IRS Eases Safe Harbor Conditions Under Which a Contract with a Hospital Will Not Result in Private Business Use of Tax-Exempt Bond-Financed Property

Under federal income tax law, the tax-exempt status of a bond is jeopardized if the proceeds of the bond are used for a private business use. Because hospital facilities are often financed with tax-exempt bonds, hospital contracts with providers must be structured so that they do not result in private business use. Examples of hospital contracts subject to the private business use restriction include:

- Exclusive Services Agreements (e.g., anesthesiology, cardiology, emergency medicine, hospital medicine, intensive care medicine, pathology and radiology)
- Management Agreements
- Medical Director Agreements
- On-Call Agreements
- Teaching Agreements

To comply with the restriction on private business use, the safe harbor conditions set forth in the IRS' 1997 Revenue Procedure 97-13 have traditionally been inserted into hospital contracts. Over the years those safe harbor conditions have been criticized as being overly formulaic and inflexible. In response to such criticism, on August 22, 2016, the IRS published Revenue Procedure 2016-44 which adopts a simpler, more flexible approach.

Under the prior Revenue Procedure's safe-harbor, the maximum term of the hospital contract depended upon the structure of the provider's fee: i.e., if the fee was a periodic fixed fee (e.g., a stated dollar amount per period) the term of the contract was limited to 5, 10 or 15 years, if the fee was based on a per-unit fee (e.g., a stated dollar amount per procedure) or combination of a per-unit fee and periodic fixed fee the maximum term was three years and if the fee was based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense, the maximum term was two years. Additionally, the contract had to be terminable by the hospital upon reasonable notice without penalty or cause at the end of the first year (if it were a 2-year contract), second year (if it were a 3-year contract) or third year (if it were a 5-year contract).

Revenue Procedure 2016-44 generally permits almost any type of fee structure in a hospital contract, so long as the fee is reasonable, not based on a share of the hospital's net profits (or combination of its revenues and expenses), and contains a single term limit equal to the lesser of (a) 30 years or (b) 80 percent of the weighted average reasonably expected economic life of the bond financed property.

Under Revenue Procedure 97-13, if an exclusive radiology services agreement between a radiology group and a hospital provided for the radiology group to be paid a percentage of fees charged, the agreement could not have a term longer than two years and the agreement had to be terminable by the hospital upon reasonable notice, without penalty or cause, at the end of the first year. However, under the new Revenue Procedure that same exclusive radiology services agreement could have a term as long as 30 years and would not need to be terminable by the hospital before then.

The new Revenue Procedure adds some new contract requirements: (i) the hospital cannot share the losses from the operation of the bond-financed property with the service provider; (ii) the hospital must bear the risk of loss upon damage or destruction of the bond-financed property; (iii) the hospital must exercise a significant degree of control over the bond-financed property. This is met if the hospital retains the right to approve the annual budget, capital expenditures, disposition of the bond-financed property, rates charged for its use and type of use; and (iv) the service provider must agree that it will not take any tax position that is inconsistent with being a service provider to the hospital with respect to the bond-financed property. For example, the service provider must agree not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the bond-financed property.

The requirement in Revenue Procedure 97-13 that the service provider must not have any role or relationship with the hospital that limits the hospital's ability to exercise its rights under the contract is continued in the new guidelines. This requirement is met if:

(i) No more than 20 percent of the voting power of the governing body of the hospital is vested in the directors, officers, shareholders, partners, members, and employees of the service provider;

(ii) The governing body of the hospital does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and

(iii) The chief executive officer of the service provider is not the chief executive officer of the hospital or of any of the hospital's related parties. For purposes of this requirement, the phrase "service provider" includes related parties and the phrase "chief executive officer" includes a person with equivalent management responsibilities.

Overall, the new Revenue Procedure eases the safe harbor conditions under which a hospital contract will not result in private business use of tax-exempt bond-financed property, which allows for greater flexibility in such contracts.

ABOUT THE AUTHOR

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John focuses his practice on business transactions and federal and state taxation. He advises businesses and healthcare practices on business formation, private placements, mergers and acquisitions, sales, and reorganizations. His services include representing physicians and dentists in connection with expanding or forming new practices through purchases, mergers, employment, equity offerings and other means, and selling their practices.

John advises clients on both personal and business tax issues and has represented clients in audits and other tax controversies before the IRS and State of Illinois. He has represented charities including medical clinics, research entities, and religious organizations and assisted them in obtaining tax-exempt status and defending that status on audit. He has extensive experience in assisting clients with IRS' Offshore Voluntary Disclosures, Streamlined Offshore Procedures, Collection Due Process hearings, audit representation, trust fund penalty representation, tax liens and levies, Offers in Compromise, installment agreements and other collection alternatives.

Additionally, John also provides legal counsel to physician and dental practices in the areas of limited liability company operating agreements, shareholder buy-sell agreements, compensation policies, employment agreements, buy-ins and buy-outs and health law, employment law, tax and other legal compliance issues.

A sports enthusiast, John enjoys participating in charitable running events and downhill and cross-country skiing. He also enjoys scuba diving and snorkeling and has done so in coral reefs in the Bahamas, Florida Keys, and Philippines. John has four children and takes great pleasure in assisting them with their schoolwork, sports activities, and musical training.

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