

Public Finance Tax Update

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Demolition of Tax-Exempt Bond Financed Facilities

In Private Letter Ruling 200928018, the IRS determined that the demolition of tax-exempt bond financed pollution facilities did not cause interest on the obligations financing such facilities to fail to be excludable from gross income under Section 103 of the Code, nor did it cause Section 150(b) of the Internal Revenue Code to apply so as to preclude the borrower from deducting interest on the financing agreements related to the obligations.

A state authority issued tax-exempt obligations, the proceeds of which were lent to a borrower that is a regulated gas and utility company. The proceeds were used to construct certain pollution control facilities for the purpose of ensuring the borrower's compliance with air quality standards, regulations and water permits required by state and Federal agencies. After completion of construction, the borrower agreed to sell its pollution control facilities to a purchaser and, notwithstanding the sale of the facilities, the obligations remained outstanding. After the sale, the purchaser discontinued operations at the pollution control facilities and subsequently demolished the facilities. Under the demolition contract, there was no net scrap value of the demolished facilities.

The IRS determined that the demolition of the facilities will neither cause interest on the obligations to fail to be excludable from gross income under Section 103 of the Internal Revenue Code nor cause Section 150(b) of the Internal Revenue Code to apply.

First, the IRS noted that neither the private activity bond regulations nor Rev. Proc. 93-17, both of which address the change of use of proceeds of a bond issue, apply to the obligations given the date on which they were issued. Nonetheless, the IRS acknowledged that although neither the regulations nor Rev. Proc. 93-17 controls in this case, both provide useful guidance regarding a change in use of the proceeds of an issue of obligations from the use for which those proceeds were used or expected to be used as of the date of issue to a different use.

Proposed Solid Waste Regulations

On September 15, 2009, the IRS released proposed regulations regarding the definition of solid waste disposal facilities. A Firm memorandum on the proposed regulations will be available shortly and will also appear in the December issue of Public Finance Tax Update. Please contact your Chapman and Cutler LLP relationship attorney to obtain a copy of the Firm memorandum or to discuss the proposed regulations.

The IRS recognized that in a case in which proceeds of an issue have been spent, the regulations and Rev. Proc. 93-17 require a threshold inquiry as to whether the proceeds will be put to a use different from that for which the obligations were issued. The IRS reasoned that demolition of the pollution facilities, although an action, precludes any further use of the facilities by causing them to change from what is currently an unexpected, non-functional use to no use at all except potentially as scrap materials for recycling. Therefore, such action is not a change in use within the meaning of the private activity bond regulations and Rev. Proc. 93-17.

Private Business Use – Management Contracts

In Private Letter Ruling 200926005, the IRS determined that professional service agreements entered into between a tax-exempt bond financed hospital and contracting physicians did not result in private business use of the hospital, although such agreements did not meet the requirements for permissible management agreements under Rev. Proc. 97-13.

The hospital proposed to enter into professional service agreements with physicians, primarily for specialty care. Under the agreements, the hospital will pay for all expenses incurred as a result of the contracting physicians performing professional services on patients at the hospital and will submit invoices for those services to patients or their payors. The hospital will reimburse the contracting physicians' expenses for continuing medical education, professional materials, text books, licensing fees and professional membership dues, up to a maximum dollar amount.

The agreements provide that a contracting physician will receive as compensation a certain percentage of net professional patient billings based on a tiered structure depending on the amount of the net professional patient billings. Net professional patient billings means gross patient billings (including capitation fees) for the professional component of direct physician care services that are personally provided by the contracting physician and do not include the technical component of ancillary services or certain designated health services. Gross patient billings are reduced by Medicare and Medicaid write-offs, customary reductions by private insurers, physician discretionary discounts and managed care discounts. Charitable expenses such as uninsured and indigent patient care and bad debt (so long as not caused by certain physician actions) do not reduce gross billings.

If a physician's compensation under the above tiered structure exceeds a certain percentage of the compensation published in the most current Medical Group Management Association Physician Compensation Survey for physicians practicing the same medical specialty within the same or comparable location within the United States, then the hospital will review the contracting physician's practice and billing to determine if the compensation being paid to the contracting physician is equitable for both parties and fair market value for the services being provided by the contracting physician.

Under the agreements, contracting physicians are also compensated for supervising nurse practitioners and physician assistants in an amount equal to a certain percentage of the net professional patient billings generated by the nurse practitioners or physician assistants the contracting physician supervises.

During the course of the year, the contracting physician will be paid a mutually agreed upon amount that is established at the beginning of the year. A reconciliation of compensation will be performed at the end of each year. If the mutually agreed upon amount is less than the compensation amount determined under the agreement, the hospital will pay the contracting physician the shortfall; if the mutually agreed upon amount is more than the compensation amount determined under the agreement, the contracting physician the shortfall; if the mutually agreed upon amount is more than the compensation amount determined under the agreement, the contracting physician will repay the hospital the excess.

Contracting physicians will be eligible to receive supplemental compensation under the agreements, consisting of an incentive portion and a portion based on the contracting physician's duration of service at the hospital, which will be paid into a non-qualified deferred compensation plan. The incentive portion of the compensation is based on the physician's satisfaction of pre-established goals and is capped at a maximum percentage of the physician's base compensation.

