
IRS Issues New Safe Harbors for Management Contracts to Facilitate P3s.

WASHINGTON – The Internal Revenue Service on Monday released a revenue procedure containing safe harbors for management contracts that allows them to more easily be used in bond-financed infrastructure and other projects involving public-private partnerships.

Rev. Proc. 2016-44 extends terms of long-term management to up to 30 years from the previous 15 years that market participants had complained was too restrictive. It also removes the formulaic fixed fee requirements for manager compensation, allowing for more incentive compensation.

"These safe harbors aim to give municipalities tools to allow more flexible and efficient incentives for longer-term private management of tax-exempt bond financed projects to facilitate infrastructure initiatives," said John Cross, the Treasury Department's associate tax legislative counsel.

The revenue procedure will be published in an Internal Revenue Bulletin on Sept. 6.

The safe harbors apply to any management contract that is entered into on or after Aug. 22, but issuers can also apply the safe harbors to any management contract that was entered into before that date.

Issuers also have the option of applying the more restrictive safe harbors in Rev. Proc. 97-13, issued in 2013, to a management contract that is entered into before Feb. 18, 2017 and not materially modified or extended after that date.

Rev. Proc. 97-13 established safe harbors for long-term management contracts, providing safe harbors under which a contract of up to 10 years would require at least 80% of the manager's annual compensation to be based on a fixed fee. Fifteen-year contracts would require at least 95% of the annual compensation be based on a fixed fee.

But bond lawyers and other market participants complained that the safe harbors were too restrictive and had not kept pace with recent market practices, such as attempts to use bonds to help finance projects with P3s, where private parties join together with state or local governments to develop, build, and operate infrastructure projects. P3s involve long-term management contracts.

Historically, the IRS has found that bond-financed projects have private business use that may jeopardize the tax-exempt status of bonds if there is private ownership or a private lease of a building or other facility.

This new Rev. Proc. 2016-44 contains three provisions containing limits that ensure there is no private ownership or leases.

The first is that a state or local government "must exercise a significant degree of control of the use of the managed property." Second, the state or local government "must bear the risk loss upon damage or destruction of the managed property."

Third, the private party “must agree that it is not entitled to, and will not take any tax position that is consistent with the state or local government with respect to the managed property. The private party must not take any depreciation or amortization, investment tax credit, or deduction for any rent payment for the property.

The revenue procedure also carries over some restrictions from the previous one such as that there must be no net profit-sharing arrangements.

The procedure is receiving praise from many bond and tax lawyers, some of whom had submitted suggestions to Treasury and IRS on how to how to liberalize management contract safe harbors and clear up points of confusion.

Stefano Taverna, an attorney with McCall, Parkhurst & Horton in Dallas, and the chair of the American Bar Association’s tax-exempt financing committee, called the new safe harbors “very significant,” adding that they may help facilitate P3s. “I think Treasury did a terrific job at understanding the industry and what it will require in the future and tried to address these concerns,” Taverna said. “All in all, I think the industry will welcome what Treasury put forward. It seems to be a lot more flexible and very reasonable.”

Carol Lew, a shareholder at Stradling at Newport Beach, Calif., said the prior time limits and compensation structure for management contracts were “too rigid” and called the new rules “much more practical and pragmatic.” The new revenue procedure is more representative of how the municipal bond industry has evolved, she said.

“It looks like Treasury and the IRS listened to comments from the industry on how to make the rules achieve IRS objectives and meet the needs of state and local governments,” Lew said.

“I think this a helpful rule that can facilitate more public-private partnerships,” she said. “It should be a good thing for issuers.”

A management contract is defined by the IRS as a “management, service or incentive payment contract between a qualified user and a service provider under which the service provider provides services for a managed property.” The contract term limit does not include the portion of a contract for services before a managed property is placed in service, such as construction design or management.

In Jan. 2015, the IRS released Notice 2014-67, which expanded the type of productivity rewards that could be used in management contracts. The notice also said that a management contract would not result in private business use if it is five years or less and compensation for services is based on a stated amount, periodic fixed fee, capitation fee, per-unit fee or any combination.

David Caprera, an attorney with Kutak Rock in Denver, said that this most recent update to management contracts acknowledges that a property manager is not supposed to be the economic equivalent of an owner of the bond-financed property, which he called a “fundamental principle.”

“An owner is one who shares in the profits and losses of the business,” Caprera said. “If the manager’s compensation is reasonable and not tied to profits or losses, the Rev. Proc. recognizes that the manager is not an owner.”

“The new rules allow long-term contracts for long-lived projects, and short-term contracts for short-lived assets so long as the compensation is reasonable and not tied to profits or losses,” he added. “In particular, the ‘4 H’s’ of housing, healthcare, highways and hotels are going to be the beneficiaries, in that long-term assets can now be managed properly on a long-term basis.”

Monday’s revised Rev. Proc. comes one week after Treasury and IRS released their 2016-17 priority guidance plan, which included six projects for tax-exempt bonds the agencies plan to allocate resources toward through June. Asked about the plan, Cross had said that the most immediate short-term projects were to update management contract safe harbors and issue final regulations on issue price.

The Bond Buyer

By Evan Fallor

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