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**Legend**

Management Contract =

Bonds =

Issuer =

State =

Hospital =

Medical Group =

University =

Date 1 =

Specialty =

Patient =

a =

b =

c =

d =

e percent =

f =

g =

h =

i =

j =

Date 2 =

Date 3 =

Dear \_\_\_\_\_ :

This letter is in response to your request for a ruling that the Management Contract will not result in private business use under section 1.141-3(b)(4)(i) of the Income Tax Regulations of the property financed by the Bonds.

### **Facts and Representations**

You make the following factual representations. The Issuer, an instrumentality of the State, is authorized under State law to issue revenue bonds for the purpose of financing the acquisition or renovation of health facilities operated by participating health institutions. The Hospital intends to use a portion of the proceeds of the Bonds and other bonds to be issued in the future by the Issuer to finance the acquisition or renovation of facilities to be owned or leased by the Hospital for the purpose of providing clinical medical services (the "Clinical Facilities"). Pursuant to the Management Contract, the Medical Group will provide physician services to the Hospital at the Clinical Facilities in exchange for the payments and reimbursements described below.

The Hospital is an organization described in section 501(c)(3) of the Internal Revenue Code (the "Code") and exempt from federal income tax under section 501(a). It is the

principal Specialty teaching hospital of the University, a State public university, which controls one-third of the Hospital's board of trustees.

The Medical Group is a State professional corporation owned by certain physicians who practice through the Medical Group. It is governed by a board of directors consisting of certain physicians, who are both shareholders of the Medical Group and University faculty members, and of certain officials of the University and Hospital. The individual employed by the University as Dean of Patient Clinical Services also serves as the president of the Medical Group and executive director of the division of the Hospital that uses the Clinical Facilities (the "President"). Not more than     percent of the voting power of the governing board of the Hospital is vested in the Medical Group or its directors, officers, shareholders, or employees. Neither the chief executive officer nor the chair of the governing board of the Hospital serves as a voting member of the Medical Group's board of directors, and neither the chief executive officer nor the chair of the board of directors of the Medical Group serves as a voting member of the Hospital's governing board.

The Management Contract provides that the Hospital will pay the Medical Group base compensation and incentive compensation. The base compensation is generally computed by multiplying the number of work relative value units ("WRVUs") produced by a division of the Medical Group (divisions are generally organized by medical specialty) over a specified period by an agreed upon fee for that division. For a minority of the divisions, however, base compensation is calculated differently. For certain divisions, base compensation is computed, as above, based on WRVUs, except that it cannot be less than a stated amount. In one case, base compensation is calculated as a fixed charge per patient visit.

The Medical Group's incentive compensation is based on the achievement of benchmarks in various performance categories. The Medical Group will receive incentive compensation for each benchmark it meets, but for most performance categories must return compensation to the Hospital if it falls short of a benchmark. At the beginning of each fiscal year, the parties will agree on the performance categories to be used in that year. You represent that, in the fiscal years beginning on or after Date 1, no performance category will be based on gross revenues or adjusted gross revenues. The performance categories for the fiscal year beginning on Date 1 will include cost management, patient access, emergency medicine patient satisfaction, emergency medicine throughput, and neonatal intensive care unit interaction satisfaction.

For the cost management category, the Medical Group will receive a percent of the amount by which the Hospital's expenses for salaries and wages, agency labor, supplies, and purchased services are less than b percent of the amount budgeted. Conversely, the Medical Group will return an amount of compensation equal to a percent of the amount by which those expenses exceed c percent of the amount budgeted. You represent that the total amount earned or returned in each year under

the incentive compensation provisions is capped and will not exceed d percent of the base compensation expected to be paid in that year.

Every third year, the base compensation and incentive compensation are renegotiated by the parties to ensure that they remain within fair market value, as determined by reference to industry group compensation surveys and a third-party valuation opinion.

The Management Contract also provides that the Hospital will pay or reimburse the Medical Group for the following miscellaneous expenses: (1) expenses not in excess of \$ \_\_\_\_\_ for travel, meetings, and professional dues incurred by each Medical Group physician; (2) administrative expenses up to a budgeted amount, including accounting expenses, meeting expenses, supply expenses, and management services expenses; and (3) reasonable professional liability tail insurance for certain resigned or terminated physicians.

