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IRS Publishes New Management Contract Safe Harbors For Property Financed With Tax-Exempt Bonds: Foley & Lardner

On August 22, 2016, the Internal Revenue Service (IRS) released Rev. Proc. 2016-44, which provides new guidance on the treatment of "management contracts" for purposes of the restrictions on use of property financed with tax-exempt bonds. This published guidance provides for new safe harbors under which the IRS will not treat management contracts as giving rise to private business use.

The new guidance applies to tax-exempt bonds that are governmental bonds issued for the benefit of state and local governments and to qualified 501(c)(3) bonds issued for the benefit of section 501(c)(3) organizations. This guidance also applies to certain qualified tax credit bonds, such as Build America Bonds, that are subject to the same private business use rules. Although the guidance nominally refers to "management contracts," it applies to most types of service contracts. The new guidance is a significant development for those types of bond issues.

Highlights

- The new guidance establishes new safe harbors that are in some ways much more liberal and flexible than the Rev. Proc. 97-13 safe harbors, but in other respects stricter.
- The new safe harbors reflect a reconceived framework and will replace the Rev. Proc. 97-13 safe harbors. Issuers and borrowers generally may continue to rely on the Rev. Proc. 97-13 safe harbors for management contracts entered into before February 18, 2017, and certain extensions of those contracts pursuant to their term.
- The new safe harbors permit almost any type of variable or fixed compensation and abandon the Rev. Proc. 97-13 framework focusing on fixed fees.
- The new safe harbors rely much more heavily on the rule that "net profits arrangements" are not permitted under the safe harbors.
- The new guidance permits management contracts having a term up to 30 years, but retain a rule limiting the term to no more than 80 percent of the weighted economic life of the managed property.
- The new guidance establishes new safe harbor requirements relating to control of the managed property, bearing of net losses, risk of loss and consistency of tax positions.
- In general, the new safe harbors are more "principles-based," and provide fewer bright lines than the Rev. Proc. 97-13 safe harbors. Accordingly, more interpretive questions may arise than under the Rev. Proc. 97-13 safe harbors, particularly with respect to the new requirements. Also, the question of whether a management contract that does not exactly meet all of safe harbor requirements should still be treated as not resulting in private business use may arise more commonly than under the Rev. Proc. 97-13 standards.
- Many management contracts that have been customarily treated as within the Rev. Proc. 97-13 safe harbors may not exactly meet the new safe harbors.
- In general, the new safe harbors may be particularly helpful for certain long-term management contracts for infrastructure. Certain shorter term management contracts in particular, however, will be subject to new standards that may involve compliance burdens.
- Many issuers and borrowers may need to consider implementing new practices to review

management contracts relating to tax-exempt bond financed property that are entered into, materially modified, or in certain cases renewed after February 17, 2017.

Description of the New Safe Harbors

"Safe Harbor" Guidance. The new guidance provides for revised "safe harbors" in the form of a new revenue procedure. It does not change the substantive rules in the IRS regulations for when a management contract gives rise to private business use. Accordingly, the new guidance would not properly be used adversely against issuers and borrowers by the IRS in examinations, but rather sets forth standards that are intended to provide a basis for conservative tax positions of issuers and borrowers.

Immediate Permissive Application. The new guidance may be applied immediately to either new or existing management contracts.

Relationship to IRS Rev. Proc. 97-13, As Amended. The new guidance supersedes Rev. Proc. 97-13, including the portions of Notice 2014-67 that amend Rev. Proc. 97-13. Issuers and borrowers may continue to rely on Rev. Proc. 97-13, as amended, to a management contract that is entered into before February 18, 2017, unless it is materially modified or in certain cases extended on or after that date. An additional effective date rule also grandfathers extensions of a management contract entered into before February 18, 2017 if the extension is pursuant to a "renewal option" provided in the contract. A renewal option is defined as a provision under which either party has a legally enforceable right to renew the contract. Accordingly, during a long transitional period, an important consideration in reviewing certain management contract extensions likely will be whether the extension is pursuant to the terms of the contract.

Because Rev. Proc. 97-13 is superseded, "Rev. Proc. 97-13 compliance" will now be referred to as "Rev. Proc. 2016-44 compliance."

The new guidance is in response to public comment requests for more flexible safe harbors for management contracts having a term greater than five years. It states that it builds upon the amplifications in IRS Notice 2014-67 that provide for flexible safe harbors for contracts having a term up to five years.

Notably, however, the new guidance reframes and in many respects reconceives the safe harbors for management contracts. Although the new guidance responds to industry calls for more flexible safe harbors, one important question raised is whether certain management contracts that currently qualify for safe harbor treatment will no longer so qualify, as is discussed further below. In general, public comments to the IRS requested additional safe harbors, not new safe harbors that displaced the existing ones; the IRS and Treasury Department did not adopt that approach.

Safe Harbor Framework Restated. The new guidance states that it provides for a "more flexible and less formulaic approach toward variable compensation for longer-term management contracts" and "applies a more principles-based approach focusing on governmental control over projects, governmental bearing of risk of loss, economic lives of managed projects, and consistency of tax positions taken by the service provider."

