

**Internal Revenue Service**

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Date:  
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LEGEND

- A =
- B =
- C =
- X =
- Bond =
- State =

Dear Sir or Madam:

This in response to your letter requesting a ruling that, based on all the facts and circumstances, C does not have any role or relationship with B, the qualified user, that substantially limits B's ability to exercise its rights, including cancellation rights, under the professional service agreement.

FACTS:

The Bond was issued for the benefit of A, a private foundation that is exempt from federal income taxation as an organization described in § 501(c)(3). A is the sole member of B. B owns and operates a hospital and X medical clinics and employs the support and administrative staff necessary to operate such hospital and clinics. Part of the Bond proceeds is to be used by B to finance the acquisition, construction, renovation, and equipping of B's hospital and clinics. This includes an addition to and installation of equipment in an existing acute care clinic to be used as an ambulatory care medical clinic (the "New Facility"). B now desires to amend the professional services agreement to require C to provide the physicians necessary to provide professional medical services at the New Facility.

A is the sole member of B, and B is the sole member of C. B is exempt from federal income taxation as an organization described in § 501(c)(3), other than a private

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foundation. C is a taxable corporation and a State nonprofit corporation that provides professional services to B. B appoints 3 of 7 members of C's board of directors. The chief executive officer of B is one of the 3 members on C's board of directors. One additional director, of C's, must contemporaneously be a community representative (appointed by B) on B's board of directors. B has the power to remove any member of C's board of directors that B appointed. As a result, 4 of the 7 members on C's board of directors are either appointed by or are on B's board of directors.

The only employees of C are the physicians who provide professional medical services at the medical clinics and hospital owned by B. B has entered into a professional services agreement with C, pursuant to which C agrees to provide all professional medical services to B as necessary in its X medical clinics and associated hospital. Under the terms of the professional services agreement C is prohibited from entering into any employment agreements, or amendments thereof, that result in private business use of the facilities by C or its employees. The initial term of the professional services agreement is one year, with an automatic renewal for successive one-year terms. Either party may terminate the agreement without cause upon 90 days prior written notice to the other effective as of the end of any term.

B has the power to approve the following with respect to C: (1) amendments to articles of incorporation and bylaws; (2) capital budgets, incurrence of long term debt, and operating budgets; (3) strategic plans; (4) risk management policies; (5) human resources and benefit policies; (6) health plan, payor or risk contracting agreements; and (7) merger, consolidation, dissolution, or sale or transfer of assets other than in the ordinary course of business. In addition, C is required to obtain B's approval of its proposed budget on an annual basis.

#### LAW AND ANALYSIS:

Section 103(a) of the Code provides, in part, that except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(b) provides that the exemption provided by subsection (a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(a) defines the term "private activity bond" as any bond issued as part of an issue that meets the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2). Section 141(b)(1) states that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(6) defines private business use as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. Use as a member of the general public is not private use.

Section 1.141-3(b)(4)(i) of the Income Tax Regulations provides that a management contract with respect to financed property generally results in private

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business use of that property if the contract 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. The determination as to whether a management contract (within the meaning of § 1.141-3(b)(4)(ii)) with respect to financed property results in private business use is based on all the facts and circumstances. A management contract is defined in § 1.141-3(b)(4)(ii) as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. 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 physicians services to patients of a hospital are each treated as a management contract.

Rev. Proc. 97-13, 1997-1 C.B. 632, sets forth certain operating guidelines or safe harbor requirements for contracts to manage bond-financed facilities. Section 5.03(6) describes a permissible management contract that does not result in private business use. This subsection requires, in part, that all compensation be based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. The term of the contract including renewal options, must not exceed 2 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the first year of the contract term. This provision applies to contracts under which the service provider primarily provides services to third parties (for example radiology services to patients).

Section 5.04 of Rev. Proc. 97-13, requires that the service provider not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under the contract, based on all the facts and circumstances. A safe harbor for this requirement is described in section 5.04(2). However, C and B are related and do not meet the safe harbor.

Under the facts of this request, physicians are employed by C to provide professional medical services to patients of B at B's medical clinics and associated hospital. The provider service agreement has an initial term of one year, and will automatically renew for successive terms of one year each, unless either party terminates. Either party may terminate the agreement without cause upon 90 days prior written notice to the other effective as of the end of any term.

B is the sole member of C and controls C through C's board of directors. It also has the power to approve: amendments to articles of incorporation and bylaws; capital budgets, incurrence of long term debt, and operating budgets; strategic plans; risk management policies; human resources and benefit policies; health plan, payor or risk contracting agreements; and, merger, consolidation, dissolution, or sale or transfer of assets. Further, B may terminate the professional services agreement annually with 90 days written notice. Under the facts and circumstances of this case C could not prevent

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B from exercising its rights as described above.

CONCLUSION:

Based on the facts and circumstances presented, C does not have any role or relationship with B that substantially limits B's ability to exercise its rights, including cancellation rights, under the professional service agreement.

Except as specifically ruled above, no opinion is expressed concerning this transaction under any other provision of the Code or regulations thereunder. Specifically, no opinion is expressed concerning whether the Bond is tax-exempt. This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,  
Assistant Chief Counsel  
(Exempt Organizations/Employment  
Tax/Government Entities)  
By: Timothy L. Jones  
Assistant Chief, Tax Exempt Bond Branch

Enclosure: Copy for § 6110 purposes