In addition, the Hospital will pay or reimburse the Medical Group for all or a portion of the Medical Group's expenses for compensation of the following employees and officers of the Medical Group: (1) certain newly recruited physicians during their first year of employment, (2) fellows in certain medical specialties, (3) legal counsel, (4) an administrator, (5) the Vice President, Surgery, (6) the Vice President, Medicine, (7) the Compliance Officer, and (8) the President. Except in the case of the President (as further described below), the amount of the compensation paid to each of these individuals and reimbursed to the Medical Group under the Management Contract will be a stated amount or a stated amount increasing periodically by a stated percentage and will be determined without reference to gross revenues or expenses of the Clinical Facilities. The Hospital will also pay or reimburse the Medical Group for the cost of employee benefits furnished to the physicians providing medical services through the Medical Group and fellows in certain medical specialties. You represent that these employee benefits will not be determined by reference to either gross revenue or expenses from the Clinical Facilities.

The Management Contract further provides that the Hospital will, on behalf of the Medical Group, pay the University e percent of the compensation of the President. The full amount of the President's compensation and other terms of his employment are set under an employment agreement between the University and the President. Of this compensation, f percent will be base compensation and g percent will be the total incentive compensation for which the President is eligible (the "Total Incentive Compensation"). The base compensation will be a stated amount. The Total Incentive Compensation will also be a stated amount, but payment will depend on satisfactory achievement with respect to certain metrics that will be redetermined from year to year.

In each fiscal year beginning on or after Date 1, you expect that the President's incentive compensation will be based at least on the following three metrics: (a) not more than h percent of the Total Incentive Compensation will be awarded at the discretion of the governing board of the Hospital, (b) not more than i percent will be

awarded if the Clinical Facilities achieve their budgeted WRVUs, and (c) not more than j percent will be awarded if the Clinical Facilities both reduce expenses and achieve a stated number of WRVUs. You have provided historical financial data showing that gross revenue of the Clinical Facilities does not increase or decrease in concert with the number of WRVUs generated in the Clinical Facilities. You also represent that the governing board of the Hospital will not award the portion of the President's incentive pay dependent on its discretion based on the Clinical Facilities' net profits.

You represent that, excluding the three metrics described in (a), (b), and (c) above, none of the metrics used in the fiscal years beginning on or after Date 1 to award incentive compensation will be determined by reference to revenues, expenses, or net profits of the Clinical Facilities. You also represent that, with the exception of the fiscal year beginning on Date 1, the amount of the Total Incentive Compensation, the elements of each metric, and the percentages awarded for achieving each metric in a given fiscal year will be determined by the end of the first quarter of that fiscal year.

The term of the Management Contract ends on Date 2 and either party can terminate without cause or penalty on Date 3, a date which is approximately three and a half years prior to Date 2.

### **Law**

Under section 103(a), gross income does not include interest on any state or local bond. Section 103(b) provides, however, that section 103(a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of section 141).

Section 141(a) provides that the term "private activity bond" means any bond issued as part of an issue which: (1) meets the private business use test of section 141(b)(1) and the private security or payment test of section 141(b)(2); or (2) meets the private loan financing test of section 141(c). Section 141(b)(1) provides, in general, 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) provides that the term "private business use" for purposes of section 141(b), means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business.

Section 141(e)(1)(G) provides that the term "qualified bond" includes any private activity bond if such bond is a qualified 501(c)(3) bond and meets other specified requirements.

Section 145(a) provides that a "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if (1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and (2) such bonds would not be a private activity bond if (A) 501(c)(3) organizations

were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and (B) sections 141(b)(1) and (2) were applied by substituting “5 percent” for “10 percent” each place it appears and by substituting “net proceeds” for “proceeds” each place it appears.

Section 1.145-2(a) provides generally that sections 1.141-0 through 1.141-15 apply to section 145(a). Section 1.145-2(b) provides, in part, that in applying sections 1.141-0 through 1.141-15 to section 145(a), (1) references to governmental persons include 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under section 513(a); and (2) references to “10 percent” and “proceeds” in the context of the private business use test and the private security or payment test mean “5 percent” and “net proceeds”.

Section 1.141-3(a)(1) provides that the private business use test relates to the use of the proceeds of an issue. The 10 percent private business use test of section 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Any activity carried on by a person other than a natural person is treated as a trade or business.

Section 1.141-3(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

Section 1.141-3(b)(4)(i) provides that, except as provided in section 141-3(d), a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract generally results in private 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.

Section 1.141-3(b)(4)(ii) defines a management contract 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 physician services to patients of a hospital are each treated as a management contract.

Revenue Procedure 97-13, 1997-1 C.B. 632, as modified by Revenue Procedure 2001-39, 2001-2 C.B. 38 (“Rev. Proc. 97-13”), sets forth conditions under which a management contract does not result in private business use under section 141(b).. Under section 5.02(1), the management contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facility. Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation. Under section 5.02(2), for purposes of section 1.141-3(b)(4)(i) and Rev. Proc. 97-13, compensation that is based on (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both, (b) a capitation fee, or (c) a per-unit fee, is generally not considered to be based on a share of net profits. Under section 5.02(3), for purposes of section 1.141-3(b)(4)(i) and Rev. Proc. 97-13, a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract, generally does not cause the compensation to be based on a share of net profits.

