

**JONES HALL,**  
A PROFESSIONAL LAW CORPORATION

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**REVENUE PROCEDURE 97-13**  
**MANAGEMENT CONTRACT RULES**

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**REVENUE PROCEDURE 97-13  
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**I. INTRODUCTION.** On January 10, 1997, the Department of the Treasury issued Revenue Procedure 97-13 setting forth conditions under which a management contract does not result in private business use of a bond-financed facility (or unrelated use, in the case of qualified 501(c)(3) bonds<sup>1</sup>). These conditions establish safe harbors.<sup>2</sup> Present Revenue Procedure 93-19 is "made obsolete" by new Revenue Procedure 97-13.<sup>3</sup>

**II. EFFECTIVE DATE.** Revenue Procedure 97-13 applies to any management contract entered into, materially modified or extended (other than pursuant to a renewal option, as defined below) on or after May 16, 1997.<sup>4</sup> In addition, the Revenue Procedure may be applied by the issuer to any management contract entered into before that date.<sup>5</sup>

**III. SCOPE (WHAT IS AND WHAT IS NOT A MANAGEMENT CONTRACT)**

**A. Management Contract Defined.** 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.<sup>6</sup>

**B. Prohibited Management Contracts.** Certain management contracts will give rise to private business use and therefore are not protected by the safe harbors of Revenue Procedure 97-13. These are management contracts that (i) give the service provider an ownership or leasehold interest in the financed facility (or an interest in the nature of an ownership or leasehold interest)<sup>7</sup> or (ii) provide for compensation for services rendered based in whole or in part on a share of net profits from operations of the facility.<sup>8</sup>

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\* Except as otherwise specifically stated, § references are to sections of Rev. Proc. 97-13. The term "Regulations" refers to the final private activity bond regulations (TD 8712). The term "Code" refers to the Internal Revenue Code of 1986.

<sup>1</sup> § 2.01(9).

<sup>2</sup> Preamble to Regulations, Part C, item 4, third paragraph.

<sup>3</sup> § 6.

<sup>4</sup> § 7.

<sup>5</sup> *Id.*

<sup>6</sup> Regulations § 1.141-3(d)(4)(ii).

<sup>7</sup> § 2.01(4). Regulations § 1.141-3(b)(4)(iv) states that a management contract gives rise to private business use if the service provider is treated as the lessee or owner of financed property for federal income tax purposes (unless a specific exception applies). Example 3 under Regulations § 1.141-3(f) states that an HMO service provider for a hospital under a contract that provided that 30 percent of the hospital's capacity would be exclusively available to the provider's members, where the provider would bear the risk of loss of that portion of hospital capacity, was properly characterized as a lease rather than a management contract.

<sup>8</sup> § 2.01(6). Regulations § 1.141-3(b)(4)(i).

The following do not represent compensation based on a share of net profits: (i) compensation based on a percentage of gross revenues (or adjusted gross revenues) or a percentage of expenses, but not both;<sup>9</sup> (ii) a capitation fee (see definition below);<sup>10</sup> (iii) a per-unit fee (see definition below);<sup>11</sup> or 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, in any annual period during the contract term.<sup>12</sup>

**C. Excluded Contracts.** The following are not treated as management contracts that give rise to private business use:<sup>13</sup>

1. Service contracts incidental to the governmental functions of a financed facility (e.g., contracts for janitor services, office equipment repair and hospital billing);

2. Granting of admitting privileges by a hospital to a doctor if the same are available to all qualified physicians in the area consistent with the size and nature of the hospital facilities;

3. Any service contract if the only compensation is reimbursement for actual and direct expenses by the service provider to unrelated parties; and

4. Contracts to provide for the operation of a facility or system that consists primarily of "public utility property" (see definition below) if the only compensation is reimbursement of actual and direct expenses and reasonable administrative overhead expenses.

**Public Utility Property Defined.** The term "public utility property" means property used predominantly in the furnishing or sale of (i) water, sewage disposal, electrical energy, (ii) gas or steam through a local distribution system, (iii) transportation of gas or steam by pipeline, (iv) telephone services, and (v) certain communication services<sup>14</sup>

#### **IV. SAFE HARBOR**

**A. In General.** A contract satisfies the conditions of Revenue Procedure 97-13 if (i) it provides for reasonable compensation for services rendered (but reimbursement for direct expenses paid by the provider to unrelated parties is not by itself treated as compensation),<sup>15</sup> (ii) it satisfies the compensation and term limits below,<sup>16</sup> and (iii) it satisfies the limitation on control below.<sup>17</sup>

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<sup>9</sup> § 5.02(2)(a).

<sup>10</sup> § 5.02(2)(b).

<sup>11</sup> § 5.02(2)(c).

<sup>12</sup> § 5.02(3).

<sup>13</sup> § 2.01(7). Regulations § 1.141-3(b)(4)(iii).

<sup>14</sup> Code section 168(i)(10). The referenced "communication services" are those furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701).

<sup>15</sup> § 5.02(1).

<sup>16</sup> § 5.03.

<sup>17</sup> § 5.04.

**B. Term/Compensation.** As used below, "term" includes renewal options. A "renewal option" means a provision under which the provider has a legally enforceable right to renew the contract and, so, a provision for automatic renewal for one-year periods absent cancellation is not a renewal option even if expected to operate.<sup>18</sup> Also, as used below, "qualified user" means the governmental unit (or, in the case of qualified 501(c)(3) bonds, the 501(c)(3) organization) that is entering into the contract with the provider.<sup>19</sup> See also the definitions of the types of fees and of "penalty" (for termination) below.

