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Legend

Issuer:

Healthcare Group:

Medical Group:

Medical Center:

Clinic:

State:

Bonds:

X:

Dear :

This responds to Issuer's request for a ruling that the Clinic Physicians Service Agreement (CPSA) described below does not result in private business use of the Bond proceeds under § 145(a)(2)(B) of the Internal Revenue Code (the Code).

Facts

Issuer makes the following representations. Issuer is an instrumentality of State, that issues bonds on behalf of State and uses the proceeds to make loans to health and educational institutions located in State. Issuer loaned the proceeds of the Bonds to Medical Center, to finance various healthcare facilities in State.

Healthcare Group is a nonprofit corporation formed under the laws of State to consolidate other entities that constitute an integrated healthcare delivery system. Healthcare Group directly or through its subsidiaries owns and operates hospitals, a surgical center, an inpatient rehabilitation facility, home care companies, physician services, pharmacies, mental health services, insurance companies and a charitable foundation.

Medical Center is a nonprofit entity described in § 501(c)(3). Medical Center is wholly owned by Healthcare Group. Medical Center currently owns or controls directly or through certain affiliates all of the physical assets of Healthcare Group including the assets financed with proceeds of the Bonds.

Medical Group, a newly formed nonprofit entity described in § 501(c)(3), provides physician services at healthcare facilities owned by Medical Center. Healthcare Group is the sole member of Medical Group and appoints the directors of Medical Group. Following its formation, Medical Group through an intermediary taxable subsidiary acquired all the outstanding stock of Clinic. Clinic is a taxable wholly-owned physician practice group managed by a board of 10.

Healthcare Group is controlled by a self-perpetuating board of directors (HG Board) consisting of 29 individuals elected by the HG Board. Currently three Clinic physicians serve on the HG Board. Healthcare Group's by-laws limit the number of Clinic physician directors to 20 percent of the aggregate number of Healthcare Group

directors. If the overall board size were to decrease, the number of Clinic physicians would be adjusted to meet the 20 percent requirement.

A designee of the CEO of Healthcare Group, an employee of the Healthcare Group, serves directly on the Clinic's governing board. The designated representative receives no compensation from Clinic, and has no special status or reserved power beyond that of any other Clinic Board member. The CEO of Healthcare Group may serve on the Clinic board in lieu of the designee.

Pursuant to the CPSA, Clinic physicians provide medical services at the facilities of Healthcare Group, and in turn Healthcare Group provides space, equipment and supplies necessary for the physicians to serve patients. The stated term of the CPSA is three years, subject to one-year automatic renewals absent cancelation; either party may terminate the CPSA by giving 30 days written notice. During the three-year term of the CPSA, Healthcare Group may not amend or terminate the compensation arrangement with Clinic physicians without approval by a majority of the Clinic Board of Directors.

Healthcare Group compensates Clinic for Clinic salaries other than physicians, Clinic's third party expenses (including employee benefits) and Clinic physician compensation. The compensation for Clinic physicians is based on a monthly aggregate of physician patient billings for that month, adjusted to reflect actual collections, for physician services at Healthcare Group facilities. Clinic earns no additional fees.

Physician compensation is an aggregate of fixed physician fees, where physicians in certain practice groups are paid a predetermined amount, and a production model, under which physician fees are set based on the amount of services provided and the unit value of those services, as established by the Centers for Medicaid and Medicare Services (CMS). The CPSA imposes two reasonability tests on physician compensation to ensure that it is at fair market value. These tests focus on the physician's production and collection ratios. If the initially determined compensation fails either of these two tests, it is adjusted accordingly. Issuer represents that physician compensation is reasonable. Physicians may also qualify for an annual bonus if certain quality benchmarks are met. Examples of such benchmarks include: attendance; good behavior; and favorable patient satisfaction surveys. Physician bonuses are paid from a bonus pool that is funded by, up to X percent, of the physician compensation remitted to Clinic.

LAW

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

Section 141(a) provides, in part, that the term “private activity bond” means any bond issued as part of an issue which meets the private business test of § 141(b)(1) and the private security or payments test of § 141(b)(2); or meets the private loan financing test of § 141(c). Section 141(b)(1) generally provides that, except as otherwise provided in this subsection, an issue meets the test of this paragraph if more than 10 percent of the proceeds of the issue are to be used for any private business use.

Section 141(b)(6)(A) provides, in part, that for the purposes of this subsection, the term “private business use” means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. Section 141(b)(6)(B) states that for the purposes of the first sentence of § 141(b)(6)(A), any activity carried on by a person other than a natural person shall be treated as a trade or business.

Section 141 (e) provides, in part, that a qualified bond means a private activity bond if the bond is a qualified 501(c)(3) bond.

Section 145(a) provides that for purposes of this part, except as otherwise provided in this section, the term “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 bond 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 § 513(a); and B) paragraphs (1) and (2) of § 141(b) 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 of the Income Tax Regulations provides that, except as provided in this section, §§ 1.141-0 through 1.141-15 apply to § 145(a).

Section 1.141-3(b)(4)(ii) provides that for the purposes of this section, a management contract is 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 treated as a management contract.

Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39, 2001-2 C.B. 38, and amplified by Notice 2014-67, 2014-46 I.R.B. 822 (Rev. Proc. 97-13), sets forth conditions under which a management contract generally will not result in private business use under § 141(b). Under section 5.02(1) of Rev. Proc. 97-13, 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 for 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.

