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Following Revenue Procedure 2016-44, Is There Still a 'Facts and Circumstances' Test for Private Business Use?

As we have discussed in previous posts (here), most practitioners treat a management contract for services at bond-financed property that does not fit within a safe harbor from private business use as giving rise to private business use of the bonds for tax purposes. However, the Treasury Regulations provide that whether or not a management contract gives rise to private business use is based on all the facts and circumstances surrounding the contract.[1] A number of IRS private letter rulings, though they technically cannot be relied on as precedent, rule that various management contracts that don't fit within a safe harbor do not give rise to private business use (discussed here).[2]

In Revenue Procedure 2016-44 (discussed here) the IRS replaced the longstanding safe harbors for management contracts under Rev. Proc. 97-13[3] with a "one-size-fits-all" type safe harbor for all management contracts. This post will discuss the evolution of the policy behind the private business use rules and show that the relevance of the "facts and circumstances" analysis following Rev. Proc. 2016-44 may be diminished. The cause of the diminished value is attributable to the fact that Rev. Proc. 2016-44 has, in effect, imported many of the considerations that previously existed in the facts and circumstances test in the Treasury Regulations into the new safe harbor. As a result, many agreements that fail to qualify for the new safe harbor will no longer be eligible for the facts and circumstances test because the agreements convey a leasehold or ownership interest in bond-financed property (and are therefore not management contracts).

History

Prior to the first appearance of private business use safe harbors for management contracts in Rev. Proc. 82-14, , in 1978, the IRS released General Counsel Memoranda 37641 (the "**1978 Memo**") which includes a thorough discussion of the facts and circumstances that the IRS considered to be necessary for a management contract to be excluded from private business use.[4] Specifically, the 1978 Memo says the following:

> "The regulations are not clear as to the result where a bond-financed facility is owned by the political subdivision or exempt person but is operated by a nonexempt person under a contract. Obviously, the mere fact that a nonexempt person makes a profit, in his trade or business, with respect to certain aspects of bond-financed facilities, is not fatal. The architect who designs a state office building, and the contractor who constructs it, no doubt make a profit, but their activity ordinarily does not constitute a 'use' of the facility that will satisfy the 'trade or business' test. Often, bonds are issued to enable a political subdivision or exempt person to finance aspects of their governmental or exempt function. Sometimes the governmental or exempt function is carried out by way of contract with a nonexempt person who provides a commodity or service. Such arrangements do not necessarily amount to a 'use' of bond proceeds within the meaning of the 'trade or business' test. **We believe the test to be applied**

> **where a manager operates a bond-financed facility is whether the nonexempt person is merely providing a service or commodity to the political subdivision that owns or is responsible for the operation of the facility, or whether the nonexempt person is itself operating the facility as a proprietor** . . . . In the obvious and typical situations where the facilities are **leased** or sold to a nonexempt person, such person 'uses' the facility in the capacity of a proprietor . . . . On the other hand, a nonexempt person that . . . provides a service to the political subdivision may benefit from the facility in an indirect economic sense, but this does not amount to 'use' within the meaning of the 'trade or business' test, unless the involvement, whether direct or indirect, amounts to a proprietary use of the facility."[5]

To determine whether a service provider is merely providing a service, or is instead operating a bond-financed facility in a proprietary capacity, the 1978 Memo instructs taxpayers to consider (i) which party controls the use of the bond-financed facility, (ii) the term of the agreement, and (iii) compensation to the provider. Look familiar?

The 1978 Memo acknowledged that a management contract could convey a proprietary interest in a bond-financed facility if, for example, the service provider uses a bond-financed facility for its own benefit and not for the benefit of the owner of the facility. Unfortunately, there is no discussion of how to determine whether a service provider uses a bond-financed facility for its own benefit. In any event, the 1978 Memo strongly suggests that a proprietary interest is necessary for an agreement to result in private business use.

In Revenue Procedure 93-19, the IRS backed away from some of its assertions in the 1978 Memo. Likely emboldened by a 1986 acknowledgement by Congress that a management contract (as well as a lease) could result in private business use,[6] in Rev. Proc. 93-19 the IRS said that "[a] management or other service contract that gives a nongovernmental service provider a proprietary interest in the operation of a facility is not the only situation in which a contract may result in private business use of the facility."

In response to proposed private business use regulations promulgated in 1994,[7] commentators requested that the Treasury Department backtrack from the pronouncement in Rev. Proc. 93-19 and promulgate final regulations that conclude that a management contract should only give rise to private business use if it transfers a proprietary interest in financed property to the service provider. When Treasury finalized these regulations in 1997, the preamble explicitly rejected that request:

> "The final regulations . . . continue to reflect the view that Congress intended that a management contract can give rise to private business use even if it does not in substance transfer a leasehold or ownership interest to a nongovernmental person for general federal income tax purposes. Thus, the final regulations do not adopt the rule that a management contract gives rise to private business use only if it transfers a proprietary interest to a nongovernmental service provider. The final regulations provide that the determination of whether a management contract that does not meet the qualified management contract safe harbors gives rise to private business use is based on all the facts and circumstances."[8]

These 1997 regulations, read together with the 1978 Memo, make clear that a management contract can result in private business use based on all the facts and circumstances even if it (a) does not convey a proprietary interest to the service provider and (b) is not properly characterized as a lease.

Prior to Rev. Proc. 2016-44, it was much easier to identify certain management contracts that did not result in private business use based on all the facts and circumstances even though the contract did not qualify for one of the private business use safe harbors in Rev. Proc. 97-13.[9] Following Rev. Proc. 2016-44, the application of the facts and circumstances standard is significantly limited because contracts that do not fit within the Rev. Proc. 2016-44 safe harbor will often be characterized as lease agreements, which are not eligible for the fall-back facts and circumstances analysis.

