Current Developments in Tax-Exempt Bonds


Perhaps the most significant aspect of Notice 2014-67, is that it substantially updates and revises the existing management contract safe harbors under Revenue Procedure 97-13, for the first time in 18 years. Notice 2014-67 provides a new favorable five-year safe harbor from private business use for management contracts and expands the types of productivity awards that are permitted.

The new safe harbor permits a 5 year contract that does not have to be terminable at 3 years (unlike the existing 5 year safe harbor in Revenue Procedure 97-13 which must be terminable at 3 years). Under this safe harbor, all of the compensation for services may be based on a stated amount, a periodic fixed fee, a capitation fee, a per-unit fee or a combination of the proceeding. Moreover, 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 new safe harbor is in addition to the existing 5 year, 3-year and 2-year safe harbors that currently exist under Revenue Procedure 97-13 and may be applied to any management contract (not just to management contracts in the healthcare setting).

Expanded rules for permitted productivity awards

The Notice provides that a productivity award for services in any annual period during the term of the contract generally also does not cause the compensation to be based on a share of net profits of the bond 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 or decreases in expenses of the facility; and

(2) the amount of the productivity award is a stated dollar amount, a periodic fixed fee, or a tiered system of stated dollar amounts or periodic fixed fees based solely on the level of performance achieved with respect to the applicable measure.

The notice states that a tiered productivity award will be treated as a stated amount of a periodic fixed fee.

Implications of New Management Contract Safe Harbor

Perhaps the most interesting aspect of Notice 2014-67 is that the new management contract safe harbor applies to contracts entered into or materially modified on or after January 22, 2015, but may be applied to contracts entered into before that date. The practical aspects of this effective date are that:
• New money financings and refundings where the borrowers will enter into or have previously signed a management contract should consider the application of the new safe harbor.

• The new rules should be reviewed when negotiating a voluntary closing agreement or defending an IRS audit.

• Bond compliance procedures already in place will need to be updated to reflect the new rules.

• Under the new safe harbor, there will be instances where there is less private business use than previously anticipated or reported. Section 501(c)(3) organization borrowers will need to consider this in reviewing their reported use on Schedule K of Form 990.

In addition, it is possible that the more liberal terms of this tax-exempt bond safe harbor may raise more difficult questions regarding establishing that a contract is entered into at fair market value. The Notice specifically states that the IRS expects to issue guidance concerning management contracts and solicits comments. Borrowers and issuers interested in providing comments should determine whether they want to submit. Furthermore, since the IRS/Treasury Business plan for this year lists management contract guidance, it is likely that there will be further updates on the management contract rules that will be published in the future.

New Bond Guidance: Accountable Care Organizations

Notice 2014-67 provides interim guidance for determining whether a State or local government entity or an organization described in section 501(c)(3) of the Internal Revenue Code, as amended (the Code) that benefits from tax-exempt bond financing will be considered to have private business use of its bond financed facilities under section 141 as a result of its participation in the Shared Savings program through an accountable care organization (ACO).

The guidance is significant because it is the first step taken by the IRS in the tax-exempt bond area in addressing the tax issues raised by nonprofit organizations with tax-exempt bond financing participating in ACOs. The Notice states that the participation of a 501(c)(3) hospital organization (or governmental entity) in the Medicare Shared Savings Program through an ACO will not result in private business use of the tax-exempt bond financed facility if all of the following conditions are met:

(1) The terms of the organization's participation in the Shared Savings Program through the ACO (including its share of Shared Savings Program payments or losses and expenses) are set forth in advance in a written agreement negotiated at arm's length.

(2) the Centers for Medicare & Medicaid Services (CMS) has accepted the ACO into and has not terminated the ACO from the Shared Savings Program.
The organization's share of economic benefits derived from the ACO (included its share of Shared Savings Program payments) is proportional to the benefits or contributions the organization provides to the ACO. If the organization receives an ownership interest in the ACO, the ownership interest received is proportional and equal in value to its capital contributions to the ACO and all ACO returns of capital, allocations, and distributions are made in proportion to ownership interests.

The organization's share of the ACO's losses (including its share of Shared Savings Program losses) does not exceed the share of ACO economic benefits to which the organization is entitled.

All contracts and transactions entered into by the organization with the ACO and the ACO's participants, and by the ACO with the ACO's participants and any other parties are at fair market value.

The qualified user does not contribute or otherwise transfer the property financed with tax-exempt bonds to the ACO unless the ACO is an entity that is a governmental person, or in the case of qualified 501(c)(3) bonds, either a governmental person or a 501(c)(3) organization.

The conditions set forth in Notice 2014-67 parallel the conditions in Notice 2011-20, which provided guidance related to the tax treatment for exempt organizations seeking participation in ACOs. Notice 2014-67 does not provide an analysis of how ACOs should be analyzed under the provisions of the existing “private business use” regulations under Sections 141 and 145 of the Code. This ACO guidance applies to bonds sold on or after January 22, 2015, but may be applied to bonds sold before that date.

Voluntary Closing Agreement Program for 501(c)(3) Organizations

The IRS announced in Announcement 2015-02 a simplified process for issuers of 501(c)(3) bonds to request a voluntary closing agreement in situations where the borrower received prospective reinstatement after its tax-exempt status was automatically revoked for failure to file an annual return for three consecutive years.

