

# A Practical Guide to Compliance with Contract Safe Harbors for Use of Bond-Financed Property

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## Introduction

Tax-exempt and governmental organizations commonly rely on tax-free bond financing for their infrastructure spending; but *tax-free* certainly doesn't mean *free*. Rather, this low-cost capital comes with considerable strings attached, and not just on how the funds are initially spent, but also on the borrower's ongoing operations affecting the bond-financed property.<sup>1</sup> One weighty restriction is the prohibition on excessive private use.<sup>2</sup> In other words, property financed with tax-exempt bonds can only be used in the trade or business of a private person to a very limited extent. The rationale is simple enough: excessive private use would inappropriately subsidize a private party with a benefit intended for the public. This article is concerned

with when excessive private use is caused by a service contract or research contract and, more specifically, the various "safe harbors" that the Internal Revenue Service (IRS) has developed to provide taxpayers with bright lines to avoid too much of this "bad" use.<sup>3</sup>

But why should we now care about these well-established safe harbors? The obvious answer is that the IRS does. Many organizations fastidiously comply with the tax-exempt bond requirements during the bond issuance process, but let the issue recede into the background after funding. Meanwhile, the IRS has recently stepped up its oversight of post-issuance compliance,<sup>4</sup> most notably with the newly redesigned Form 990. For the first time, exempt organizations with outstanding bonds must report annually to the government and the public, under penalties of perjury, the exact percentage of private use of bond-financed property and whether they believe their existing contracts affecting such property comply with the safe harbors.

Reporting of private use is optional for the first year the new Form 990 is filed but is required for Forms 990 filed for tax years starting on or after January 1, 2009. Thus, calendar year taxpayers will first have to report on their compliance during calendar year 2009, which is drawing to a close. Taxpayers with a tax year ending June 30 will first have to report on their compliance for the period July 1, 2009 to June 30, 2010. As this article is being published, most exempt organizations will have at least started the tax year for which they must report, and some will be close to completing that year. Accordingly, now is the time for exempt organizations to confirm that their contracts comply with the safe harbors—or conform them to the safe harbors—and ensure that they have procedures in place to conform new contracts to the safe harbors.

## Service Contracts

### What contracts are covered under this category?

The regulations provide that a "management contract"<sup>5</sup> with respect to bond-financed property may result in private business use of that property, depending on the facts and circumstances, but that a contract generally will result in private business use if it provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.<sup>6</sup> For this purpose, a management contract is defined as a management, service, or incentive payment contract between the exempt user and a service provider, or vendor, under which the vendor provides services involving all, a portion of, or any function of, a facility.<sup>7</sup> (This article uses the term "service contract" to cover all contracts falling under the regulatory definition of "management contract.")



Certain contracts are explicitly excluded from the definition of service contract, including employment agreements; agreements for services that are solely incidental to the primary function of the facility (e.g., janitorial, hospital billing, office equipment repair); agreements granting solely medical staff privileges; and agreements with other Section 501(c)(3) organizations where the exempt vendor's activity is related to its exempt purposes.<sup>8</sup> But despite these carve-outs, a seemingly limitless number of arrangements—both written and unwritten—still fall under the reign of the private use provisions. Just a small sampling of such agreements in the healthcare industry includes professional services agreements (anesthesiology, radiology, pathology, etc.); medical director agreements; on-call agreements; teaching agreements; reading panel agreements; food service agreements; management agreements; and so on.

### What are the general requirements for service contracts?

The safe harbor contained in Revenue Procedure 97-13 subjects service contracts to three general requirements. First, compensation must be reasonable.<sup>9</sup> Second, compensation may not be based, in whole or in part, on the net profits from the operation of the bond-financed facility.<sup>10</sup> And third, a service contract can never satisfy the safe harbor if the vendor is a non-exempt related party. Several additional rules are useful to keep in mind in analyzing contracts under the safe harbors:

- » The safe harbors' references to a "periodic fixed fee" means just that: fixed. And the amount must be fixed *at the time the contract is entered into* (subject only to adjustment as described in the next bullet). In other words, when the agreement is signed, the fixed fee must be known for each year of the contract, subject only to external index adjustments. Similarly, a per-unit fee must be specified for each year of the contract, subject only to external index adjustments. These compensation categories do not permit renegotiation or adjustment based on experience in previous contract years.
- » Automatic adjustments are permitted if based on a specified, objective, external standard that is not linked to the output or efficiency of the facility.
- » All payments received by the vendor under the contract—whether or not directly paid by the 501(c)(3) organization—are included as compensation. For example, hospital agreements with physicians under which the physicians bill and collect fees for their own services and receive no other compensation must be analyzed viewing the patient collections as compensation.
- » The only exception to the above point is that "compensation" does not include reimbursement of actual and direct expenses paid by the vendor to unrelated parties.<sup>11</sup> For example, although the safe harbors do not explicitly say so, salaries and benefits paid to the vendor's employees (such as the chief executive officer and chief financial officer

provided under a facility management agreement) are usually not included as "compensation."

