the use of telehealth, remote patient monitoring, and other such enabling technologies.
- (8) The ACO shall demonstrate to the HHS Secretary that it meets patient-centeredness criteria specified by the Secretary, such as the use of patient and caregiver assessments or the use of individualized care plans.

On November 2, 2011, the Centers for Medicare & Medicaid Services (CMS), the agency within HHS that administers the Medicare program, published final regulations addressing § 1899 of the SSA (76 FR 67802). The regulations contain specific eligibility criteria for entities to qualify as ACOs under the Shared Savings Program and describe quality measures, reporting requirements, and monitoring by CMS. The regulations require the ACO to be a legal entity formed under applicable State, Federal, or Tribal law, identified by a taxpayer identification number, and authorized in each State in which it operates for purposes of (1) receiving and distributing shared savings; (2) repaying shared losses or other monies determined to be owed to CMS; (3) establishing, reporting, and ensuring provider compliance with health care quality criteria, including quality performance standards; and (4) fulfilling other ACO functions identified in the regulations. The regulations require an ACO to provide for meaningful participation in the composition and control of the ACO's governing body by ACO participants (or their designated representatives). In addition, the regulations generally require that the ACO's governing body include a Medicare beneficiary representative(s) served by the ACO who does not have a conflict of interest with the ACO.

The regulations require an ACO seeking to participate in the Shared Savings Program to submit a written application to CMS describing how the ACO plans to use and distribute any Shared Savings Program payments and how that plan would contribute to achieving the specific goals of the Shared Savings Program and the general aims of better care for individuals, better health for populations, and lower growth in expenditures.

Finally, consistent with the authorization in § 1899(i) of the SSA of alternative payment models, the regulations provide a “two-sided model” under which participating ACOs not only would be eligible to share in cost savings at higher rates but also would be required to repay losses resulting from spending that exceeds a benchmark of expected average per capita Medicare fee-for-service expenditures (Shared Savings Program losses).

#### Private Business Use of Tax-Exempt Bonds

Section 103(a) of the Code provides that, except as provided in § 103(b) of the Code, gross income does not include interest on any State or local bond. Section 103(b)(1) of the Code provides that § 103(a) of the Code shall not apply to any private activity bond that is not a qualified bond (within the meaning of section 141 of the Code).

Section 141(a) of the Code provides that the term “private activity bond” means any bond issued as part of an issue (1) that meets the private business use test and private security or payment test, or (2) that meets the private loan financing test.

Section 141(b)(1) of the Code provides generally that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(6) of the Code defines “private business use” as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person must be treated as a trade or business use.

Section 1.141-3(a) of the Income Tax Regulations provides, in part, that the 10 percent private business use test of § 141(b)(1) of the Code is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Section 1.141-1(b) defines a nongovernmental person as a person other than a governmental person. Pursuant to § 1.141-1(b), a governmental person means a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof, or any instrumentality of the foregoing. The United States and any agencies and instrumentalities thereof are not governmental persons.

Section 1.141-3(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user as a result of ownership; actual or beneficial use of property pursuant to a lease, a management contract, or an incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract. Section 1.141-3(b)(7) provides that any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to the special legal entitlements described above results in private business use.

Section 1.141-3(b)(4)(i) provides generally that a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operations of the facility.

Section 1.141-3(b)(4)(ii) defines “management contract” as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion, or any function, of a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management

services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

Section 1.141-3(b)(4)(iii) provides that certain arrangements described therein generally are not treated as management contracts that give rise to private business use. The described arrangements include (A) contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services); and (B) the mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services if those privileges are available to all qualified physicians in the area, consistent with the size and nature of the hospital's facilities.

Section 141(e) of the Code provides, in part, that the term "qualified bond" includes a qualified 501(c)(3) bond if certain requirements stated therein are met.

Section 145(a) of the Code provides generally that the term "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if (1) all property that is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and (2) such bond would not be a private activity bond if (A) 501(c)(3) organizations were treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses, determined by applying § 513(a) of the Code, and (B) §§ 141(b)(1) and (2) of the Code were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears. Section 150(a)(4) of the Code defines the term "501(c)(3) organization" to mean any organization described in § 501(c)(3) and exempt from tax under § 501(a) of the Code.