Section 5.02(2) of Rev. Proc. 97-13, states that compensation generally is not treated as based on a share of net profits if compensation is based on: 1) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; 2) a capitation fee; or 3) a per unit fee.

Section 5.02(3) of Rev. Proc. 97-13, states that for purposes of § 1.141.-3(b)(4)(i) and the revenue procedure, a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenue (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. A productivity reward for services in any annual period during the terms of the contract generally also does not cause the compensation to be based on a share of net profits of the financed facility if: 1) the eligibility for the productivity award is based on the quality of the services provided under the management contract (for example, the achievement of Medicare Shared Savings Program quality performance standards or meeting data reporting requirements), rather than increases in revenue or decreases in expenses of facility; and 2) the amount of the productivity award is stated dollar amount, a periodic fixed fee, or tiered system of stated dollar amounts or periodic fixed fees based solely on the level of performance achieved with respect to the applicable measure.

Section 5.03 of Rev. Proc. 97-13 requires that the compensation and contract term be limited to one of several permissible arrangements. Section 5.03(7) permits an arrangement under which all of the compensation for services is based on a stated amount, a periodic fixed fee, a capitation fee, a per-unit fee, or a combination of the preceding. The compensation for services also may include a percentage of gross revenues, adjusted gross revenues, or expenses of the facility (but not both revenues and expenses). The term of the contract, including all renewal options, may not exceed five years. Such contract need not be terminable by the qualified user prior to the end of the term. A tiered productivity award of stated dollars amounts or periodic fixed fee is treated as a stated amount or a periodic fixed fee, as appropriate.

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 a governmental entity or a 501(c)(3) organization.

Section 3.08 of Rev. Proc. 97-13 defines “renewal option” as 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 5.04 of Rev. Proc. 97-13 provides that the arrangement between the service provider and the governmental person or 501(c)(3) organization must by such that the service provider does 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 cancelation rights, under the contract, based on all the facts and circumstances. Rev. Proc. 97-13 provides a safe harbor for this requirement if: 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 employee; 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 §1.150-1(b).

Section 1.150-1(b) defines related party to mean, in reference to a governmental unit or 501(c)(3) organization, any member of the same controlled group and, in reference to any person that is not a governmental unit or 501(c)(3) organization, a related person as defined in § 144(a)(3).

Section 1.150-1(e) defines controlled group as a group of entities controlled directly or indirectly by the same entity or group of entities. The determination of direct control is made on the basis of all the relevant facts and circumstances. One entity or group of entities (the controlling entity) generally controls another entity or group of entities (the controlled entity) for purposes of this paragraph if the controlled entity possesses either of the following rights or powers and the rights or powers are discretionary and non-ministerial: 1) the right or power both to approve and remove without cause a controlling portion of the governing body of the controlled entity; or 2) the right or power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity. If a controlling entity controls a controlled entity then the controlling entity also controls all entities controlled, directly or indirectly, by the controlled entity or entities.

Analysis

The CPSA has an initial term of three years, and will automatically renew for successive terms of one year each, unless either party terminates. As provided in section 3.08 of Rev. Proc. 97-13, a provision under which a contract is automatically renewed for one year periods absent cancelation by either party is not a renewal option. The three year term with automatic renewals absent a cancelation, is within section 5.03(7) of Rev. Proc. 97-13.

The compensation arrangement of Clinic consists of reimbursement of direct expenses for non-physician salaries, employee benefits, and a direct distribution of physician

compensation. Other than physician bonuses, physicians are compensated based on either a per-unit or a capitation basis both of which Rev. Proc. 97-13 permits. Physician bonuses, triggered by factors other than net profits and based on a share of gross revenues from physician billings, are also permitted under Rev. Proc. 97-13. Finally, the issuer represents that physician compensation is reasonable and the CPSA requires that physician compensation be no greater than its fair market value.

However, the CPSA does not meet the requirements of section 5.04(2) of Rev. Proc. 97-13, because Healthcare Group and Clinic are related parties. Therefore, whether the CPSA causes private business use of the facilities financed with the Bonds depends on the facts and circumstances. Because the other elements of Rev. Proc. 97-13 are satisfied, the only question is whether the parties' relationship will substantially limit the Healthcare Group's ability to exercise its rights under the CPSA.

Although Healthcare Group and Clinic are related parties under § 1.150-1(b), Healthcare Group is effectively the sole shareholder of Clinic, giving Healthcare Group ultimate control in the relationship between these two parties. Further, only up to 20 percent of the Clinic physicians may be members of the HG Board. The designee of the CEO who serves on the Clinic board has no special status or special powers and represents less than 10 percent of the Clinic board. Consequently, we believe that, Clinic cannot control Healthcare Group and cannot prevent Healthcare Group from terminating the CPSA.

Conclusion

Based on all of the facts and circumstances, we conclude that the CPSA meets the requirements of section 5.04 of Rev. Proc. 97-13, and will not result in private business use of the Bond proceeds under § 145(a)(2)(B). We expressly condition this conclusion on the CEO of Healthcare Group continuing not to be a member of the Clinic Board.

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 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 representatives.

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. 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.

Sincerely,

Associate Chief Counsel
(Financial Institutions & Products)

/S/

By: _____
Timothy L. Jones
Senior Counsel, Branch 5