### What combinations of term and compensation provisions satisfy the safe harbors?

The safe harbors provide that a contract's term and compensation must fall within one of five defined combinations. Two of the five categories are rarely seen in healthcare arrangements and are beyond the scope of this article. The other three categories—percentage contracts, per-unit contracts, and fifty-percent fixed contracts—are laid out in the table below.



Contract Characteristic	Percentage Contracts	Per-Unit Contracts	Fifty-Percent Fixed Contracts
Maximum term <sup>12</sup>	Two years	Three years	Five years
Requirements for termination on reasonable notice without penalty or cause	At the end of the first year of the term	At the end of the second year of the term	At the end of the third year of the term
Permitted compensation methods	Percentage of revenues or expenses (but not both), or combination of per-unit fee and percentage of revenues or expenses	Per-unit or combination of per-unit and periodic fixed fee. Aside from external index adjustments, fee amounts must be specified in contract or otherwise specifically determined by independent third party <sup>13</sup>	At least 50% of each year's compensation is a fixed fee <sup>14</sup> (determinable for all years, except for external indices, at the beginning of the contract)
Other	Permissible only in (a) a facility startup period for one year or (b) contracts under which vendor primarily provides services to third parties (e.g. radiology services to patients)	Separate billing arrangements between physicians and hospitals are generally treated as per-unit fees	The other 50% can be based on revenues or expenses (but not both), as well as incentive amounts based on non-financial indicators (such as quality indicators)

Examples of the application of these categories are as follows.

- » If radiologists have an exclusive contract but receive only the right to bill and collect professional fees that are specified in the contract, the contract can qualify as a per-unit contract with a three-year term, terminable at two years.
- » If the radiologists have an exclusive contract and receive the right to bill and collect professional fees that are specified in the contract, as well as a \$50,000 annual medical director fee, the contract can qualify as a per-unit contract.
- » Suppose the radiologists have an exclusive contract, receive a \$50,000 annual medical director fee as well as the right to bill and collect professional fees that are specified in the contract, and also receive incentive payments for meeting quality and service indicators. Depending on how the incentive payments are structured: the incentive payments may be viewed as variable fees causing the contract to fail to qualify as a per-unit contract, but the contract may qualify as a percentage contract (notwithstanding the fixed fee component); or the incentive payments might qualify as additional per-unit payments.<sup>15</sup>
- » If the radiologists or the hospital insist on a five-year contract (terminable at three years), the contract must be structured as a fifty-percent fixed fee contract to satisfy the

safe harbors. This requires establishing a “collar” around collections to be retained by the physicians, with a maximum no more than twice the minimum. This is similar to the guarantee arrangement discussed below.

The safe harbors do not define the term “reasonable notice” for purposes of applying the contract termination and nonrenewal provisions. Most bond counsel generally view a 90-day or less notice period as reasonable, but the facts and circumstances can warrant a much longer notice period, such as 180 days. For example, contracts with longer terms, such as five years, may require a longer notice period to effectively transition the removal of the existing service provider with the replacement of a new service provider. In fact, organizations will argue that a 180-day period is necessary to find a suitable replacement service provider in some instances, especially in rural areas.

### How do you handle difficult contractual arrangements?

Two contractual arrangements that do not fit neatly into the safe harbors, but must be shoehorned in, are guaranteed collection contracts and contracts with adjustments for future events. For example, if emergency physicians want compensation consisting of professional fees for their services and a guaranteed annual minimum, that arrangement is no longer a simple per-unit contract. It could be structured in one of two ways. One is to structure the contract as a per-unit contract with a combination of a periodic fixed fee and a per-unit fee. The annual guaranteed minimum is the periodic fixed fee and collections, if any, for services in excess of the periodic fixed fee (for example, collections in excess of \$100,000 per year) is the per-unit fee portion. This contract would have a three-year maximum term with a two-year out but with no ceiling on the fees the physicians could earn.