1. 95% Fixed Compensation; 15/20 Year Term

*Maximum Term of Contract:* The lesser of (i) 15 years (20 years in the case of public utility property) or (ii) 80 percent of the reasonably expected useful life of the financed property.<sup>20</sup>

*Compensation:* For each annual period during the term, at least 95 percent is based on a periodic fixed fee. (In this category, a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award, equal to a single, stated dollar amount, under which compensation automatically increases when a gross revenue or expense target, but not both, is reached.)<sup>21</sup>

2. 80% Fixed Compensation; 10/20 Year Term

*Maximum Term of Contract:* The lesser of (i) 10 years (20 years in the case of public utility property) or (ii) 80 percent of the reasonably expected useful of the financed property.<sup>22</sup>

*Compensation:* For each annual period during the term, at least 80 percent is based on a periodic fixed fee. (In this category, a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award, equal to a single, stated dollar amount, under which compensation automatically increases when a gross revenue or expense target, but not both, is reached.)<sup>23</sup>

3. 50% Fixed or 100% Capitation/Fixed Compensation; 5 Year Term

*Maximum Term of Contract:* 5 years and, in addition, the contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term.<sup>24</sup>

*Compensation:* For each annual period during the term, (i) at least 50 percent is based on a periodic fixed fee, (ii) 100 percent is based on a capitation fee (see definition below), or (iii) 100 percent is based on a combination of a capitation fee and a periodic fixed fee.<sup>25</sup>

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18 § 4.08.

19 § 3.07.

20 §§ 5.03(1) and (3).

21 § 5.03(1).

22 §§ 5.03(2) and (3).

23 § 5.03(2).

24 § 5.03(4).

25 *Id.*

4. 100% Per-Unit or Per-Unit/Fixed Compensation; 3 Year Term

*Maximum Term of Contract:* 3 years and, in addition, 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.<sup>26</sup>

*Compensation:* All compensation is based on (i) a per-unit fee or (ii) a combination of a per-unit fee and a periodic fixed fee.<sup>27</sup>

5. 100% Revenues/Expenses Percentage Compensation; 2 Year Term; Limited Use

*Maximum Term of Contract:* 2 years and, in addition, 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.<sup>28</sup>

*Compensation:* All compensation is based on (i) a percentage of fees charged, or (ii) a combination of a per-unit fee and a percentage of revenue or expense fee, except during start-up the compensation may be based on a percentage of (i) facility gross revenues, (ii) facility adjusted gross revenues, or (iii) facility expenses.<sup>29</sup>

*Limitation.* This alternative is available only for (i) contracts where the provider provides services to third parties (e.g., radiology services to patients), and (ii) management contracts for facilities during a start-up period where there are insufficient operations to estimate annual gross revenues and expenses.<sup>30</sup>

C. **General Limitation on Control.** The following conditions relating to control must be satisfied:<sup>31</sup>

1. Not more than 20 percent of the voting power of the qualified user may be vested in the service provider and its directors, officers, shareholders and employees;
2. Overlapping board members may not include the chief executive officers of the service provider or the qualified user or their governing bodies; and
3. The qualified user and the service provider under the contact may not be related parties<sup>32</sup>

D. **Relevant Definitions**

1. "Periodic fixed fee" means a stated dollar amount for services for a specified period (e.g., a stated dollar amount per month). It may automatically increase according

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<sup>26</sup> § 5.03(5).

<sup>27</sup> *Id.*

<sup>28</sup> § 5.03(6).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> § 5.04(1).

<sup>32</sup> § 5.04(2).

to a specified, objective, external standard not linked to output or efficiency of a facility (e.g., the consumer price index).<sup>33</sup>

2. "Capitation fee" means a fixed periodic amount for each person for whom the provider or qualified user assumes responsibility to provide all needed services for a specified period (e.g., a fixed dollar amount payable monthly to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified means). A capitation fee may include a variable component up to 20 percent of the total fee to protect against risks such as catastrophic loss.<sup>34</sup>

3. "Per-unit fee" means a fee based on a unit of service specified in the contract or determined by an independent third party (e.g., the administrator of the Medicare program) or the qualified user (e.g., a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile). Separate billing arrangements between physicians and hospitals are generally per-unit fee arrangements.<sup>35</sup>

4. "Adjusted gross revenues" means gross revenues less allowances for bad debts and contractual and similar allowance.<sup>36</sup>

5. "Penalty" (for termination).

a. A penalty includes a limitation on the qualified user's right to compete, a requirement that the qualified user purchase equipment, goods, or services from the service provider and a requirement that the qualified user pay liquidated damages for cancellation of the contract.

b. A "penalty" does not include a requirement on cancellation that the qualified user reimburse the provider for ordinary and necessary expenses or a restriction on the qualified user against hiring key personnel of the service provider.

c. A separate contract between the provider and the user (e.g., a loan or guarantee by the service provider) creates a contract termination penalty if it contains terms that are not customary or arm's length that could operate to prevent the user from terminating the contract (e.g., provisions for termination of the separate contract if the management contract is terminated) or that substantially restrict selection of a substitute service provider.<sup>37</sup>

January 20, 1997

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<sup>33</sup> § 3.05.

<sup>34</sup> § 3.02.

<sup>35</sup> § 3.06.

<sup>36</sup> § 3.01.

<sup>37</sup> § 3.04.