Rev. Proc. 2016-44

A more comprehensive analysis of Rev. Proc. 2016-44 is here. Under Rev. Proc. 2016-44, a management contract fits within a private business use safe harbor if it meets the following criteria:

- The service provider's compensation is reasonable, and it isn't based on net losses or net profits of the bond-financed facility.
- The term of the contract is within permitted time limits.
- Control over the managed property generally remains with the owner.
- Risk of loss of the managed property generally remains with the owner.
- The service provider must take tax positions consistent with it being a manager and not a lessee of the bond-financed facility.
- There are no circumstances substantially limiting the qualified user's ability to exercise its rights.

Certain of these criteria should look familiar. For example, control over managed property and risk of loss are two of the criteria explicitly mentioned in the 1997 private business use regulations as factors that distinguish management contracts from lease agreements.[10] Put another way, a management contract that conveyed too much control or the risk of loss to the service provider is not eligible to meet the "facts and circumstances" test because it is not a management contract. Furthermore, the ability to substantially limit a qualified user's ability to exercise its rights is another form of control, so arguably failing that requirement could also cause the agreement to be considered a lease.[11]

That leaves the following facts and circumstances criteria that are not already encapsulated by Rev. Proc. 2016-44:

- Reasonable compensation (incl. no net profits or net losses)
- Term of the contract
- Consistent tax positions

Although not drafted with tax-exempt bonds in mind, Section 7701(e) provides certain relevant criteria to distinguish a lease from a management contract. One of those criteria is whether the service provider has a significant economic interest in the property. In a 2015 letter to the IRS discussing the impact of Section 141 of the Code on public/private arrangements, the ABA Taxation Section interpreted Section 7701(e) and relevant case law as standing for the proposition that a "contract should be treated as a lease (as contrasted with a mere service contract), based upon . . . the operator's ability to share in both the combined revenues and expenses of the applicable enterprise."[12]

That leaves the following facts and circumstances criteria that are not already encapsulated by Rev. Proc. 2016-44:

- Term of the contract
- Consistent tax positions

The 1978 Memo indicates that when the term of a contract is "unreasonable," the continued possession and operation of the bond-financed facility may amount to de facto control and virtual ownership regardless of any provisions in the contract that give the qualified user supervisory control. Furthermore, long-term contracts that exceed the permitted length in Rev. Proc. 2016-44 may raise an inference that the contract conveys an ownership interest in the bond-financed facility which results in private business use without regard to any facts and circumstances.[13] In addition, for qualified 501(c)(3) bonds, another byproduct of a contract term in excess of the permitted length in Rev. Proc. 2016-44 is the possibility that the contract results in a violation of the ownership requirement in Section 145(a)(1).

Finally, a management contract will not run afoul of the consistent tax position requirement if the manager agrees "not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property." To the extent that the manager fails this requirement, it is very likely that the provider's interest in the bond-financed facility is greater than that of a service provider and that the contract is not properly treated as a management contract.

In sum, Rev. Proc. 2016-44 has, in effect, swallowed up many of the considerations that previously existed in the facts and circumstances test in the Treasury Regulations, and they have been instead imported into Rev. Proc. 2016-44's bigger safe harbor.

Conclusion

Following the release of Rev. Proc. 2016-44, many of the contracts that fail to qualify for the new safe harbor will likely be considered to convey a leasehold or ownership interest in the bond-financed facility for federal income tax purposes. Because agreements that convey a leasehold interest or an ownership interest may not be excluded from private business use based on all facts and circumstances, the relevance of the facts and circumstances test is diminished (maybe significantly) by Rev. Proc. 2016-44.

[1] Treas. Reg. § 1.141-3(b)(4)(i).

[2] PLR 201228029 (although compensation was not within Original Safe Harbors, it was not based on net profits so, based on facts and circumstances, the management contract did not result in Private Business Use); PLR 201145005 (although the term of the agreement exceeded what was permitted to qualify for the Original Safe Harbors, based on facts and circumstances, the management contract did not result in Private Business Use); PLR 200813016 (although compensation was not within Original Safe Harbors, it was not based on net profits so, based on facts and circumstances, the management contract did not result in Private Business Use); PLR 200330010; PLR 200222006

[3] As amplified by Rev. Proc. 2001-39 and Notice 2014-67 discussed here and here.

[4] The "facts and circumstances" test was not included in the Treasury Regulations until the Final Regulations (defined herein) were promulgated in 1997. Practically speaking, as illustrated in the detailed factual analysis in the 1978 Memo, even before the facts and circumstances test appeared in the Treasury Regulations, the IRS has always applied it.

[5] Emphasis added.

[6] Conference Report for the Tax Reform Act of 1986, H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II-687, 1986-3 (Vol. 4) C.B. 687-88.

[7] 59 FR 67658.

[8] 62 FR 2275.

[9] See footnote 2.

[10] Treas. Reg. 1.141-3(b)(3)(i) and (ii).

[11] A valid argument could be made that the ability to "substantially limit" the exercise of the owner's rights and the "control" requirement are two separate requirements; however, consider the following language in the 1978 Memo: "[This control] requirement will be met if the [qualified user] retains control or a veto power over the decisions of the management company. To effectuate this requirement there should be no common or related members of the governing body or board of directors of the [qualified user] and the manager."

[12] Available here.

[13] Treas. Reg. § 1.141-3(b)(2).

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By Joel Swearingen on September 23, 2016