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Recent IRS Private Letter Ruling Provides Helpful Guidance on Management Contracts: Squire Patton Boggs

On May 27, 2016, the National Office of the Internal Revenue Service ("IRS") released Private Letter Ruling ("PLR") 201622003. PLR 201622003 continues the trend of favorable PLRs issued by the IRS on the question of whether, under a facts-and-circumstances analysis, a management contract that fails to satisfy a Rev. Proc. 97-13 safe harbor from private business use results in private business use of a tax-exempt bond issue. PLR 201622003 also provides helpful guidance in interpreting the scope of the safe harbor from private business use set forth in Rev. Proc. 97-13 §5.03(7) in the case of a management contract that provides for incentive compensation based on the attainment of a threshold for an increase in gross revenue of the managed facility or a decrease in the expenses of operating the managed facility (but not both an increase in revenue and decrease in expenses).[1]

PLR 201622003 involves a management contract for a hotel that was financed with the proceeds of a tax-exempt bond issue. The PLR does not state the precise term of the management contract, but it does make clear that the contract's term exceeded five years. The manager's compensation under the contract consisted of a base fee equal to a stated percentage of the hotel's gross revenue, as well as an incentive fee equal to an additional stated percentage of the hotel's gross revenue in those years where: (1) the net profits of the hotel exceeded a specified threshold; and (2) the hotel's revenue-per-available-room exceeded a stated percentage of the average revenue-per-available-room for a pre-determined group of comparable hotels.

The IRS found that the contract did not satisfy a safe harbor from private business use contained in Rev. Proc. 97-13. The IRS further found that the although the hotel's net profits served as a partial trigger for the payment of incentive compensation, the incentive compensation consisted of an additional stated percentage of the hotel's gross revenues, rather than a portion of the hotel's net profits, because the incentive compensation was a fixed percentage of gross revenue and did not rise or fall in proportion to increases or decreases in the hotel's net profits. Ultimately, the IRS concluded that the manager's compensation under the contract was comprised entirely of a percentage of the hotel's gross revenues, and that the management contract's only deviation from the safe harbor set forth in Rev. Proc. 97-13 §5.03(7) was the contract's term, which exceeded five years. The IRS found that the contract's term was reasonable under the facts and circumstances. Consequently, the IRS held that the management contract did not give rise to private business use of the tax-exempt bond-financed hotel.

The holding in PLR 201622003 with respect to the use of a net profits threshold for the payment of incentive compensation that consists of a fixed percentage of gross revenues accords with the same conclusion the IRS reached on this issue in PLR 201145005. It is helpful to have some consistent indication from the IRS that a net profits trigger for the payment of incentive compensation will not be treated as the sharing of net profits with the manager if the incentive compensation is a stated amount or a specified percentage of an item like gross revenues, where the incentive compensation itself does not constitute a portion of the net profits of the managed facility.

PLR 201622003 also provides helpful guidance with respect to the scope of the safe harbor from

private business use contained in Rev. Proc. 97-13 §5.03(7). This safe harbor was added to Rev. Proc. 97-13 by IRS Notice 2014-67, and it provides that a management contract does not result in private business use where:

> All of the compensation for services is based on a stated amount; periodic fixed fee; a capitation fee; a per-unit fee; or a combination of the preceding. 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 term of the contract, including all renewal options, does not exceed five years. Such contract need not be terminable by the qualified user prior to the end of the term. For purposes of this section 5.03(7), a tiered productivity award as described in section 5.02(3) will be treated as a stated amount or a periodic fixed fee, as appropriate.

Rev. Proc. 97-13 §5.03(7) therefore specifically includes a qualifying tiered productivity award under Rev. Proc. 97-13 §5.02(3) among the mix of compensation that will satisfy the safe harbor from private business use. Rev. Proc. 97-13 §5.02(3), which was modified in large extent by Notice 2014-67, provides as follows regarding productivity awards and tiered productivity awards:

> For purposes of § 1.141-3(b)(4)(i) and this revenue procedure, 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 increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract, generally does not cause the compensation to be based on a share of net profits. A productivity reward 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 financed facility if:
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> (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 in revenues or decreases in expenses of the facility; and
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> (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.

Safe harbors are narrowly construed, and the only reference to a tiered productivity award in Rev. Proc. 97-13 §5.02(3) is with respect to productivity awards that are paid for the achievement of a given level of performance for a measure of the quality of services provided, rather than the attainment of a quantitative target, such as a level of revenue or expense (but not both). Thus, the reference to qualifying tiered productivity awards in Rev. Proc. 97-13 §5.03(7) could easily be interpreted as limited to incentive compensation arrangements that are based on qualitative, rather than quantitative, measures. PLR 201622003 does not adopt this narrow reading of the safe harbor.

Incentive compensation paid on the basis of quantitative measures is quite common, so a restrictive interpretation of the Rev. Proc. 97-13 §5.03(7) safe harbor would leave these arrangements dependent on a favorable facts-and-circumstances analysis to avoid resulting in private business use of a tax-exempt bond issue. Prior to the modification of Rev. Proc. 97-13 by Notice 2014-67 to include the safe harbor from private business use set forth in Rev. Proc. 97-13 §5.03(7), the IRS had found in certain instances that such incentive compensation arrangements do not result in private business use, based on that facts-and-circumstances analysis. See, e.g., PLR 201338026. It is refreshing that the IRS has indicated in PLR 201622003 that the safe harbor from private business use in Rev. Proc. 97-13 §5.03(7) can extend to incentive compensation arrangements that are based

on quantitative measures and that a facts-and-circumstances analysis therefore need not be applied to determine whether the management contract results in private business use.

[1] Code Section 6110(k)(3) provides that a private letter ruling cannot be used or cited as precedent unless regulations to the contrary are issued. Nonetheless, as reasoned by the U.S. Supreme Court, private letter rulings "reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws," and such rulings aid in the interpretation of the internal revenue laws. Hanover Bank v. Comm'r, 369 U.S. 672, 686-87 (1962). See also Rowan Cos. Inc. v. United States, 452 U.S. 247, 261 n.17 (1981). Moreover, the Tax Court has found that private letter rulings may be cited to show the practice of the IRS. Rauenhorst v. Comm'r, 119 T.C. 157, n.8 (2002); Estate of Cristofani v. Comm'r, 97 T.C. 74, 84 n.5 (1991); and Woods Inv. Co. v. Comm'r, 85 T.C. 274, 281 n.15 (1985).

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July 6, 2016

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