Section 1.145-2 provides that, with certain exceptions and modifications, §§ 1.141-0 through 1.141-15 apply to § 145(a) of the Code. Section 1.145-2(b) provides that, in applying §§ 1.141-0 through 1.141-15 to § 145(a), (1) references to governmental persons include 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under § 513(a) of the Code; (2) references to "10 percent" and "proceeds" in the context of the private business use test and the private security or payment test mean "5 percent" and "net proceeds", respectively; and (3) references to the private business use test in §§ 1.141-2 and 1.141-12 include the ownership test of § 145(a)(1) of the Code.

Rev. Proc. 97-13 sets forth conditions under which a management contract between a qualified user and a service provider does not result in private business use under § 141(b) of the Code. Rev. Proc. 97-13 also applies to determinations of the effect of such a management contract on whether a bond meets the test in § 145(a)(2)(B) of the Code. Section 3.07 of Rev. Proc. 97-13 defines "qualified user" as any State or local governmental unit as defined in § 1.103-1 or any instrumentality thereof. The term also includes a 501(c)(3) organization if the financed property is not used in an unrelated trade or business under § 513(a) of the Code. The term does not include the United States or any agency or instrumentality thereof.

Section 5.01 of Rev. Proc. 97-13 provides that if the requirements of section 5 of Rev. Proc. 97-13 are satisfied a management contract does not itself result in private business use. In addition, the use of financed property, pursuant to a management contract meeting these requirements, is not private business use if that use is functionally related and subordinate to that management contract and that use is not, in substance, a separate contractual agreement (for example, a separate lease of a portion of the financed property).

Under section 5.02(1) of Rev. Proc. 97-13, the management contract must provide for reasonable

compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facility.

Section 5.02(2) of Rev. Proc. 97-13 provides, for purposes of § 1.141-3(b)(4)(i) and Rev. Proc. 97-13, that compensation based on (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; (b) a capitation fee; or (c) a per-unit fee is generally not considered to be based on a share of net profits.

Section 5.02(3) of Rev. Proc. 97-13 provides, for purposes of § 1.141-3(b)(4)(i) and Rev. Proc. 97-13, that a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract, generally does not cause the compensation to be based on a share of net profits.

Section 5.03 of Rev. Proc. 97-13 provides that the management contract must be described in section 5.03(1), (2), (3), (4), (5), or (6). Section 5.03(4) describes periodic fixed fee and capitation fee arrangements in certain 5-year contracts. Section 5.03(5) describes per-unit fee arrangements in certain 3-year contracts. Section 5.03(6) describes percentage of revenue or expense fee arrangements in certain 2-year contracts.

### SECTION 3. INTERIM GUIDANCE

#### 01. Participation by Governmental Persons or Section 501(c)(3) Organizations in the Shared Savings Program through ACOs

The IRS understands that governmental persons (as defined in § 1.141-1(b)) and 501(c)(3) organizations typically will be participating in the Shared Savings Program through ACOs with nongovernmental persons. The IRS further understands that this participation may take a variety of forms, including membership in a nonprofit membership corporation, ownership of shares in a corporation, ownership of a partnership interest in a partnership, and ownership of a membership interest in an LLC.

Under the private business use test described above, participation by a user of a health care facility financed with tax-exempt bonds in the Shared Savings Program through an ACO that includes participants that are nongovernmental persons must be structured so as not to result in private business use of the facility. In addition, any 501(c)(3) organization using a facility financed with tax-exempt bonds must structure its participation in an ACO so that its participation neither jeopardizes its 501(c)(3) status nor causes it to be engaged in an unrelated trade or business under § 513(a) of the Code.

The participation of a qualified user (as defined in section 3.07 of Rev. Proc. 97-13) in the Shared Savings Program through an ACO in itself will not result in private business use of the tax-exempt bond financed facility if all of the following conditions are met:

The terms of the qualified user's participation in the Shared Savings Program through the ACO (including its share of Shared Savings Program payments or losses and expenses) are set forth in advance in a written agreement negotiated at arm's length.

CMS has accepted the ACO into, and has not terminated the ACO from, the Shared Savings Program.

The qualified user's share of economic benefits derived from the ACO (including its share of Shared

Savings Program payments) is proportional to the benefits or contributions the qualified user provides to the ACO. If the qualified user receives an ownership interest in the ACO, the ownership interest received is proportional and equal in value to its capital contributions to the ACO and all ACO returns of capital, allocations, and distributions are made in proportion to ownership interests.

The qualified user's share of the ACO's losses (including its share of Shared Savings Program losses) does not exceed the share of ACO economic benefits to which the qualified user is entitled.