Under section 6033(j) when a 501(c)(3) organization fails to file an annual return or notice required under subsection 6033(a)(1) or 6033(i) for three consecutive years, the organization's status as a 501(c)(3) organization is considered revoked on and after the required date for the filing of the third annual return or notice (the revocation date). Section 6033(j)(2) provides a mechanism by which an organization may seek reinstatement of its exempt status after automatic revocation. Retroactive reinstatement of the organization's 501(c)(3) status may be granted if an organization can show reasonable cause for its failure to file. If the organization receives retroactive reinstatement, there will be no time during which the organization was not a 501(c)(3) organization. The announcement does not cover this situation. However, under certain situations described in Revenue Procedure 2014-11, the effective date of reinstatement of the 501(c)(3) organization's exempt status may be later than the revocation date (prospective reinstatement). The announcement is intended to cover those situations by allowing an issuer of qualified 501(c)(3) bonds to resolve the loss of 501(c)(3) status by applying for a closing
agreement. The issuer of qualified 501(c)(3) bonds may apply for a closing agreement if the following requirements are met:

(1) the 501(c)(3) organization that is the beneficiary of the bonds has received prospective reinstatement of its exempt status;

(2) the organization's exempt status has not been previously revoked since the issue date of the bonds. If the proceeds of the bonds were used to refund prior qualified 501(c)(3) bonds, for purposes of the announcement, the issue date means the issue date of the refunded bonds.

(3) the request for the closing agreement is submitted within 12 months of the date of the reinstatement letter. If the reinstatement letter is dated before December 30, 2014, the issuer has 12 months from December 30, 2014 to submit a closing agreement under the announcement and

(4) the bonds are not under examination by the IRS.

The announcement provides that if the organization's revocation affects more than one of the issuer's bond issues, the issuer may submit one closing agreement to cover all affected bond issues. If the bonds fail to qualify because more than one organization that is the borrower of the proceeds of the bonds had its exempt status revoked under section 6033(j) of the Code, the issuer must submit a separate closing agreement under the announcement for each organization.

The closing agreement amount for each bond issue covered by an agreement is equal to $500 for each calendar month or portion thereof in the period, starting with the month of revocation and ending in the month when the organization’s exempt status was reinstated.

Announcement 2015-02 comes as a welcome piece of guidance to the bond community. In a recent webcast held on February 5th, Rebecca Harrigal, Director of Tax-exempt Bonds, IRS Tax-Exempt and Government Entities Division said that the IRS will continue keep working on improving the voluntary closing agreement program for issuers of tax-exempt bonds. This statement by Mrs. Harrigal suggests that this announcement is likely to be the first of many to come.

**Section 501(r) regulations**

Final 501(r) regulations were released on December 31, 2014 (79 FR 78953).

Of significance in the bond context is that:

- Final regulations provide that a noncompliant hospital facility subject to tax under section 501(r) will continue to be treated as an organization that is exempt from tax under section 501(a) as an organization described in section 501(c)(3) and therefore would not by itself affect the tax-exempt status of bonds issued to finance the noncompliant facility.

- Final regulations also state that the application of the facility level tax will not, by itself, result in the operation of the noncompliant facility being considered an unrelated trade or business described in section 513 with respect to the hospital organization.
Even though the final regulations are generally favorable with respect to tax-exempt bond compliance, the final regulations raise a number of important considerations for tax-exempt bond borrowers and practitioners. The qualification of “qualified 501(c)(3) bonds” as tax-exempt depends upon the continued compliance of borrowers and other users of tax-exempt bond proceeds as 501(c)(3) organizations. Accordingly, tax-exempt bond transactions customarily require both legal opinions and disclosures to investors regarding status of borrowers and other users as 501(c)(3) organizations. For example, the detailed nature of many of the requirements in the final regulations may have implications for opinion and due diligence practice in this area. In addition, compliance with the final regulations, including particularly required disclosures to the IRS, will raise issues regarding proper disclosures to tax-exempt bond investors for securities law purposes.

**Administration's Budget Proposals**

- The Administration's budget for the last 3 years has included a proposal to loosen up the restrictions on research agreements for bond financed facilities. Revenue Procedure 2007-47 sets forth two safe harbors that if met do not result in the research agreement creating private business use. One of the safe harbors for corporate sponsored research provides that:

  (1) the agreement must relate to property used for basic research sponsored by a sponsor, (2) the license or resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by any unrelated, non-sponsoring party with the price paid for the use determined at the time the license or other resulting technology is available for use; and (3) 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.

The proposal for research agreements provides an exception to the private business use limits for research agreements relating to basic research in situations where:

(1) the qualified user (501(c)(3) entity or state and local government) owns the research facilities;

(2) the qualified user enters into any bona fide, arm's length contractual agreement with a private business sponsor of basic research regarding the terms for sharing the economic benefits of any products resulting from the research in which the economic terms are determined in advance at the time the parties enter into the contractual arrangement.

This research proposal has generated interest among lawmakers.

- Proposal for a permanent America Fast Forward Bond program: taxable bonds issued by state and local governments in which the Federal government makes direct payments to State and local issuers in an amount equal to 28% of the coupon interest on the bonds. The eligible users for America Fast Forward Bonds would include financing for section 501(c)(3) entities.