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Management Contracts For Projects Financed With Tax-Exempt Bonds: Faegre

Government and nonprofit borrowers recently received some favorable new rules from the IRS regarding management contracts for projects financed with tax-exempt bonds. Rev. Proc. 2016-44 provides flexible guidance to determine when management contracts and similar service agreements involve problematic private use. It establishes a new safe harbor for identifying whether such contracts exceed the private business use limitation applicable to governmental bonds and tax-exempt bonds issued on behalf of 501(c)(3) organizations.

The new safe harbor is effective for agreements entered into on or after August 22, but issuers can apply it to any management contract entered into before that date.

Rev. Proc. 2016-44 replaces Rev. Proc. 97-13 which established separate safe harbors for management contracts based on the term of the contract. For longer-term contracts it required that a minimum percentage of the manager's compensation be based on a fixed fee depending on the length of the contract. These formulaic tests are replaced with a flexible safe harbor for contracts up to 30 years based on such things as control, risk of loss, economic levies of managed projects and consistency of tax positions taken by the service provider. The general principle that compensation may not be based on a share of the net profits from the managed property is retained.

The other features of a safe-harbor management contract are as follows:

- Compensation may be fixed or variable, but must be reasonable compensation for the service provided. Incentive compensation based on the service provider's performance in meeting one or more standards that measure quality of services, performance or productivity is expressly permitted.
- The contract must not require the service provider to share the burden of net losses from operation of the managed property.
- The term of the contract, including renewal options, may not exceed the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property.
- The service recipient must exercise significant control over the use of the managed property.
- The service recipient must bear the risk of loss upon damage or destruction of the managed property.
- The service provider must not take a tax position inconsistent with being a service provider, such as taking depreciation, investment tax credits or rent deductions.
- The service provider must not have a role or relationship with the service recipient that limits the service recipient's ability to exercise its rights under the contract. A safe harbor is provided if (a) no more than 20% of the voting power of the governing body of the service recipient is vested in the directors, officers, shareholders, partners, members and employees of the service provider; (b) the governing body of the service recipient does not include the chief executive officer of the service provider or the chair of the service provider's governing body; and (c) the chief executive officer of the service provider is not the chief executive officer of the service recipient or any of its related parties.

The economic life restriction in the new safe harbor applies to the “managed property” under both long-term and short-term contracts, while the economic life restriction in Rev. Proc. 97-13 applied to “financed property” under only long-term contracts. Managed property is defined as the portion of a project (as defined in the regulations) with respect to which the services are provided. These wording changes may have unexpected substantive consequences, including possibly requiring issuers to determine the scope of the project being financed and the useful life of property other than financed property and regardless of the term of the contract.

While the new safe harbor can be applied to existing contracts, the safe harbors of Rev. Proc. 97-13 may be applied to a contract entered into before August 18, 2017, and that is not materially modified or extended on or after August 18, 2017, other than pursuant to a renewal option.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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