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Foley: IRS Releases Favorable Private Business Use Rules For Facilities Financed With Tax-Exempt Bonds.

On October 24, 2014, the IRS released Notice 2014-67, which establishes more favorable safe harbors for types of service contracts and other arrangements using property financed with tax-exempt bonds. The Notice also provides helpful guidance of more limited scope regarding the treatment of Accountable Care Organizations under the Medicare Shared Savings Program.

The more favorable rules generally can be applied retroactively, and are of immediate practical importance.

Notice 2014-67 is available here.

Highlights of the New Rules

- The Notice includes a very significant expansion of the safe harbors for service contracts that are not treated as resulting in "private business use" previously set forth in IRS Revenue Procedures 97-13 and 2001-39.
- The Notice establishes a new safe harbor for contracts with a 5-year term. In practice, this new more favorable safe harbor in most instances displaces the existing safe harbors for 2-year, 3-year and 5-year contracts.
- 5-year contracts qualifying for the safe harbor do not need to be terminable by the qualified user (that is, the issuer or borrower) before the end of the 5-year term.
- Many, but not all, types of compensation are permitted for the 5-year safe harbor. To qualify for the 5-year safe harbor all compensation for services must be 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). In addition, for this purpose, a tiered productivity award as described in the Notice will be treated as a stated amount or a periodic fixed fee, as appropriate.
- The new rules expand the types of permitted productivity awards. The Notice provides that a productivity award 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 (1) 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 (2) 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.

Highlights of New Rules for Certain Accountable Care Organizations

- The Notice provides helpful, but limited guidance on whether a State or local government entity or 501(c)(3) organization that benefits from tax-exempt financing will be considered to have private

business use of its facilities as a result of participation in the Medicare Shared Savings Program through an "accountable care organization" ("ACO").

- The Notice provides that the participation of a nonprofit hospital organization (or other "qualified user") in the Medicare Shared Savings Program through an ACO will not result in private business use of the tax-exempt bond financed facility if all of the following conditions are met: (1) the terms of the qualified user's participation in the Medicare 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; (2) the Centers for Medicare and Medicaid Services has accepted the ACO into, and has not terminated the ACO from, the Medicare Shared Savings Program; (3) the qualified user's share of economic benefits derived from the ACO (including its share of Medicare 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; (4) the qualified user's share of the ACO's losses (including its share of Medicare Shared Savings Program losses) does not exceed the share of ACO economic benefits to which the qualified user is entitled; (5) 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; and (6) 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.

Practical Consequences of the New Rules

The following is a list of certain of the most important consequences of the new IRS rules. Because the rules may be applied to outstanding bond issues and contracts, many of these consequences may apply immediately.

- Borrowers and issuers of tax-exempt bonds (including particularly nonprofit hospital organizations) generally will need to revise bond compliance procedures to reflect the new, more favorable rules.
- In many instances, it is possible that "carve outs" for new financings and refundings to address private business use compliance (that is, reduction in the size of tax-exempt bond issues) could be reduced or eliminated under the new, more favorable rules.
- Borrowers and issuers of tax-exempt bonds and service providers may request, or consider, amendment of existing contracts (or renewals of existing contracts on different terms). This may arise in particular in cases where the private business use rules prevented service contract provisions with business terms otherwise desired by both parties.
- Nonprofit organizations that have reported the amount of private business use of bond issues in Form 990, Schedule K, may be able to reduce the amount of private business use reported. The proposed resolution of voluntary closing agreement requests to the IRS, and IRS examinations of tax-exempt bonds, which involve service contracts may be affected by this development.

Further Discussion

Tax-exempt bonds that benefit State and local governments and section 501(c)(3) organizations are subject to "private business tests" under sections 141 and 145 of the Internal Revenue Code that restrict the use of bond-financed facilities. These rules include restrictions on the "private business use" of bond-financed facilities.