The agreements have terms of a specified number of years and will be automatically renewed for additional consecutive terms unless either party gives ninety days' notice prior to the end of a term. The agreements also may terminate on the occurrence of certain events, such as the contracting physician's death, or by mutual agreement of the parties.

The hospital represents that the business model in the physician service agreements is necessary because of the poor economic climate and sub-par provider payment history, both of which cause difficulties in the recruitment and retention of qualified physicians in the state in which the hospital is located. The traditional salary plus bonus business model is inadequate to address the difficulties, and the model contained in the agreements is an effort to recruit and retain qualified physicians in the community.

The contracting physicians will not have a role with the hospital that substantially limits the hospital's ability to exercise its rights under the agreements, including termination rights, and less than twenty percent of the voting power of the hospital's board of directors will be vested in one or more contracting physicians. The contracting physicians are not related to the hospital within the meaning of the Treasury Regulations.

The IRS determined that although the agreements do not satisfy the requirements of permissible arrangements under Rev. Proc. 97-13, based on the facts and circumstances, the agreements do not result in private business use of the hospital. Initially, the IRS found that the agreements met the definition of a management contract because they constitute incentive payment contracts for physician services to patients of a hospital. The IRS noted that the compensation under the agreements consists of a percentage of fees generated and most closely resembles the compensation structure of the permissible arrangement under Rev. Proc. 97-13 applicable to the provision of services to third parties, but the term of the agreements exceeds the permissible term under Rev. Proc. 97-13.

In reviewing the facts and circumstances, the IRS found that the agreements provide for reasonable compensation, in part because the hospital has a right to review a contracting physician's base compensation allocable to the direct provision of physician services if it reaches a certain percent of

an objective industry standard. Because the supplemental compensation is determined as certain percentages of the base compensation, the supplemental compensation is indirectly subject to the hospital's review of the direct services portion of the base compensation. Further, the base compensation is based on adjusted gross revenues and not on a share of net profits from the operation of the hospital and none of the expenses of the hospital or the contracting physicians incurred in performing medical services at the hospital is taken into account in determining the base compensation. The maximum amount of incentive compensation is a percentage of base compensation, which is a percentage of fees or adjusted gross revenues allocable to the contracting physician. The incentive compensation is based upon the physician's attainment of specified goals, none of which is based on the number of patients treated by the contracting physician, the productivity of the hospital or the net profits of the hospital. The supplemental compensation based on years of service also depends on the underlying base compensation, which is a percentage of fees or adjusted gross revenue, and not on the productivity of the contracting physician or hospital, or on the net profits of the hospital.

While the term of the agreements is greater than the permissible term under Rev. Proc. 97-13, the IRS noted that the term is specifically tailored to address the difficulties encountered by the health industry in the hospital's coverage area in attracting and retaining qualified physicians to become members of, and improve health services in, the local community.

Lastly, the IRS acknowledged that the contracting physicians do not have a role in or a relationship with the hospital that substantially limits the hospital to exercise its rights, including cancellation rights, under the agreements because no more than twenty percent of the voting power of the governing body of the hospital is vested in one or more contracting physicians. Further, none of the contracting physicians and the hospital are related parties within the meaning of the Treasury Regulations.

Permissible Reallocations of Bond Proceeds

In Private Letter Ruling 200924013, the IRS determined that a city's reallocation of a portion of tax-exempt bond proceeds to expenditures for park system expansion is a permissible allocation under the Treasury Regulations.

The city issued tax-exempt obligations, a portion of the proceeds of which was used to finance the acquisition, construction, improvement and equipping of a sports stadium. The city expected that the sports stadium would be used in a manner that would not result in private business use. After the issuance of the tax-exempt obligations, sponsorship and other private business use opportunities related to the sports stadium arose, and the city determined that such opportunities would be economically beneficial to the city.

Approximately two years after the tax-exempt obligations were issued, the city issued taxable obligations, a portion of the proceeds of which was used and will be used to expand the city's park system. The park system expansion has not been used nor is expected to be used in a manner that results in private business use. After the date of issuance of the taxable obligations, the city allocated

taxable bond proceeds to expenditures for the sports stadium in an amount equal to the tax-exempt bond proceeds spent on the sports stadium expenditures. The sports stadium was placed in service during the eighteen-month period prior to the date the city allocated taxable bond proceeds to the sports stadium expenditures.

The city represented in its request for a private letter ruling that since the date the tax-exempt obligations were issued, the city has had on hand at all times an amount equal to the portion of the proceeds of the tax-exempt obligations used for sports stadium expenditures, plus investment earnings thereon. The city will treat such amounts as allocated to the tax-exempt obligations for arbitrage and rebate purposes and then allocate proceeds of the tax-exempt obligations to park system expansion expenditures no later than eighteen months after the dates the actual expenditures for the park system expansion were incurred.

The IRS determined that the allocation of tax-exempt bond proceeds by the city to park system expansion expenditures is a permissible allocation under the Treasury Regulations, noting that by not requiring allocations to be determined when the expenditure is paid or incurred, the Treasury Regulations acknowledge that day-to-day practicalities require some flexibility for when issuers must make allocations. The IRS concluded that such day-to-day practicalities also require flexibility to change allocations, so long as the changes are made no later than eighteen months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service, and in any event by sixty days after the fifth anniversary of the issue date or the date sixty days after the retirement of the issue, if earlier.

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