Alternatively, the contract could be structured as a fifty-percent fixed fee contract. The guaranteed amount is the periodic fixed fee. Physicians are paid annual collections in excess of this amount but only to the extent that this variable payment does not exceed the periodic fixed fee. In other words, if collections for a year turn out to be more than twice the guaranteed amount for that year, the physicians receive total compensation (including fees) equal to twice the guaranteed amount. The contract would have a five-year maximum term with a three-year out, but there would be a ceiling on the fees the physicians could earn.

But what if the emergency physicians want compensation consisting of professional fees with a guaranteed annual minimum, and they want the minimum to vary based on number of newly recruited physicians? In that situation, the contract could be structured as a per-unit contract with a three-year term and a two-year out. The contract would provide for the physicians to receive a specified amount per physician per month with additional compensation equal to collections in excess of the per-physician payment.

### What about non-complying contracts?

On occasion, contracts do not, on their face, comply with the safe harbors, but the disqualifying event has not yet occurred. For example, suppose a per-unit contract has a five-year no-out

term, but the contract has been in effect for less than two years. Despite the impermissible terms, the vendor's actual use of the facility is within the safe harbors' allowed parameters, i.e., three years with a two-year out. One could argue that the contract does not violate the safe harbors if it is amended before the end of the second year. Similarly, a contract may provide for compensation that is not permitted under the safe harbors, but the non-compliant compensation has not yet been paid. Again, one could argue that if the contract is amended to provide for only permissible compensation for the periods both before and after the amendment, the payment of impermissible compensation—the private use—has not occurred. The IRS' position in these circumstances is not clear; and different bond counsel may take different positions in these situations.

## Research Contracts

On June 26, 2007, the IRS issued Revenue Procedure 2007-47,<sup>16</sup> which provides updated safe harbors under which certain types of research agreements will not result in private use of property financed with qualified 501(c)(3) bonds. The safe harbors apply to three types of sponsored research agreements: (1) corporate-sponsored research; (2) industry-sponsored research; and (3) federally-sponsored research. If the sponsored research agreement satisfies the safe harbors described below, the research agreement will not result in private use of bond-financed property.

### Corporate-Sponsored Research

Corporate-sponsored research is probably the most common of the three types of sponsored research conducted by healthcare organizations. A research agreement relating to bond-financed property used for basic research supported or sponsored by a corporate sponsor will not result in private use if any license or other use of resulting technology by the sponsor is permitted only at competitive rates and that rate was determined at the time the license or other resulting technology is available for use.<sup>17</sup> Although the exempt organization need not permit persons other than the sponsor to use any license or other resulting technology, the price paid by the sponsor must be no less than the price that would be paid by any non-sponsoring party for those same rights.<sup>18</sup>

Unfortunately, most corporate-sponsored research agreements do not comply with the above safe harbor. The research conducted on the bond-financed property must be "basic research," which by definition excludes research having a specific commercial objective.<sup>19</sup> Most research agreements with for-profit sponsors involve the development or testing of a commercial product in support of the sponsor's trade or business. Additionally, the safe harbor requires that the sponsor pay a competitive price for the use of the resulting technology, determined at the time the resulting technology is available for use. This is generally not the case, as the research agreement typically includes an agreed-upon price or fee schedule for the research activities determined at the time the research agreement is entered into by the 501(c)(3) organization and the sponsor.



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### Industry or Federally-Sponsored Research Agreements

A research agreement relating to bond-financed property used pursuant to an industry or federally-sponsored research arrangement must satisfy the following requirements:

- (1) The sponsor(s) must agree to fund governmentally performed basic research;
- (2) The 501(c)(3) organization must determine the research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research);
- (3) Title to any patent or other product incidentally resulting from the basic research must lie exclusively with the exempt organization; and
- (4) The sponsor(s) is entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research.<sup>20</sup>



The rights of the federal government and its agencies mandated by the Patent and Trademark Law Amendments Act of 1980, as amended (the “Bayh-Dole Act”),<sup>21</sup> will not cause a federally-sponsored research agreement to fail the safe harbor, provided that (a) requirements 2 and 3 above are met, and (b) any license granted to a party other than the exempt organization is no more than a nonexclusive, royalty-free license.<sup>22</sup> For example, the mere existence of “march-in” rights<sup>23</sup> or other special rights of the federal government or the sponsoring federal agency mandated by the Bayh-Dole Act will not cause a research agreement to fail the safe harbor, provided that (1) the exempt organization determines the subject and manner of the research, (2) the organization retains exclusive title to any patent or other product of the research, and (3) the nature of any license granted to the federal government or the sponsoring federal agency (or to any third party for-profit entity) to use the product of the research is no more than a nonexclusive, royalty-free license.<sup>24</sup>

### Alternatives for Dealing with Non-Compliant Contracts

In most cases, an exempt organization will amend a non-compliant contract to get in compliance with the safe harbors. But there are situations in which a contract cannot be amended to comply with the safe harbors. An organization has a few alternatives to prevent non-compliant contracts from adversely affecting the tax-exempt status of its bonds.

