

# Monitor "Private Use" To Protect Tax-Exempt Bonds

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Practice Area: Health Law

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Health care administrators who are presented with opportunities for joint ventures, leases and other contracts for services should keep in mind that the Internal Revenue Service restricts the use by third parties of facilities financed with tax exempt bonds – including use by contract or lease. If a contract results in a prohibited level of "private business use," the bonds may become taxable.

The IRS recently adopted updated regulations and a Revenue Procedure which provide detailed guidance and examples outlining the limits on private business use of facilities financed with tax-exempt bonds. The new guidelines apply to bonds issued and contracts signed after May 16, 1997, but may also be applied to existing bond issues and contracts.

Private business use can involve use of the facility 1) for any unrelated business activity and; 2) by any individual or entity other than employees of the tax-exempt entity. Although not all of these situations result in private use, a systematic review will prevent any relationship from "slipping through the cracks."

## **Private Business Use**

For facilities financed with tax-exempt bonds, the aggregate amount of private business use may not exceed 5 percent of the bond proceeds. If the borrower already used 2 percent of the proceeds to finance issuance costs, this limit is effectively 3 percent.

Under the new regulations, the amount of private business use of a facility is equal to the average percentage of private business use in each one-year period, over the term of the bond issue. The annual calculation is based upon the average private use divided by the aggregate of the 501(c)(3) and private use for the year.

The use of a facility can be measured by the amount of space occupied, the amount of time the facility is occupied, or other reasonable means. By measuring average private business use over the entire term of the issue, the IRS is allowing greater flexibility than it did under the previous regulations, which measured use on a year-by-year basis.

The regulations also offer an exception for incidental use of a facility for things like vending machines or newsstands as long as the use does not exceed 2.5 percent of the bond proceeds, does not transfer exclusive possession of any separate space in the facility and does not, in the aggregate, exceed 2.5 percent of the facility.

## **Management Contracts**

The IRS is very concerned about management and service contracts involving 501(c)(3) entities – particularly contracts that give a non-501(c)(3) corporation a financial stake in a facility.

A five-year management agreement to operate or staff a hospital's emergency room constructed with bond proceeds, for example, would be subject to review. On the other hand, the IRS excludes contracts for services which are "solely incidental" to the primary function of the facility, such as a contract to perform billing for a hospital.

In Revenue Procedure 9713, the IRS has established a "safe harbor," setting forth terms under which a contract will not constitute private business use of a facility. By bringing all of its contracts within these requirements, a tax-exempt entity can avoid exceeding the 5 percent limit on private use.

To ensure arm's-length dealings, the safe harbor prohibits a service provider (and its directors, officers, shareholders and employees) from having more than 20 percent of the voting power of the governing body of the tax-exempt borrower.

As a starting point, the procedure requires that all compensation paid to the contracting party be "reasonable" and that none of the compensation be based upon the net profits of the 501(c)(3) corporation. In addition, the procedure outlines six permitted compensation arrangements applicable to health care facilities:

**95-Percent Fixed Fee Arrangement.** At least 95 percent of the annual compensation for services for the term of the contract is based on a periodic fixed fee, and the term of the contract (including renewal options) does not exceed the lesser of 15 years or 80 percent of the expected useful life of the related property.

**80-Percent Fixed Fee Arrangement.** At least 80 percent of the annual compensation for services for the term of the contract must be based on a periodic fixed fee, and the term of the contract (including renewal options) cannot exceed the lesser of ten years or 80 percent of the expected useful life of the related property.

**50-Percent Fixed Fee Arrangement.** At least 50 percent of the annual compensation for services for the term of the contract must be based upon a periodic fixed fee. The contract may be for a term of up to five years and must be cancelable by the qualified user without cause or penalty at the end of three years.

**Capitation Fee Arrangement.** All of the compensation must be based upon a capitation fee or a combination of a capitation fee and a periodic fixed fee. The term may be for up to five years and must be cancelable by the qualified user without cause or penalty at the end of three years.

**Per-Unit Fee Arrangement.** All of the compensation must be based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. For example, compensation could be paid based on a formula of a certain amount per procedure plus a certain amount per month. The term of the contract cannot exceed three years and must be cancelable by the qualified user without cause or penalty at the end of two years.

**Percentage of Revenue Arrangement.** All of the compensation must be based on a percentage of the fees charged or, during a startup period, on a percentage of gross revenues or expenses. This arrangement applies only to service contracts under which service is provided primarily to third parties or during an initial startup period where there is no reasonable way to estimate annual gross revenues and expenses.

Although these regulations may seem limiting, it is almost always possible to structure a transaction to comply with these technical requirements.

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