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Protecting The Status of Your Tax-Exempt Bonds

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Hospitals, health systems and nursing homes, ("institutional providers") often finance major capital improvements, acquisitions and other growth by issuing tax-exempt government bonds. Indeed, the January 7, 2002 issue of Modern Healthcare magazine, reports that not-for-profit hospitals and health systems sold almost $20.1 billion in tax exempt bonds in 2001. We offer this caution to all institutional providers with tax exempt bonds: engaging in certain transactions including management and service contracts poses a risk of jeopardizing the tax-exempt status of your bonds.

The Internal Revenue Service ("IRS") defines a management contract as a management, service, or incentive payment contract between a tax-exempt bond issuer and a service provider whereby the service provider renders services involving all or a portion of a facility. For example, contracts for the provision of management services for an entire hospital, contracts for management services for a specific department of a hospital, and an incentive payment contracts for physician services, are all treated as management contracts by the IRS.

The IRS Code section 141, has established a ten percent test which provides that if more than ten percent of the bond proceeds or financed facility is used by one or more private trades or businesses, then the bonds may cease to be tax exempt. The IRS has also created a safe harbor in Revenue Procedure 97-13, as amended ("Rev. Proc. 97-13"), for certain management contracts. You may not think that your management contracts result in the use of your facility by a private trade of business, but you are well advised to consult with your legal advisors to ensure that the management contracts you execute either fall within the safe harbor or are exempted from the IRS' definition of management contracts.

A management contract will fall within the safe harbor set forth in Rev. Proc 97-13 if (i) it provides for reasonable compensation for services rendered, not based in whole or in part on the net profits of the facility; (ii) it satisfies certain limits on compensation and term as described below; and (iii) it satisfies the limitations on control described below.

While Rev. Proc. 97-13 provides for contracts with maximum terms of up to fifteen years, hospitals in New York are also regulated by New York Code Rules and Regulations ("NYCRR"), Title 10, Section 405.3(f), which provides that management contracts (as defined by the NYCRR) can not have a term exceeding three years. Management contracts with a maximum term of three years, under Rev. Proc 97-13, must be terminable on reasonable notice, without penalty or cause, at the end of the second year of the contract term. Rev. Proc. 97-13 further provides that the compensation paid to a service provider under a contract with a maximum term of three years, must be based on (i) a per unit fee which is specified in the contract, or (ii) a combination of a per unit fee and a periodic fixed fee.

The limitation on control which is described in the safe harbor is satisfied if the service provider does not have any role or relationship with the bond issuer that substantially limits the bond issuer's ability to exercise its rights under the contract, including the right to cancel the contract. The requirement is satisfied if: (i) the service provider does not hold more than 20% of the voting power of the bond issuer; (ii) the chief executive officers of the service provider and the bond issuer do not overlap; and (iii) the bond issuer and the service provider, are not related parties as defined by the IRS.

Notwithstanding the foregoing, management contracts that give the service provider an ownership or leasehold interest in the financed property, or which provide for compensation to the service provider based in whole or in part on a share of net profits from operations of the facility will not satisfy Rev. Proc. 97-13.

The IRS has determined that certain arrangements are exempt and do not fall within the IRS' definition of management contracts. These include, for example, (a) grant of privileges to a physician; (b) contracts for services that are incidental to the primary function of the facility; and (c) contracts to provide services, where the compensation is equal to reimbursement for expenses incurred by the service provider.

Institutional providers that have issued tax-exempt bonds should be mindful of the fact that the IRS is ever vigilant to ensure that the proceeds of tax-exempt bonds are not used to provide benefits to private third parties. Accordingly, the IRS has broad power to analyze transactions between bond issuers and private parties and to penalize abusers. Thus, it is important for institutional providers with tax exempt bonds to have all management and service contracts reviewed by experienced counsel in order to ensure compliance with the relevant IRS laws and regulations. Failure to do so may jeopardize the tax-exempt nature of the institutional provider's outstanding bonds and invites disaster.

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