# NATIONAL ASSOCIATION OF BOND LAWYERS, AMERICAN BAR ASSOCIATION AND AMERICAN HOSPITAL ASSOCIATION ALL REQUEST CHANGES TO REVENUE PROCEDURE 97-13

On May 2, 2012, the National Association of Bond Lawyers ("NABL") submitted suggested clarifications and changes to Revenue Procedure 97-13 ("Rev. Proc. 97-13") to the Internal Revenue Service (the "IRS"). These comments were prepared by a subcommittee of NABL's Tax Committee, which subcommittee included Kendall Schnurpel of Hall Render's Health Care and Public Finance Department. On May 9, 2012, the American Bar Association Section of Taxation (the "ABA") submitted comments to the IRS that are substantially similar to those provided by NABL. On May 11, 2012, the American Hospital Association (the "AHA") submitted a request for an update to Rev. Proc. 97-13, highlighting the challenges posed by Rev. Proc. 97-13 in implementing new hospital-physician arrangements and requesting that the IRS include accountable care organizations ("ACOs"), shared savings programs and bundled payments in the Rev. Proc. 97-13 safe harbors.

The changes to Rev. Proc. 97-13 proposed by NABL and the ABA, if adopted, would provide "qualified users" (including hospitals and health care systems) with greater flexibility in negotiating management and service contracts with third parties that include the use of bond-financed space, by allowing more arrangements to meet the Rev. Proc. 97-13 private business use safe harbors. The AHA request, if implemented, would allow hospitals and health care systems to move forward with ACOs, shared savings programs, bundled payments and similar innovative cost-reduction programs, without jeopardizing the tax-exempt status of the bonds used to finance hospital facilities.

The full text of the suggested clarifications and changes from NABL, the ABA and the AHA can be found here, here and here, respectively.

A summary of the most significant of these comments for hospitals and health care systems is set forth below.

1. **Clarify that participation in an ACO does not give rise to private business use**

   *Current law:* While the IRS has provided guidance that it does not expect that a 501(c)(3) hospital's participation in the Medicare shared savings program through an ACO will result in private inurement or impermissible private benefit to the private party participants in an ACO, under certain circumstances, no guidance has been provided as to whether or not agreements between an ACO and a 501(c)(3) or governmental hospital need to be considered management contracts under Rev. Proc. 97-13. If so, the sharing of savings and risk of loss might be considered to result in compensation based on the net profits of the bond-financed facility, or at least would likely be outside the safe harbors of Rev. Proc. 97-13.*Proposed change:* The AHA requests that Rev. Proc. 97-13 be revised to clarify that participation in an ACO under the Medicare shared savings program, or a similar arrangement that is not part of a government program, does not give rise to private business use, even if it includes the use of facilities financed with tax-exempt bond proceeds.

2. **Bundled payments** *Current law:* The Medicare bundled payment initiative includes payment of a single payment for all services received by a patient in a single episode of care. Under the prospective model, private physicians are paid by the hospital out of the bundled payment, referred to as "shared savings." Current IRS guidance could cause such an arrangement to be treated as private business use, or at least be considered outside the safe harbors of Rev. Proc. 97-13.*Proposed change:* The AHA recommends a modification of the Rev. Proc. 97-13 safe harbors to allow for additional forms of compensation, such as those provided for under the bundled payment initiative.

3. **Expand the list of "incidental services"**

   *Current law:* Contracts for services that are "solely incidental to the primary function...of a financed facility" are not treated as management contracts, and therefore do not give rise to private business use, even if their terms do not meet the safe harbors of Rev. Proc. 97-13. Treasury Regulations list as examples of incidental services "contracts for janitorial, office equipment repair, hospital billing or similar services."*Proposed change:* Both NABL and the ABA request that the IRS expand the list of incidental services to include building maintenance services, lawn and landscaping services, equipment and machinery repair services, billing services, security services, employee or patient laundry services, uniform services, patient or resident nutrition services, patient, student or resident transport services, valet parking services for patients and visitors, call center or help desk services, secretarial services, consulting services and purchasing services.

4. **Combine the two-, three- and five-year safe harbors into a single three-year safe harbor** *Current law:* Rev. Proc. 97-13 provides safe harbors for management contracts with stated maximum terms of five, three and two years, each of which has its own permitted compensation formula. For example, a contract with compensation based on a combination of a periodic fixed fee and a percentage of revenues will meet the five year safe harbor if the periodic fixed fee is at least 50% of the total compensation under the contract, but only the two year safe harbor if the periodic fixed fee is less than 50% of the total compensation.Current law also only allows for contracts that include incentive-based compensation to meet one of the Rev. Proc. 97-13 safe harbors when at least 50% of the total compensation under the contract consists of a periodic fixed fee.*Proposed changes:* Both NABL and the ABA request that the IRS allow any compensation methodology, or any combination of compensation methodologies, for a contract with a term of three years or less, so long as the compensation is not based on net profits. This would allow for incentive payments to service providers, so long as those incentive payments were not based on net profits.The AHA requests that the IRS increase the permitted terms under Rev. Proc. 97-13 to no less than five years.