All contracts and transactions entered into by the qualified user with the ACO and the ACO's participants, and by the ACO with the ACO's participants and any other parties, are at fair market value.

The qualified user does not contribute or otherwise transfer the property financed with tax-exempt bonds to the ACO unless the ACO is an entity that is a governmental person, or in the case of qualified 501(c)(3) bonds, either a governmental person or a 501(c)(3) organization.

## .02 Management Contracts

It is anticipated, further, that qualified users of hospitals or other health care facilities that are financed with tax-exempt bonds will enter into management contracts (as defined in § 1.141-3(b)(4)(ii)) with nongovernmental persons to provide health care services at the qualified users' facilities that will take into account the quality performance standards and Medicare fee-for-service expenditures relevant to participation in the Shared Savings Program. Under the private business use test described above, a qualified user must structure its management contracts with respect to those facilities to avoid private business use.

This notice amplifies the permitted productivity rewards and the types of permissible arrangements described in Rev. Proc. 97-13 that do not result in private business use, provided all other requirements of section 5 of Rev. Proc. 97-13 are met.

(1) Section 5.02(3) of Rev. Proc. 97-13 is amplified to add the following text at the end:

A productivity reward for services in any annual period during the term of the contract generally also does not cause the compensation to be based on a share of net profits of the financed facility if:

The eligibility for the productivity award is based on the quality of the services provided under the management contract (for example, the achievement of Medicare Shared Savings Program quality performance standards or meeting data reporting requirements), rather than increases in revenues or decreases in expenses of the facility; and

The amount of the productivity award is a stated dollar amount, a periodic fixed fee, or a tiered system of stated dollar amounts or periodic fixed fees based solely on the level of performance achieved with respect to the applicable measure.

(2) Section 5.03 of Rev. Proc. 97-13 is amplified to revise the first sentence and add new section 5.03(7) at the end as follows:

.03 Permissible Arrangements. The management contract must be described in section 5.03(1), (2), (3), (4), (5), (6), or (7).

\* \* \* \* \*

(7) Arrangements in certain 5-year contracts. All of the compensation for services is based on a stated amount; periodic fixed fee; a capitation fee; a per-unit fee; or a combination of the preceding.

The compensation for services also may include a percentage of gross revenues, adjusted gross revenues, or expenses of the facility (but not both revenues and expenses). The term of the contract, including all renewal options, does not exceed five years. Such contract need not be terminable by the qualified user prior to the end of the term. For purposes of this section 5.03(7), a tiered productivity award as described in section 5.02(3) will be treated as a stated amount or a periodic fixed fee, as appropriate.

#### SECTION 4. REQUEST FOR PUBLIC COMMENTS

The IRS expects to issue guidance concerning management contracts for purposes of §§ 141 and 145(a)(2)(B) of the Code. That guidance may address issues relevant to participation in the Shared Savings Program. To help inform that guidance, the Treasury Department and the IRS solicit comments on the guidance that is described in section 3 of this notice and on further guidance needed to facilitate participation in the Shared Savings Program by qualified users of tax-exempt bond financed facilities through ACOs.

Public comments should be submitted in writing on or before January 22, 2015. Comments should be sent to the following address:

Internal Revenue Service  
CC:PA:LPD:PR (Notice 2014-67)  
P.O. Box 7604  
Ben Franklin Station  
Washington, DC 20044  
Comments may be hand delivered to:

CC:PA:LPD:PR (Notice 2014-67)  
Courier's Desk  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Comments may also be sent electronically to [notice.comments@irs.counsel.treas.gov](mailto:notice.comments@irs.counsel.treas.gov). Please include "Notice 2014-67" in the subject line.  
All comments will be available for public inspection.

#### SECTION 5. APPLICABILITY DATES

Section 3.01 of this notice applies to bonds subject to § 141 or § 145(a)(2)(B) of the Code sold on or after January 22, 2015. Section 3.01 may be applied to bonds sold before January 22, 2015 that are subject to § 141 or § 145(a)(2)(B) of the Code.

Section 3.02 of this notice applies to contracts entered into, materially modified, or extended (other than pursuant to a renewal option) on or after January 22, 2015. Section 3.02 may be applied to contracts entered into before January 22, 2015.

#### SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 97-13 is amplified by this notice.

#### SECTION 7. DRAFTING INFORMATION

The principal author of this notice is Johanna Som de Cerff of the Office of Associate Chief Counsel



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