Section 3.01 defines “adjusted gross revenue” as gross revenues of all or a portion of a facility, less allowances for bad debts and contractual and similar allowances.

Section 3.05 defines a “periodic fixed fee” as a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective external standards. Capitation fees and per-unit fees are not periodic fixed fees.

Section 3.06 of Rev. Proc. 97-13 defines a “per-unit fee” as a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fee arrangements.

Section 3.08 of Rev. Proc. 97-13 provides that a renewal option means a provision under which the service provider has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for one year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

Section 5.03 of Rev. Proc. 97-13 sets forth six permissible arrangements that satisfy the requirements of section 5. Under section 5.03(5), a permissible arrangement is one under which all of the compensation for services is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 3 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the second year of the contract term.

Section 5.04(1) of Rev. Proc. 97-13 provides in general that a 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, including cancellation rights, based on all the facts and circumstances. Under section 5.04(2), the qualified user's rights are not substantially limited if the following requirements are satisfied: (1) not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees; (2) overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and (3) the qualified user and the service provider under the contract are not related parties, as defined in section 1.150-1(b).

### **Analysis**

The Management Contract does not meet the requirements of section 5 of Rev. Proc. 97-13. Therefore, whether the Management Contract results in private business use of the Clinical Facilities under section 1.141-3(b)(4) depends on all of the facts and circumstances. In determining whether the facts and circumstances relating to a management contract indicate private business use, the factors set forth in Rev. Proc. 97-13 are useful reference points. For the reasons described below, we conclude that the Management Contract does not result in private business use of the Clinical Facilities.

Setting aside the incentive pay of the President, neither the Hospital's payment or reimbursement of the Medical Group's miscellaneous expenses nor its payment or reimbursement of the Medical Group's compensation expenses, as each such expense is described above, supports a conclusion that the Management Contract causes private business use of the Clinical Facilities because neither the miscellaneous expenses nor the compensation expenses are calculated based on net profits.

Likewise, the facts and circumstances of the President's incentive pay do not support a conclusion that the Management Contract causes private business use of the Clinical Facilities. The metric based on the Clinical Facilities' achievement of their budgeted WRVUs does not support a conclusion of private business use because a per-unit fee is generally not considered to be based on a share of net profits. The metric based on the discretion of the governing board of the Hospital does not support a conclusion of private business use because you represent that it will not be based on net profits. The



metric based on a combination of expense reduction and achievement of a WRVU target does not support a conclusion of private business use because, based on the historical financial data provided, WRVUs are not a proxy for gross revenue such that, in combination with expense reduction, they track net profits.

Based in part on the periodic renegotiation to ensure that base compensation and incentive compensation remain within fair market value, as determined by an external standard, the Management Contract provides for reasonable compensation for the services provided by the Medical Group. The base compensation paid by the Hospital to the Medical Group under the Management Contract does not support a conclusion that there is private business use under these facts and circumstances. The base compensation closely resembles the arrangement in section 5.03(5) of Rev. Proc. 97-13, although the term of the Management Contract exceeds the permissible term under section 5.03(5). Additionally, the Medical Group's incentive compensation does not support a conclusion that there is private business use. It is not based on a share of net profits because, although based in part on reductions in expenses, it is not, and will not be, based on gross revenues or adjusted gross revenues.

Finally, the Medical Group does not have any role or relationship with the Hospital that substantially limits the Hospital's ability to exercise its rights under the Management Contract, including its termination right. No more than percent of the voting power of the governing board of the Hospital is vested in the Medical Group or its directors, officers, shareholders, or employees. The chief executive officers and the chairs of the governing board of the Hospital and the Medical Group do not vote on the governing board of the other. Also, the Medical Group and the Hospital are not related within the meaning of section 1.150-1(b).

### **Conclusion**

We conclude that the Management Contract will not result in private business use of the Clinical Facilities under section 1.141-3(b)(4)(i).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. The representations relied upon include but are not limited to your representations that metrics used in the future to measure performance will not be based in whole or in part on the net profits of the Clinical Facilities. We have taken the term "net profits" as used in your representations throughout this ruling to mean net profits as the term is used in section 1.141-3(b)(4)(i). In addition, the continued application of this ruling is conditioned upon the continued existence of the facts you provided, including but not limited to the continuation of the lack of a close relationship evidenced in the historical financial data you provided between the number of WRVUs and the gross revenue of the Clinical Facilities. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Associate Chief Counsel  
(Financial Institutions and Products)

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By: \_\_\_\_\_  
Timothy L. Jones  
Senior Counsel  
(Financial Institutions & Products)