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Management Contracts: When Good Intentions Can Lead to Disastrous Results
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This Briefing is brought to you by AHLA's Tax and Finance Practice Group.

After months of meetings among various departments, financial advisors, bond counsel and underwriters, the tax-exempt bonds have been issued and the proceeds have been deposited into various funds. Construction has begun. With a little luck, the much-needed cafeteria expansion should be up and running in no time. The only thing left to do is engage a third-party company to manage the hospital's food services program. *That should be a piece of cake, right?* Yes—sort of…

Governmental and tax-exempt health care systems often outsource the management of all or a portion of their facilities to third-party companies to enhance efficiency, mitigate risk, and, in certain cases, increase revenue. However, if not properly structured, a third-party management contract can result in private business use of bond-financed property—that, depending upon the amount, could result in the bonds losing their tax-exempt status.

Fortunately, the Internal Revenue Service (IRS) has periodically promulgated guidance, including safe harbors, compliance with which will prevent the occurrence of private business use. Moreover, Revenue Procedure 2017-13 (Rev. Proc. 2017-13), the most recent IRS guidance, is more favorable than prior IRS guidance (i.e., Revenue Procedure 97-13, as modified by Revenue Procedure 2001-39 and amplified by Notice 2014-67 (collectively, Rev. Proc. 97-13)) in many respects. However, Rev. Proc. 2017-13 demands a keen understanding of its nuances to structure a compliant agreement and avoid private business use.

Rev. Proc. 2017-13 was released a few years ago, but many contracts that were executed prior to its effective date are expiring or being renegotiated. As a result, many health care systems are now having to incorporate the principles of the new safe harbor for the first time. To assist in that process, set forth below are summaries of the more salient points of Rev. Proc. 2017-13.

Management Contract Defined

Under the applicable Treasury Regulations, a "management contract" is a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility financed with the proceeds of tax-exempt bonds.[1] For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

Rev. Proc. 2017-13 expands upon this definition by providing that a management contract means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services for a managed property. Therefore, contracts between a hospital and a physician group for the performance of clinical or research services by the physician group at the hospital are included in the definition of "management contract." Importantly, however, under Rev. Proc. 2017-13, a "management contract" does not include a contract or portion of a contract for the provision of services before a managed property is placed in service (for example, pre-operating services for construction design or construction management).

Effective Date of Rev. Proc. 2017-13

Rev. Proc. 2017-13 applies to any management contract that is entered into on or after January 17, 2017, and may be applied to any management contract that was entered into before such date. In addition, the prior IRS Revenue Procedure setting forth management contract safe harbors (i.e., Rev. Proc. 97-13) may be relied upon for any management contract that is entered into before August 18, 2017, and that is not materially modified or extended on or after such date (other than pursuant to a permissible renewal option).

Limits on the Term Length

Rev. Proc. 97-13 included various term limits for management contracts depending upon the applicable compensatory arrangement. Rev. Proc. 2017-13 simplifies these rules by providing just one rule—the term of the management contract, including all renewal options, ***must not be greater than the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property***. For these purposes, the reasonably expected economic life of the managed property may be determined by reference to the depreciable class life of the property, and land is treated as having an economic life of 30 years if 25% or more of the net proceeds of the bond issue is used to finance land. In addition, a "renewal option" is a provision under which either party has a legally enforceable right to renew the management contract. For example, a provision under a management contract that is automatically renewed absent cancellation by either party is not a renewal option, even if it is expected to be renewed.

As a result of this simplified rule, health care systems now may be able to obtain certain benefits that would not have been available under the more stringent term limits set forth under Rev. Proc. 97-13.

Permissible Financial Arrangements

Under Rev. Proc. 2017-13, a management contract that is an "eligible expense reimbursement arrangement" will be a permissible financial arrangement. An eligible expense reimbursement arrangement means a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonably related administrative overhead expenses of the service provider.