The new guidance provides a general safe harbor and another safe harbor for "eligible expense reimbursement arrangements." The references in this description to the "new safe harbor" refer to the new general safe harbor when context requires.

Term Up to 30 Years Permitted. If a management contract meets the other requirements for the

new safe harbor, the term of the contract may have a term that is no greater than the lesser of 30 years or 80% of the "weighted average reasonably expected economic life of the managed property." By comparison, the existing Rev. Proc. 97-13 establishes separate safe harbors for management contracts with terms not exceeding five years, 10 years, 15 years, and, in some cases, 20 years. The new safe harbor applies the 80 percent limit to contracts with any term, although Rev. Proc. 97-13 does not apply the 80 percent limit to contracts having a term not exceeding five years.

The Rev. Proc. 97-13 safe harbors also generally limit the term of longer-term contract to not more than 80 percent of the useful life of the "financed property." The reference to the "managed property" rather than the "financed property" possibly signals a helpful clarification, because the new safe harbor possibly can be read as focusing on the economic life of the property that is managed, and not the assets that are financed by a particular bond issue. New provisions that describe in more detail how the 80 percent limit applies may raise additional questions.

Variable and Fixed Compensation Permitted. If a management contract meets the other requirements of the new safe harbor, almost any type of variable or fixed compensation is permitted. The Rev. Proc. 97-13 safe harbors are based on the extent to which compensation is fixed. That fixed fee framework will no longer apply under Rev. Proc. 2016-44.

No "Net Profits Arrangements." The new guidance relies more heavily on the rule in the IRS regulations that states that a management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation based, in whole or in part, on a share of net profits from the operation of the facility. The new guidance provides an additional gloss on this continuing standard, which may or may not be helpful to issuers and borrowers.

The new guidance states that compensation to the service provider will not be treated as providing a share of net profits if "no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues or expenses for any fiscal period." For this purpose, the elements of compensation are "the eligibility for, the amount of, and the timing of the payment of the compensation."

In general, this appears to be a somewhat strict interpretation of the no "net profits" standard. Because a contract will not qualify for the safe harbor if the "eligibility for" or "timing of" a payment is based on a net profits standard, it appears that any trigger for a payment based on net profits will not qualify. By comparison, in a recently released private letter ruling (PLR 20162203), the IRS concluded that a hotel management contract did not give rise to private business use, even though the contract provided for additional compensation triggered by a benchmark that was "a variant of net profits." In that case, the IRS permitted favorable treatment of the contract, in part because the amount of the payment was not based on net profits. Such a private letter ruling only applies to the specific issuer that requested it, and it is unclear whether its favorable conclusion would still apply under the reframed standards of Rev. Proc. 2016-44.

The new guidance also states that "incentive compensation will not be treated as providing a share of net profits if the eligibility for incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance or productivity," but only if the amount and timing of the payment meets the requirements set forth above.

In general, this reframed "net profits" standard will be one of the most important considerations in reviewing management contracts for private business use compliance. One important point, however, is it appears that the somewhat strict interpretation of the no "net profits" rule in the new guidance applies only for the purposes of the safe harbor, and is not necessarily an interpretation of

the substantive rule in the IRS regulations for when a management contract is noncompliant.

No Bearing of Net Losses of the Managed Property. The new guidance provides that a management contract will not meet the safe harbor if it, in substance, imposes on the service provider "the burden of bearing any share of net losses from the operation of the managed property." For this purpose, an arrangement will not be treated as requiring the service provider to bear a share of net losses if: (1) the determination of the amount of the service provider's compensation and the amount of any expenses paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and (2) the timing of the payment of compensation is not contingent upon the managed property's net losses.

The new guidance helpfully provides that, as an example, a service provider whose compensation is reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) will not be treated as bearing a share of net losses as a result of this reduction.

This new requirement is not set forth in Rev. Proc. 97-13. In general, it is framed in a manner similar to the provision concerning net profits arrangements.

Control Over Use of the Managed Property. Perhaps the core provision of the new guidance is a requirement that the qualified user "must exercise a significant degree of control over use of the managed property." This new requirement is not set forth in the current Rev. Proc. 97-13, although certain provisions relating to control were set forth in prior versions.

The "qualified user" is the term used in the safe harbors for the state or local government or 501(c)(3) organization that uses the bond-financed property. The qualified user is usually the issuer or the borrower, and may include other users, such as affiliates.

The new guidance states that this control requirement is met if "the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property, and general nature and type of use of the managed property (for example, the type of services)." It is unclear whether the "significant degree of control" requirement can be established in other ways. For example, it is unclear whether a contract including most of this list of control rights, but not all, can still meet the safe harbor.

The new guidance provides some clarification of what is meant by certain of the listed control rights. As an example, a qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific amounts, and may show approval of dispositions of property in a similar manner. Further, a qualified user may show approval of rates charged for use by either expressly approving such rates (or the methodology for setting such rates) or by including in the contract a requirement that the service provider "charge rates that are reasonable and customary as specifically determined by an independent third party."