5. **For contracts terminable without penalty or cause, measure the term as the stated notice period for termination** *Current law:* Each safe harbor under Rev. Proc. 97-13 includes a maximum permitted term. Contracts that do not have a stated term, or that have a longer term than that permitted under the safe harbor but which allow the qualified user to terminate without penalty or cause, may nonetheless be considered outside the safe harbors of Rev. Proc. 97-13.*Proposed changes:* Both NABL and the ABA suggest that where the qualified user may terminate without penalty or cause at any time, the term of a management contract should be deemed to be the stated notice period. For example, a contract with a perpetual term, or a 20-year term, but which gives the qualified user the right to terminate at any point, without penalty or cause, upon 180 days notice, would be considered to have a 180-day term.

6. **Eliminate the requirement that the qualified user be able to terminate the contract without penalty or cause.**

   *Current law:* Rev. Proc. 97-13 requires that the qualified user be able to terminate the management contract, without penalty or cause, at the end of one, two or three years, during the two-, three- and five-year safe harbors, respectively.*Proposed changes:* All of NABL, the ABA and the AHA request that the IRS eliminate the requirement that the qualified user be able to terminate the management contract, without penalty or cause, prior to the expiration of its stated term, as this requirement effectively limits the permitted term of the contract.

7. **If the requirement that the contract be terminable without penalty or cause is retained, it should be clarified** *Current law:* The two-, three- and five-year safe harbors each require that the qualified user be able to terminate the management contract "without penalty or cause" after one, two or three years, respectively. Rev. Proc. 97-13 specifies that termination penalties include "a limitation on the qualified user's right to compete with the service provider; a requirement that the qualified user purchase equipment, goods or services from the service provider; and a requirement that the qualified user pay liquidated damages for cancellation of the contract." In practice, service contracts may include the purchase of equipment from the service provider, payment for which is amortized over the term of the contract, and the balance of which is due upon early termination by the qualified user.*Proposed changes:* Both NABL and the ABA request the IRS to clarify that, if the requirement that a qualified user be able to terminate a management contract without penalty or cause is retained, accelerated repayment to the service provider of a loan, or the conversion of an advance to a loan, may not constitute a termination penalty, based on all the facts and circumstances, such as the ability of the qualified user to make such accelerated repayment or the percentage of the accelerated payment as compared to total payments made under the contract.

8. **Permit incentive compensation based on criteria other than financial performance**

   *Current law:* Under Rev. Proc. 97-13, incentive compensation is expressly permitted only in extremely limited circumstances, namely as the non-periodic fixed fee compensation under the five-year, ten-year and fifteen-year safe harbors, or as an annual payment of a fixed fee, based on the service provider achieving pre-established revenue or expense targets (but not both).*Proposed change:* All of NABL, the ABA and the AHA request that the IRS revise Rev. Proc. 97-13 to allow for greater flexibility in allowing quality and affordability incentives. NABL and the ABA suggest that the IRS allow compensation equal to a stated dollar amount, or a sliding scale for progressive benchmarks, to be awarded for achieving quality or performance standards, without any limit on the amount or frequency of such compensation.

9. **Clarify that certain types of compensation that include both revenue and expense measures are not based on net profits** *Current law:* Rev. Proc. 97-13, as well as Section 1.141-3(b)(4)(i) of the Treasury Regulations, provides that compensation based in whole or in part on net profits results in private business use. Currently, compensation containing both revenue and expense measures is generally treated as based on net profits, and thus private business use.*Proposed changes:* Both NABL and the ABA suggest that the IRS revise Rev. Proc. 97-13 to provide that: (1) a management contract may contain separate elements of incentive compensation for meeting specific performance targets, some of which are for increasing revenues and others of which are for reducing expenses, without the contract being treated as based on net profits, so long as each element of incentive compensation is a stated dollar amount or a sliding scale of stated amounts; and (2) a management contract containing incentive compensation methods, some of which pay the service provider a portion of increased revenues above a pre-established target and others of which pay the service provider a portion of reduced expenses, will not be treated as being based on net profits so long as the total compensation derived from such incentives constitutes a relatively minor portion of the total compensation to the service provider under such agreement. (NABL and the ABA suggest 10-20%.)
10. **Permit adjustments to a periodic fixed fee based on measurable factors that are not within the control of the service provider or the qualified user** *Current law:* The definition of a "periodic fixed fee" under Rev. Proc. 97-13 provides that the fee may automatically increase by a specified objective external standard that is not linked to the output or efficiency of the bond-financed facility, such as the Consumer Price Index. However, adjustments based on the volume of services provided, where not controlled by either the service provider or the qualified user, may dramatically impact the economic arrangement with the service provider.*Proposed changes:* NABL recommends that Rev. Proc. 97-13 be revised to permit the adjustment of a periodic fixed fee by a stated formula based on measureable factors that are not within the control of the service provider or qualified user, so long as they are not based on the net profits, output or efficiency of a bond-financed facility.

Hall Render supports these proposed changes and hopes that they will be promptly adopted by the IRS. Until such time, hospitals and health care systems should continue to comply with existing regulations, with the assistance of bond counsel.

For any questions about these proposed changes, Rev. Proc. 97-13 or private business use of facilities financed with tax-exempt bonds, please contact:

- Your regular Hall Render attorney.