If the management contract is not an eligible expense reimbursement arrangement, then the following requirements generally must be satisfied:

- Payments to the service provider must ***be reasonable compensation*** for the services rendered. For these purposes, payments to reimburse the service provider's actual and direct expenses and related administrative overhead expenses must be included as compensation.
- The service provider ***cannot receive a share of net profits*** from the operation of the managed property. There is no sharing of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties) for any fiscal period. Note that under Rev. Proc. 2017-13, reimbursements of amounts paid by the service provider to its employees are *not* considered payments to unrelated third parties. ***Incentive compensation*** will not result in a sharing of net profits if eligibility is determined by the service provider's performance in meeting standards that measure quality of services, performance, or productivity (i.e., qualitative incentive compensation for meeting certain performance metrics).
- The service provider ***cannot bear any share of net losses*** from the managed property. An arrangement will not cause the service provider to bear a share of net losses if (i) the determination of the amount of the service provider's compensation and the amount of any expenses to be paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and (ii) the timing of the payment is not contingent upon the managed property's net losses. For example, a service provider whose compensation is reduced by one or more stated dollar amounts for failure to keep the managed property's expenses below one or more specified targets will not be treated as bearing a share of net losses as a result of a reduction.
- Certain types of compensation will not be treated as providing a share of net profits or requiring the service provider to bear a share of net losses, without

regard to whether the service provider pays expenses with respect to the operation of the managed property without reimbursement by the qualified user. These types include compensation that is (i) based solely upon a ***capitation fee***, a ***periodic fixed fee***, or a ***per-unit fee***; (ii) ***qualitative incentive compensation***; or (iii) ***any combination of (i) and (ii)***. Note that a percentage of gross revenue, which was specifically authorized under prior IRS guidance, is not mentioned under Rev. Proc. 2017-13. Nevertheless, compensation based upon a percentage of gross revenue may fit within the safe harbor, but only if the totality of the facts do not result in a sharing of net profits and the service provider does not bear the burden of sharing net losses from the operation of the managed property. For these purposes, reimbursement provisions must be carefully analyzed to ensure that the arrangement is not a de facto sharing of net profits.

- ***Deferral of payment of compensation*** due to insufficient net cash flows from the operation of the managed property is permitted if the management contract (i) requires payment of compensation at least annually; (ii) imposes reasonable consequences for late payment (e.g., reasonable interest charges or late payment fees); and (iii) requires payment of the deferred compensation and interest/fees within five years of the original due date.

Control over Managed Property

To satisfy the safe harbor, the qualified user must ***exercise a significant degree of control over the use of the managed property***. This will be satisfied if the management contract requires the qualified user to approve the annual budget for the managed property, capital expenditures with respect to the managed property, and the general nature and type of use of the managed property (e.g., the type of services). For example, a qualified user may show approval of rates charged for use of the managed property by expressly approving such rates or a general description of the methodology for approving such rates, or by requiring that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (e.g., an insurance company or valuation company).

Risk of Loss over Managed Property

The qualified user must ***bear the risk of loss*** upon damage or destruction of the managed property. For this requirement, however, it is acceptable to insure against risk of loss through a third party or by imposing upon the service provider penalties for failure to operate the property in accordance with the management contract.

No Inconsistent Tax Positions

The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider with respect to the managed property. As a result, the management contract should provide that the service provider will not claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the managed property.

No Circumstances Substantially Limiting Exercise of Rights

Finally, of particular relevance to tax-exempt health care systems, the service provider must not have any role or relationship with the qualified user that substantially limits the qualified user's ability to exercise its rights under the management contract. For this purpose, a service provider will not be treated as having such a role or relationship if:

- No more than 20% of the voting power of the governing body of the qualified user is vested in the directors, officers, shareholders, partners, members, and employees of the service provider;
- The governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson of the service provider's governing body; and
- The chief executive officer of the service provider is not the chief executive officer of the qualified user or any of the qualified user's related parties.

Conclusion

If the management contract can satisfy the safe harbors set forth in Rev. Proc. 2017-13 as outlined above, the hospital can engage the third-party company to manage their food services program and the hospital's patients can have their cake (or healthier food) and eat it too.

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[1] In the case of tax-exempt governmental bonds, the term "qualified user" means a governmental entity, and the term "service provider" means any entity other than a governmental entity, such as a for-profit entity or even a Section 501(c)(3) organization. In the case of qualified 501(c)(3) bonds, the term "qualified user" means a governmental entity or a Section 501(c)(3) organization, and the term "service provider" means any entity that isn't a governmental entity or a Section 501(c)(3) organization that is providing management services in furtherance of its tax-exempt purpose.