These new control rights requirements, and in particular the requirement that the qualified user control rates, may raise many questions and require a change in practices for management contracts entered into, materially modified, or in certain cases extended after February 17, 2017. For example, in the case of physician contracts for hospitals financed with tax-exempt bonds, many existing "separate billing" arrangements that have been treated as within the Rev. Proc. 97-13 safe harbors may not be within the new safe harbors, unless the contracts are reframed to reflect these new

requirements.

Risk of Loss of the Managed Property. In order to meet the new safe harbor, the qualified user must bear the risk of loss of the managed property (for example, upon force majeure). A qualified user does not fail to meet this risk of loss requirement as a result of insuring against risk of loss through a third party or imposing on the service provider a penalty for failure to operate the managed property in accordance with standards set forth in the management contract. This is another new requirement.

No Inconsistent Tax Position. Another new requirement is that the service provider must agree "that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property." As an example, the service provider must agree not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property. It appears that this express agreement will need to be included in contracts under the new safe harbor.

This new requirement is another provision that will likely require a change from current prevailing practices for management contracts entered into, materially modified, or in certain cases extended after February 17, 2017. Many existing contracts that are treated as within the Rev. Proc. 97-13 safe harbors do not contain such an express agreement. Specific agreements regarding tax treatment of the type required by the new safe harbor as a matter of prevailing practice may have been included in long-term management contracts, but have been less common in shorter-term contracts because the tax treatment has been regarded as implicit.

No Circumstances Substantially Limiting Exercise of Rights. The new guidance continues the general requirement in Rev. Proc. 97-13 that the service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract.

Like Rev. Proc. 97-13, the new guidance contains a "safe harbor within a safe harbor" for establishing that the service provider has no such role or relationship. This safe harbor continues the general approach of Rev. Proc. 97-13, but is in some respects stricter. The new guidance requires as a safe harbor that (1) no more than 20 percent of the governing body of the qualified user is vested in persons having a role with the service provider; and (2) that the governing body of the qualified user not include the chief executive officer of the service provider (or a person with equivalent management responsibilities) or the chairperson (or equivalent executive) of the service provider's governing body. For the purpose of this safe harbor, "service provider" now expressly includes related parties to the service provider.

Because the specific requirements concerning overlapping board members continue to be framed as a "safe harbor within a safe harbor," it appears that issuers and borrowers could reasonably meet the substantive requirement based on other factors.

Functionally Related and Subordinate Use. The new guidance contains a new helpful provision relating to "functionally related and subordinate use." Under this new rule, a service provider's use of a project that is functionally related and subordinate to performance of its services under a management contract does not result in private business use, if the contract meets all of the requirements of the new guidance. An example is use of storage areas to store equipment used to perform activities under a management contract.

Eligible Expense Reimbursement Arrangements. A separate safe harbor is established for "eligible expense reimbursement arrangements." An "eligible expense reimbursement arrangement"

is defined as a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider. An eligible expense reimbursement arrangement does not result in private business use, regardless of whether the other requirements of the new guidance are met.

This separate safe harbor is an expansion of an exception set forth in the IRS regulations from private business use that previously applied only to management contracts for public utility property.

Contracts Properly Characterized as Leases. The new guidance recites a rule in the IRS regulations that provides that a lease generally results in private business use and that any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease (even if the arrangement is in form a management contract). The new guidance further recites a provision in the IRS regulations to the effect that, in determining whether a management contract is properly characterized as a lease, it is necessary to consider all the facts and circumstances, including (1) the degree of control over the property that is exercised by the service provider; and (2) whether the service provider bears the risk of loss of the financed property.

The new guidance does not otherwise expressly address the question of when a management contract is properly characterized as a lease. As a practical matter, however, it would appear that any management contract meeting the new safe harbor should not ordinarily be subject to characterization as a lease, because many of the new requirements (including requirements relating to control and risk of loss) are also factors relevant to determining whether an arrangement is in substance a lease.

Anti-Abuse Rules. The new guidance does not override any of the provisions of the IRS regulations. Accordingly, it is important to continue to interpret the new guidance in the context of the rules of the IRS regulations. In particular, the anti-abuse rules in the IRS regulations provide that, in certain circumstances, an arrangement that directly or indirectly passes through to private persons the financial benefit of tax-exempt interest rates may result in private business use, even if the arrangement would not otherwise result in private business use under the regulations. This anti-abuse rule will continue to be an important consideration in the consideration of certain management contracts.

Expected Future Developments. The new guidance does not request any further public comments. We expect that public comments may be submitted, however, particularly in light of the reconceived nature of the new safe harbor and its many new requirements. One likely request will be to permit issuers and borrowers to continue to rely on the Rev. Proc. 97-13 safe harbors, at least for a period longer than six months. There is no current indication, however, that the IRS and the Treasury Department would respond to any such public comments. We expect, however, that officials of the IRS and the Treasury Department will make clarifying public statements before February 18, 2017.

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