

Health Care Reform

Selected Issues from the Vantage Point
of 501(c)(3) Hospitals

ROPES
& GRAY

Hospital-Physician Affiliations – Issues related to Tax-Exempt Bonds

- **Factors driving integration**
 - Cost pressures
 - Emphasis on care coordination and shared accountability
- **Implications for tax-exempt hospitals**
 - Sharing bond-financed infrastructure with physicians
 - Managing bundled payments and compliance with bond covenants

Sharing Bond-Financed Infrastructure with Physicians

- **Infrastructure types**

- Outpatient clinics and medical office buildings
- Health information technology

- **Key factor – exempt status of the physicians**

Why?

- **Private Business Use**

- Treasury Regulations, Subchapter A, Sec. 1.141–3
- Limits on use of property financed with tax-exempt bonds in a private trade or business
 - Leases, service contracts, research agreements, unrelated business activities
- Generally, up to 5% of bond proceeds may finance property that is used in private use

Sharing Bond-Financed Infrastructure with Physicians

- How is private use avoided?
 - Physician employment by 501(c)(3) entity
 - Physician practice exclusively treats patients of 501(c)(3) entity
 - Medical foundation model
 - Physician practice obtains 501(c)(3) determination from IRS

Sharing Bond-Financed Infrastructure with Physicians

- If none of these is the case, what do you do?
 - Comply with Rev Proc. 97-13, but. . .
 - Parties typically want a long-term contract
 - Gainsharing and other performance incentive programs involving variable-payments are generally precluded
 - Convince bond counsel that an arrangement that's not compliant with 97-13 is nevertheless compliant with private business use restrictions on the “facts and circumstances”
 - Defease or redeem the allocable bonds
 - Apply for a private letter ruling from the IRS (but be prepared to defease or redeem the bonds)

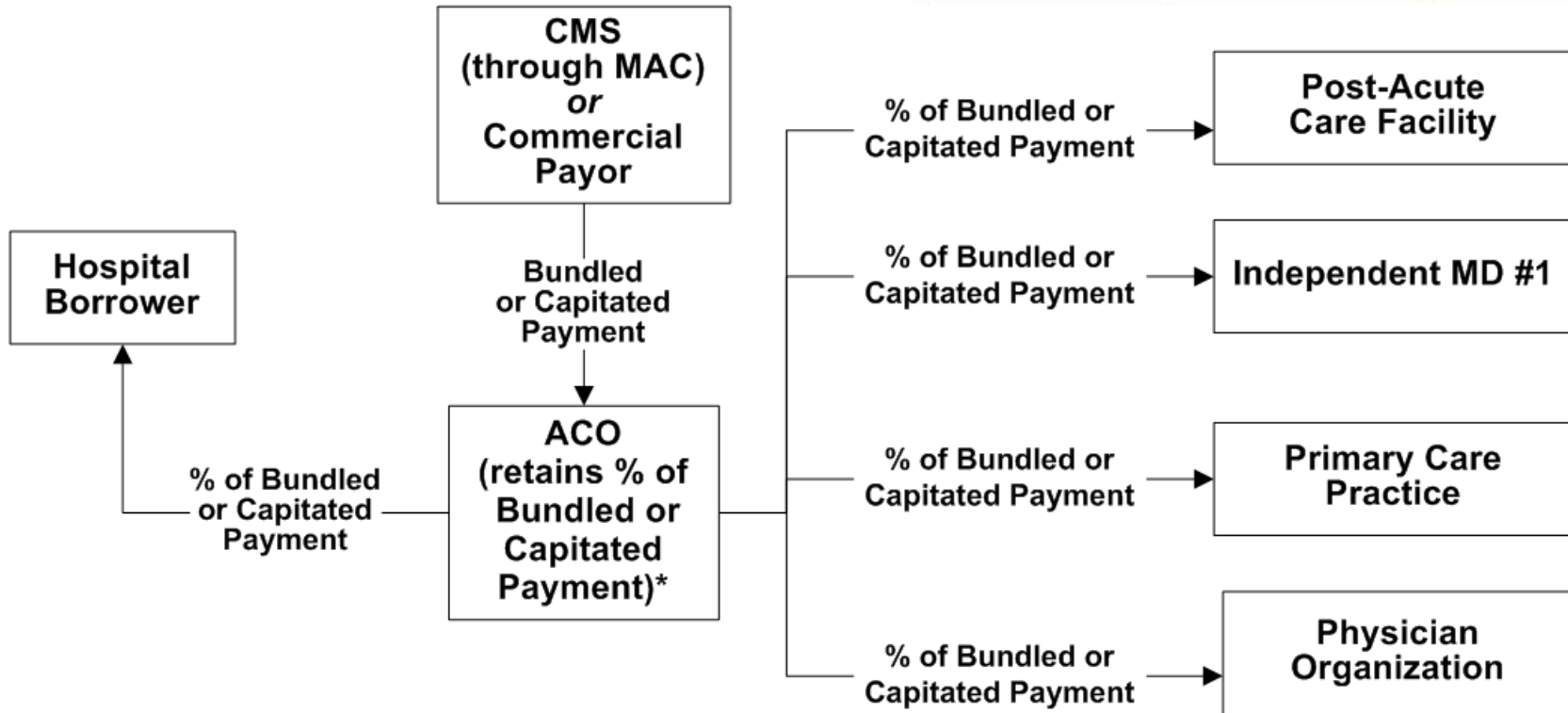
Sharing Bond-Financed Infrastructure with Physicians

- Will the status quo change?
 - Past private letter rulings addressing integrated delivery systems
 - Emphasis now by federal government (i.e., HHS) on collaboration among health care providers
- Until then. . .
 - Plan financings to allocate upfront to equity the costs of any project that might be used by physicians in “non-core” hospital activities
 - Ensure that bond compliance issues are understood by individuals at 501(c)(3) hospitals responsible for deals with physicians

Bundled Payments and Bond Covenant Compliance

- PHOs, ACOs and other acronyms
 - Affiliation structures not involving mergers
- CMS's proposed Bundled Payments Initiative
- Commercial health plans' programs

Bundled Payments and Bond Covenant Compliance



Note: This diagram could be replicated several times within an obligated group consisting of multiple hospitals participating in different ACOs responsible for different patient populations.

* ACO may retain a portion of shared savings to cover its costs of operation or to invest in systems for care coordination, quality measurement and reporting.

Bundled Payments and Bond Covenant Compliance

As a broad generalization ...

- Security Pledge – gross revenues, gross receivables, mortgage, “negative pledge”
- Debt Service Coverage Ratio – net revenue available for debt service as a percentage of annual debt service
- Days Cash on Hand – cash available to fund average daily operating expenses
- Debt to Capitalization Ratio – long-term debt as percentage of long-term debt plus unrestricted fund balance
- Restrictions on incurring additional debt
- Limitations on asset sales or dispositions

Bundled Payments and Bond Covenant Compliance

- Which entity is in charge of the bundle? Who gets the payment and how is it redistributed?
- Potential for Problems
 - ACO is part of obligated group but receives and is responsible for paying out revenue to non-obligated group members
 - ACO is not part of obligated group but is conduit for or has control over obligated group member revenue
 - ACO is not part of obligated group but becomes the focus of hospital investment or the owner/manager of substantial hospital assets

Disclosure Matters

- **Bondholders' Risk Factors**
 - Health Reform Topics

- **Situation-Specific Impacts**
 - Management's Discussion and Analysis
 - Intercompany/ Network Financial Dynamics