#### Five-Percent Private Use Allowance

Generally, up to 5% of the proceeds of qualified Section 501(c)(3) bonds may be used to finance property that is used for non-qualified purposes.<sup>25</sup> (Hence, this is often appropriately referred to as the “five-percent private use allowance.”) In some cases, an exempt organization may be able to determine that the amount of bond proceeds spent on property that is used in connection with a non-compliant service contract or research contract fits within the five-percent private use allowance. For example, assume that an exempt organization borrows \$100 million in principal amount of bonds. Accordingly, the five-percent private use allowance for the bonds would be \$5 million (5% of \$100 million).<sup>26</sup> If \$3 million of the bond proceeds were spent on renovations to the radiology department, which is managed under a non-compliant service contract, and at least \$3 million of the five-percent private use allowance is still available, the amount of bond-financed property allocable to the non-compliant radiology contract would fit within the allowance.

Additionally, it is common for an organization’s research facilities to be used for both qualified research and non-qualified research. For these types of “mixed use” research facilities, it may be possible to determine the amount of proceeds of the bonds allocable to non-qualified research by calculating the percentage of total research revenues received by the exempt organization from non-qualified research and applying that percentage to the amount of bond proceeds spent on the research facilities. The IRS issued a private letter ruling in 2001 that permitted a revenue-based alloca-

tion method for certain research facilities.<sup>27</sup> Additionally, on September 26, 2006, the IRS issued proposed regulations that would permit a revenue-based allocation method for research facilities in certain circumstances.<sup>28</sup> If, for example, 3% of an organization’s research revenue was derived from non-qualified research and \$10 million of the proceeds of its bonds were spent on research facilities, then \$300,000 (3% of \$10 million) would be allocable to the non-compliant research contracts for purposes of complying with the five-percent private use allowance.

#### Taxable Debt or Equity

For planning purposes, exempt organizations should take into account the potential private use of property proposed to be financed with outstanding tax-exempt bonds or tax-exempt bonds to be issued in the future. If an organization anticipates private use resulting from non-compliant service contracts or research contracts with respect to property proposed to be financed with outstanding tax-exempt bonds, it may be possible to reallocate the use of the bond proceeds to an alternative qualified use and allocate taxable debt or the organization’s own equity to finance the non-qualified facilities. Additionally, if an organization anticipates private use resulting from non-compliant contracts with respect to tax-exempt bonds to be issued in the future, the organization may decide to finance the portion of the property allocable to the non-compliant contracts with taxable debt or its own equity.



**Exempt organizations also may want to adopt policies to ensure that future contracts will comply with the relevant safe harbors.**

## Remedial Action

If the five-percent private use allowance is not sufficient and it would not be possible to allocate taxable debt or equity to the non-qualified facilities, it may be necessary to take remedial action to preserve the tax-exempt status of the bonds.<sup>29</sup> The most common remedial action taken by exempt organizations in these circumstances is to redeem (or defease) the portion of the bonds allocable to property to be used in connection with the non-compliant service contracts and research contracts.<sup>30</sup> However, this remedial action generally must be taken at the time that the organization enters into the non-compliant contracts. As a last resort, an exempt organization could voluntarily pursue a closing agreement with the IRS pursuant to the IRS' Voluntary Closing Agreement Program (VCAP) to remediate private use caused by non-compliant contracts.<sup>31</sup> Organizations that voluntarily approach the IRS to resolve problems with their tax-exempt bonds through VCAP generally will be able to negotiate a more favorable settlement than if the bonds were the subject of an IRS audit. The private use reporting that will be required on Schedule K will, of course, help the IRS to identify audit targets.

