

IRS UPDATES PRIVATE BUSINESS USE GUIDANCE AGAIN - NEW GUIDANCE RAISES CONCERNS FOR REVENUES-BASED MANAGEMENT AND SERVICE CONTRACTS

On January 17, 2017, the IRS released Revenue Procedure 2017-13 ("Rev. Proc. 17-13") regarding private business use safe harbors for management and service contracts that affect assets financed with tax-exempt bond proceeds. Rev. Proc. 17-13 modifies, amplifies and supersedes safe harbors Revenue Procedure 2016-44 ("Rev. Proc. 16-44"), which we discussed [here](#), and which in turn had replaced Revenue Procedure 97-13 ("97-13"), as amended and modified by Notice 2014-67. Rev. Proc. 17-13 is now the third revision in two years to safe harbors that had been in place for nearly twenty years. For the most part, Rev. Proc. 17-13 keeps in place the single safe harbor established by Rev. Proc. 16-44, but clarifies a number of areas of uncertainty. However, both Rev. Proc. 16-44 and Rev. Proc. 17-13 leave outside the comfort of the safe harbor most management and service contracts that include compensation based on a percentage of revenues.

The new safe harbor is effective for management and service contracts entered into or amended on or after January 17, 2017. The prior safe harbors of 97-13, as amplified by Notice 2014-67, may continue to be applied to any contract entered into (and not materially modified after) August 18, 2017.

Specific Modifications and Clarifications of Rev. Proc. 17-13. Rev. Proc. 17-13:

1. Clarifies the ambiguity in Rev. Proc. 16-44 regarding whether or not employees of a service provider are unrelated third parties. Rev. Proc. 17-13 makes clear that employees of service providers are not properly treated as unrelated third parties, thus any reimbursement of costs (such as salaries and benefits) related to employees is considered compensation to the service provider.
2. Considers "whether a service provider's payment of expenses of the operation of the managed property without reimbursement from the qualified user affects the treatment" of compensation based on capitation fees, periodic fixed fees and per-unit fees. Rev. Proc. 17-13 ultimately concludes it does not and thus management or service contracts with only these forms of compensation generally will not give rise to private use. However, Rev. Proc. 17-13 leaves contracts payable based on a percentage of revenues off this list of explicitly permitted compensation. This omission may call into question contracts where compensation to the service provider is based on a percentage of revenue and the service provider is responsible for some or all of the expenses of the facility (including now the payment of salaries and benefits to the service provider's employees).
3. Clarifies that compensation subject to an annual payment requirement and reasonable consequences for late payments will not be treated as contingent upon net profits or net losses, so long as the contract requires the qualified user to pay the deferred compensation within five years of its original due date.
4. Provides ways for the qualified user to show approval of rates charged for use of the managed property, namely: (a) expressly approving such rates; (b) approving the methodology for setting such rates; or (c) requiring that the 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).

KEY CONSIDERATIONS WHEN APPLYING THE NEW REV. PROC.

Percentage of Revenues Contracts Will Be Challenging to Execute Within the New Safe Harbor. Rev. Proc. 17-13's silence on percentage of revenue contracts means that the only percentage of revenues arrangement that will now fit squarely within the new safe harbor are contracts in which the qualified user pays, or reimburses the service provider for, all of the expenses of the operation of the managed property and the service provider is paid a percentage of revenues, or compensation is otherwise based on the revenues of the managed property. As a practical matter, this is not often the case. Whether contracts that include compensation based on a percentage of revenues and where the service provider bears at least some of the expenses of the managed property (such as paying service provider employees) are "based on the net profits" of the managed property remains an open question. Thus, treatment of percentage of revenue-based contracts falls to an analysis of all the facts and circumstances.

Degree of Required Control. How a qualified user proves that it retains sufficient control over its bond-financed assets may also prove challenging. In many cases, a hospital will exercise such control by approving the annual budget for a department while restricting the use of the managed property to the services being provided. However, in some outsourcing arrangements, a hospital may not review all capital expenditures or each disposition of property, instead having an overall cap on the amount of such expenditures or dispositions. It remains to be seen whether such parameters-based approvals would be considered to be sufficient control by the IRS.

No Inconsistent Tax Positions. With regards to the prohibition on the service provider taking an inconsistent tax position, we note that the new Rev. Proc. does not test the actual compliance of the service provider, but rather the agreement of the service provider to do so. This is more administrable by the qualified user, but it also means that this representation needs to be made by the service provider in every management and service contract.

Continuation of Conflicts Prohibition. Rev. Proc. 17-13 continues and emphasize the long-standing requirement that there be no circumstances substantially limiting the qualified user's ability to exercise its rights under the contract. As with 97-13, a safe harbor is provided, which includes that: (a) no more than 20 percent of the voting power of the governing body of the qualified user is vested in the directors, officers, shareholders, partners, members and employees of the service provider; (b) the governing body of the qualified user does not include the CEO, chairperson or equivalent executive of the service provider; and (c) the CEO of the service provider is not the CEO of the qualified user or any of the qualified user's related parties. The expansion of this safe harbor to all related parties of a qualified user may create additional diligence or compliance burdens for large organizations with multiple corporate entities.

PRACTICAL TAKEAWAYS

Some of the interpretations and implications of the new Rev. Proc. and the amendments and clarifications thereto are still evolving. For now, we recommend clients:

1. Engage bond or finance counsel to review any new or amended management or service contracts that include compensation to the service provider based on the revenues of the managed property;
2. Update all form agreements to include a representation by the service provider that it has not taken, and will not take, any inconsistent tax positions;
3. Review all form agreements for compliance with the control requirements of the new Rev. Proc., updating such agreements where necessary and discussing with counsel where any conflicts with the new control requirements may arise; and
4. Review policies in place to prevent related party issues, in particular overlapping CEOs or board members, from arising.

For any questions about the new Rev. Proc. or private business use of facilities financed with tax-exempt bonds, please contact:

- Your regular Hall Render attorney.

View this article and other health law-related posts by visiting the [Hall Render Blog](#), or click [here](#) to sign up to receive Hall Render alerts on topics related to health care law.