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IRS Issues New Guidelines for Qualified Management Contracts for Facilities Financed with Tax Exempt Bonds

By: Craig Hammond

Health care providers with facilities financed with tax exempt bonds need to be aware of recent changes to the IRS rules for qualified management contracts. On August 22, 2016, the IRS issued Rev. Proc. 2016-44 which replaced the safe harbors for management contracts previously set forth in Rev. Proc. 97-13 with new safe harbors that are intended to provide more flexibility with respect to term and compensation arrangements. On January 17, 2017, in response to feedback received on the new rules, the IRS issued Rev. Proc. 2017-13, which supersedes Rev. Proc. 2016-44. The safe harbors under Rev. Proc. 2016-44 became effective for any contract entered into on or after August 22, 2016 and may be applied to any management contract entered into before August 22, 2016. The safe harbors under Rev. Proc. 2017-13 became effective for any contract entered into on or after January 17, 2017 and may be applied to any management contract entered into before that date. In addition, the prior safe harbors in Rev. Proc. 97-13 may continue to be applied to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended on or after August 18, 2017 (other than pursuant to a permissible renewal option).

Background. Section 145 of the Internal Revenue Code permits nonprofit 501(c)(3) corporations to borrow money through the issuance by state or local units of government of tax exempt private activity bonds known as “qualified 501(c)(3) bonds.” The proceeds of such qualified 501(c)(3) bonds are loaned by the bond issuer to the 501(c)(3) borrower to finance capital expenditures for facilities that will be used in furtherance of the charitable purposes of such institution. Nonprofit hospitals, assisted living facilities, nursing facilities, senior retirement communities, universities and other nonprofit institutions frequently use this type of tax exempt bond financing for large capital projects.

The Internal Revenue Code restricts the amount of “private business use” which may occur at facilities financed with tax exempt qualified 501(c)(3) bonds. Failure to comply with these restrictions may cause the bonds to lose their exemption from federal income taxes and may require the 501(c)(3) borrower to undertake certain remedial actions. Private business use may occur as a result of a management contract or service contract with a party that is not a governmental entity or a 501(c)(3) corporation. 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 based, in whole or in part, on the net profits from the operation of the managed property. The IRS rules for qualified management contracts are intended to provide guidance as to how to structure management contracts to avoid private business use.

More Flexible Approach to Compensation Arrangements. The previous safe harbors under Rev. Proc. 97-13 were formula driven based on the nature of the compensation and duration of the contract. Under the new rules of Rev. Proc. 2017-13, the IRS has adopted ostensibly a more flexible approach by permitting any type of fixed or variable compensation so long as it is "reasonable compensation" for the services rendered under the contract. The compensation may not be based on net profits from operating the facility and cannot be contingent on the managed facility's net profits or both revenues and expenses of the managed facility (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties).

Incentive Compensation. Incentive compensation is not treated as based on a share of the net profits if the eligibility for the incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity, and the amount and timing of the payments meets the requirements described below.

Treatment of Certain Types of Compensation. Rev. Proc. 2017-13 clarifies that compensation arrangements which are based on the familiar fee arrangements identified in Rev. Proc. 97-13 can continue to be eligible fee structures. Thus, a capitation fee, periodic fixed fee, or a per-unit fee, or any combination thereof, as well as certain types of incentive compensation as described above, are all eligible.

Treatment of Timing of Payment of Compensation. A deferral of compensation due to insufficient cash flows from the operation of the managed property will not cause the deferred compensation to be contingent upon net profits or net losses if the contract includes requirements that:

(a) the compensation is payable at least annually;

(b) the qualified user is subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees; and

(c) the qualified user will pay such deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of the payment.

No Bearing of Net Losses. The contract must not impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property. An arrangement is not treated as bearing a share of net losses if: (i) the determination of the amount of the compensation and amount of any expenses to be paid by the service provider (and not reimbursed) do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and (ii) the timing of the payment of compensation is not contingent upon the managed property's net losses.

Term of the Contract and Revisions. A significant change by Rev. Proc. 2017-13 is the permissible term of the contract. Under Rev. Proc. 2017-13, the term of the contract, including all renewal options, may not be greater than the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property. Rev. Proc. 2017-13 provides that land will be treated as having an economic life of 30 years if 25% or more of the bonds that financed the managed property financed land. Under Rev. Proc. 2016-44 land was never taken into account, which could have reduced the permitted maximum term of the contract. While Rev. Proc. 2017-13 sanctions the use of longer term arrangements, it does hold that all long-term -- or even short-term -- contracts will meet the safe harbor. 501(c)(3) borrowers must now more closely scrutinize the remaining useful life of the "managed assets" at the time of entering or materially modifying the contract to assess whether the contract's term is permissible under the safe harbor.

Control Over Use of Managed Property. The qualified user (the 501(c)(3) borrower) must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, any disposition of the managed property, rates charged for use of the managed property, and the general nature and type of use of the managed property. Rev. Proc. 2017-13 loosened the approval process by permitting a qualified user to show (i) approval of capital expenditures by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts, and (ii) approval of rates by approving a general description of the methodology for setting such rates or by requiring that 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).

Risk of Loss. The qualified user must bear the risk of loss upon damage or destruction of the managed property.

No Inconsistent Tax Position. The service provider must agree not to take any position that is inconsistent with being a service provider to a qualified user with respect to the managed property. 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. In other words, the 501(c)(3) borrower must remain the tax owner of the bond-financed property.

No Substantial Limitation of Rights. The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract. A service provider will not be treated as having a prohibited role or relationship if:

(a) No more than 20% of the voting power of the governing body of the qualified user is vested in directors, officers, shareholders, partners, members and employees of the service provider or any of its related parties, in the aggregate;

(b) The governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson of its governing body; and

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

Nonprofit 501(c)(3) health care providers with tax exempt financed facilities will need to consider these management contract guidelines when negotiating service contracts with third parties who will use such facilities.