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Client Alert

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October 31, 2014

IRS Releases Guidance on Private Business Use

On October 24, 2014, the IRS issued Notice 2014-67, Private Business Use of Tax-Exempt Bond Financed Facilities (the "Notice"). The Notice provides rules under which a governmental entity or a 501(c)(3) organization may participate in the Medicare Shared Savings Program (the "Shared Savings Program") through an accountable care organization (an "ACO") without causing private business use of its tax-exempt bond-financed facilities. Additionally, the Notice expands the management contract safe harbor guidelines of Revenue Procedure 97-13 ("Rev. Proc. 97-13") to permit certain productivity awards and liberalizes the requirements for certain types of 5-year contracts that will not result in private business use.

Accountable Care Organization Guidance

Pursuant to the Patient Protection and Affordable Care Act, enacted March 23, 2010, the Centers for Medicare & Medicaid Services (*"CMS"*) established the Shared Savings Program in which physicians and other health care practitioners, suppliers and hospitals may participate by creating or joining an ACO. Under the Shared Savings Program, ACOs that meet certain quality-of-care and Medicare savings benchmarks are entitled to receive payments for Medicare shared savings. There are a number of requirements an ACO must meet to participate in the Shared Savings Program. Among others, the ACO must be accountable for the quality, cost and care of the Medicare fee-for-services patients assigned to it, the ACO must have at least 5,000 Medicare fee-for-services patients assigned to it, the ACO must participate in the Shared Savings Program for at least a three-year period, and the ACO must have a formal legal structure that allows it to receive and distribute Shared Savings Program payments to its participants. The ACO is required to be a legal entity formed under State, Federal or Tribal law, identified by a taxpayer identification number and authorized in each State in which it operates for purposes of receiving and distributing shared savings, repaying shared losses, establishing, reporting and ensuring provider compliance with health care quality criteria, including quality performance standards, and fulfilling certain other ACO functions.

Generally, a governmental entity or 501(c)(3) organization would participate in an ACO with nongovernmental persons and non-501(c)(3) organizations, and the structure of the ACO could include, for example, each participant having a membership in a nonprofit membership corporation, ownership shares in a corporation, a partnership interest in a partnership or a membership interest in an LLC. Consequently, a number of concerns have been raised by the tax-exempt bond community with respect to private business use of tax-exempt bond-financed health care facilities as a result of the participation by a governmental entity or 501(c)(3) organization in an ACO that includes nongovernmental participants. First, the 501(c)(3) organization or governmental entity must structure its participation in an ACO that includes participants that are nongovernmental persons so as not to result in private business use of the governmental entity's or 501(c)(3) organization's tax-exempt bond-financed facilities. Second, if the participant is a 501(c)(3) organization, it must structure its participation in the ACO so that its participation neither jeopardizes its 501(c)(3) status nor causes the organization to be engaged in an unrelated trade or business, which can create private business use of the organization's tax-exempt bond-financed facilities.

The Notice provides interim guidance for determining whether a governmental entity or 501(c)(3) organization that benefits from tax-exempt bond financing will be considered to have private business use of its bond-financed facilities as a result of its participation in the Share Savings Program through an ACO. The Notice provides that the participation by a governmental entity or a 501(c)(3) organization in the Shared Savings Program through an ACO in itself will not result in private business use of tax-exempt bond-financed facilities if the following conditions are met:

(1) The terms of the governmental entity's/501(c)(3) organization'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;

(2) CMS has accepted the ACO into, and has not terminated the ACO from, the Shared Savings Program;

(3) The governmental entity's/501(c)(3) organization'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 governmental entity/501(c)(3) organization provides to the ACO. If the governmental entity/501(c)(3) organization 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 governmental entity's/501(c)(3) organization'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 governmental entity/501(c)(3) organization is entitled;

(5) All contracts and transactions entered into by the governmental entity/501(c)(3) organization 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 governmental entity/501(c)(3) organization does not contribute or otherwise transfer tax-exempt bond-financed property 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.

Additional Management Contract Guidance

The Notice also 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. Rev. Proc. 97-13 sets forth the conditions under which a management contract between a governmental entity or 501(c)(3) organization and a service provider will not result in private business use of tax-exempt bond-financed facilities. Generally, Rev. Proc. 97-13 applies when, under a management contract, a service provider provides management or other services involving property financed with proceeds of qualified 501(c)(3) bonds or tax-exempt bonds that are not private activity bonds. Rev. Proc. 97-13 describes six types of management contract arrangements, based primarily on the method of compensation and the length of contract, that will not result in private business use. Rev. Proc. 97-13 further provides that in order to be a management contract that falls within the safe harbor contract arrangements described in Rev. Proc. 97-13, none of the compensation under the contract can be based on a share of net profits of the bond-financed facility.

The Notice provides that a productivity award for services in any annual period during the term of the contract will not cause the compensation under a management contract to be based on a share of net profits if (i) eligibility for the productivity award is based on the quality of services provided under the management contract (for example, the achievement of Shared Savings Program quality performance standards or meeting data reporting requirements), rather than increases in revenues or decreases in expenses of the facility and (ii) 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.

The Notice also supplements Rev. Proc. 97-13 to add a seventh type of management contract arrangement that will not result in private business use. The Notice provides that a contract with a term of no more than 5 years, including all renewal options, will not result in private business use so long as all of the compensation for services is based on a stated amount, periodic fixed fee, capitation fee, a per unit fee, or a combination of the preceding. In addition, 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 contract does not need to be terminable by the 501(c)(3) organization/governmental entity prior to the end of the term, which is a requirement for certain types of other arrangements described in Rev. Proc. 97-13. Additionally, for purposes of this new safe harbor, a tiered productivity award as described above will be treated as a stated amount or a periodic fixed fee, as appropriate. As a result, this additional safe harbor for 5-year contracts significantly broadens the types of management contract arrangements that will not result in private business use.

The Notice further provides that the IRS expects to issue guidance concerning management contracts and requests public comments on the Notice. The ACO guidance provided in the Notice applies to bonds sold on or after January 22, 2015, but may be applied retroactively. The management contract guidance applies to contracts entered into, 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 before January 22, 2015. As a result, certain previously executed contracts that may have been treated as creating private business use of tax-exempt bond-financed facilities or as

creating uncertainty because a safe harbor was not satisfied may satisfy the new 5-year contract safe harbor, providing a governmental entity or 501(c)(3) organization with assurance that the contract did not create private business use.

For More Information

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