The main impetus for publication of the Notice appears to have been to provide helpful guidance for certain accountable care organizations. In practice, however, the new rules in the Notice for service

contracts are a more significant development that has widespread significance for issuers and borrowers of tax-exempt bonds, and also service providers to those issuers and borrowers. The Notice is the most significant IRS guidance on the treatment of service contracts involving facilities financed with tax-exempt bonds since the publication of IRS Rev. Proc. 97-13 in 1997.

For the most part, the new safe harbor for 5-year contracts displaces the existing Rev. Proc. 97-13 safe harbors for 2-year, 3-year and 5-year contracts. Each of those safe harbors requires that the qualified user (generally, the issuer or borrower) have the right to terminate the contract without penalty or cause after a 1-year, 2-year or 3-year period, respectively. The new 5-year safe harbor does not require any such termination provision. The types of compensation arrangements permitted by the new 5-year safe harbor are broad, but do not include all types of compensation arrangements. It is possible that, in some cases, issuers and borrowers may seek to continue to use an existing 2-year, 3-year or 5-year safe harbor; the existing safe harbors are not affected, and may still be relied upon.

The new rules set forth safe harbors, not requirements. The IRS has issued many private letter rulings providing that certain service contracts that do not technically meet all of the requirements of a Rev. Proc. 97-13 safe harbor, but are nonetheless sufficiently consistent with the principles of a published safe harbor, may still be favorably treated as not giving rise to private business use. Accordingly, it can be expected that many interpretive questions will arise regarding whether contracts that do not exactly meet all of the requirements of the new safe harbor for 5-year contracts, but are consistent with the spirit of the new safe harbor, may receive similar favorable treatment.

Use of the new 5-year safe harbor for service contracts may heighten the need to consider and review the general requirements of Rev. Proc. 97-13, as amended, and other federal tax and regulatory requirements for service contracts. For example, the safe harbors of Rev. Proc. 97-13, and the rules under section 501(c)(3) of the Internal Revenue Code, generally require that all such service contracts be entered into at fair market value. The longer term contracts permitted under the new rules may heighten the need to consider how to best establish and document that a contract is entered into a fair market value. As another example, the regulations continue to provide that a service contract generally results in private business use if the contract provides for compensation based, in whole or in part, on a share of net profits from operation of the facility. The new 5-year safe harbor may heighten the need to consider and review whether the compensation arrangement meets this requirement.

The new rules may be applied immediately, but are not required to be applied until on or after January 22, 2015. The Notice states that the provisions relating to ACOs under the Medicare Shared Savings Program apply to bonds sold on or after January 22, 2015, but may be applied to bonds sold before that date. The Notice states that the provisions relating to service contracts apply to contracts entered into, or materially modified or extended (other than pursuant to a renewal option) on or after January 22, 2015, but may be applied to contracts entered into, modified or extended before or after that date.

The favorable treatment for ACOs entered into under the Medicare Shared Savings Program is similar to the approach taken in IRS Notice 2011-20, which provided similar favorable treatment for purposes of section 501(c)(3) of the Internal Revenue Code. Guidance regarding the treatment of the many other types of ACOs is not provided in this Notice, although nonprofit organizations and their counsel may look to Notice 2014-67 for helpful benchmarks for the analysis of treatment of other ACO arrangements. In other words, particularly because participation in the Medicare Shared Savings Program is limited, the portion of Notice 2014-67 that concerns ACOs represents only a helpful “toe in the water” towards providing broader needed guidance on the treatment of ACOs.

The Notice concerns only “short-end” safe harbors for service contracts (that is, contracts having a term not longer than 5 years). The existing Rev. Proc. 97-13 also sets forth safe harbors for longer term contracts (10-year, 15-year and 20-year), which are not directly affected by the Notice. In general, the safe harbors for the “short-end” have more significance in certain sectors (particularly including health care) than others. Public comments have also been submitted to the IRS for additional safe harbors on the “long-end”. For example, more flexible long-term safe harbors could be particularly helpful for governmental utility systems, convention centers, and similar facilities financed with tax-exempt bonds. It is possible that the release of the favorable guidance for the “short-end” increases the possibility of future favorable guidance on the “long-end” as well.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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