## Conclusion

Over time, the safe harbors with respect to service and research contracts have become more specific and defined. But there are still many questions of interpretation, and different bond counsel—the ultimate arbiters—may reach different conclusions on points of interpretation. Nevertheless, exempt organizations must prepare now for the increased Form 990 reporting. This means assessing the methods for determining what property is financed with tax-exempt bonds and whether related contracts comply with the applicable safe harbors. Exempt organizations also may want to adopt policies to ensure that future contracts will comply with the relevant safe harbors. The alternative—doing nothing and losing a bond's tax-exempt status and triggering default provisions—may be easier, but is certainly less desirable. **C**

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## Endnotes

- 1 See Internal Revenue Code (Code) Sections 141-150; Treas. Reg. Sections 1.141-1 through 1.141-15 and 1.145-2.
- 2 Code Section 103(b), as in effect before the Tax Reform Act of 1986.
- 3 The safe harbor with respect to management and service contracts was initially provided by Rev. Proc. 82-14, 1982-1 C.B. 459 and Rev. Proc. 82-15, 1982-1 C.B. 460, which were replaced by Rev. Proc. 93-17, 1993-1 C.B. 526, and then by Rev. Proc. 97-13, 1997-1 C.B. 632 (modified by Rev. Proc. 2001-39, 2001-2 C.B. 38); the safe harbor with respect to research

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contracts was originally provided by Rev. Proc. 97-14, 1997-1 C.B. 634, which was replaced by Rev. Proc. 2007-47, 2007-29 IRB 108.

- 4 See, e.g., Elizabeth M. Mills, *Post-Issuance Compliance of Section 501(c)(3) Bonds*, TAXATION OF EXEMPTS (Jan/Feb 2006).
- 5 While the regulations use the term "management contract," we use "service contract" here to reflect the broad group of contracts covered.
- 6 Treas. Reg. Section 1.141-3(b)(4)(i).
- 7 Treas. Reg. Section 1.141-3(b)(4)(iii).
- 8 Treas. Reg. Section 1.141-3(b)(4)(iii).
- 9 Rev. Proc. 97-13, Section 5.02(1).
- 10 Treas. Reg. Section 1.141-3(b)(4)(i); Rev. Proc. 97-13, Section 5.02(1).
- 11 Rev. Proc. 97-13, Section 5.02(1).
- 12 Renewal for additional terms may occur automatically unless notice of nonrenewal is given. Only the 501(c)(3) organization, not the vendor, is required under Rev. Proc. 97-13 to have the right to give notice of nonrenewal, although the vendor is permitted to have this right as well.
- 13 In the situation in which physicians bill for their services, bond counsel differ as to whether a fee schedule must be attached to the contract, changes in fees must be approved by the 501(c)(3) organization, or physician fees are all viewed as determined by independent third parties.
- 14 While Rev. Proc. 97-13, Section 5.03(4) provides that a contract falls within this category if all compensation is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee, this type of arrangement is seldom seen.
- 15 For example, an arrangement in which the vendor receives a specified dollar amount for each percentage increase in patient satisfaction scores might be viewed as a per-unit payment.
- 16 Rev. Proc. 2007, 2007-29, I.R.B. 108 (modifying and superseding Rev. Proc. 97-14, 1997-1 C.B. 634).
- 17 *Id.*, at Section 6.02.
- 18 *Id.*, at Section 6.02.
- 19 *Id.*, at Section 3.01.
- 20 *Id.*, at Section 6.03.
- 21 35 U.S.C. § 200, et seq. (2006).
- 22 Rev. Proc. 2007-47, Section 6.04. The Bayh-Dole Act generally applies to any contract, grant, or cooperative agreement with any federal agency for the performance of research funded by the federal government. Rev. Proc. 2007-47, Section 2.02(1). Under the Bayh-Dole Act, the federal government and sponsoring federal agencies receive certain rights to inventions that result from federally funded research activities performed by non-sponsoring parties pursuant to contracts, grants, or cooperative research agreements with the sponsoring federal agencies. Rev. Proc. 2007-47, Section 2.02(3).
- 23 The term "march-in rights" refers to certain rights granted to the sponsoring federal agencies under the Bayh-Dole Act to take certain actions, including granting licenses to third parties to ensure public benefits from the dissemination and use of the results of federally-sponsored research in circumstances in which the original contractor or assignee has not taken, or is not expected to take within a reasonable time, effective steps to achieve practical application of the product of that research. Rev. Proc. 2007-47, Section 2.02(3).
- 24 Rev. Proc. 2007-47, Section 6.04.
- 25 Code Section 145(a).
- 26 In this example, it has been assumed for purposes of simplicity that there are no other expenditures or costs financed with the proceeds of the bonds that would be taken into account in calculating the five percent private use allowance.
- 27 Private Letter Ruling 200132017.
- 28 Prop. Treas. Reg. Section 1.141-6(d).
- 29 See Treas. Reg. Section 1.141-12.
- 30 Treas. Reg. Section 1.141-12(d).
- 31 See IRS Notice 2008-31, I.R.B. 2008-11.