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More on Rev. Proc. 2016-44: What Light Is Shed on Net Profits Compensation?

As reported several times in this blog ([here](#), [here](#), and [here](#)), Rev. Proc. 2016-44 significantly expands the opportunities for management/service contracts that don't result in private business use. One such post was Joel Swearingen's very thoughtful piece on the future of the facts and circumstances test as applied to these contracts ([here](#)). Of course, Rev. Proc. 2016-44 retains the prohibition against any portion of the manager's compensation being based on net profits, as that rule is set forth in the Treasury Regulations (specifically Treas. Reg. 1.141-3(b)(4)(iv)), so the IRS cannot override that rule through a Revenue Procedure. Unfortunately, in restating this prohibition, the IRS has muddied the water as to its boundaries, creating potential need for application of the facts and circumstances test. Please read on for a discussion of the questions that have been created.

Rev. Proc. 97-13 states the net profits prohibition very simply: "The contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facility." Section 5.02(1). It then states that the compensation arrangements specifically authorized in 97-13 – percentage of gross revenues or expenses, capitation fee and per-unit fee – are not based on net profits.

In contrast, Rev. Proc. 2016-44 expands the discussion of a net profits arrangement, including the following:

The contract must not provide to the service provider a share of net profits from the operation of the managed property. 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 and expenses for any fiscal period. For this purpose, the elements of the compensation are ***the eligibility for, the amount of, and the timing of the payment of the compensation.***"

Section 5.02(2) (emphasis added).

Prior to the issuance of 2016-44, the IRS issued several private letter rulings applying the facts and circumstances test to conclude that the management fee described in the ruling did not violate the net profits prohibition. In one such ruling, the contract permitted the qualified user to defer paying a stated dollar amount of a fixed periodic management fee and the full amount of a productivity reward to the service provider if net cash flow was insufficient, after taking into account a payment to the qualified user, to pay those fees. Ltr. Rul. 200222006 (Feb. 19, 2002). Any deferred compensation was payable when cash flow was sufficient to make the payment or, at the latest, upon expiration or earlier termination of the contract. In ruling that the contract did not create private business use, based on the facts and circumstances test, the IRS reasoned as follows:

The Owner's right to defer a stated dollar amount that represents a portion of the management fee and the full amount of the productivity reward (the 'deferred fees') under the circumstances presented raises the issue of whether these fees are based on a share of Hotel net profits. Although the timing of payment of the deferred fees is based on Hotel net profits and, therefore, indicates private business use of the Hotel by Manager, we think that the circumstances support a conclusion otherwise. The full amount of all deferred fees will be payable regardless of the existence and amount of net profits when the Management Contract expires or is terminated. In addition, the deferrable portion of the management fee is a stated dollar amount and is not, itself, a percentage of Hotel net profits. The productivity reward is analogous to the productivity reward approved by Rev. Proc. 97-13, 5.02(3) because it is to be made only once and is based on an increase in gross revenues for a period specified in the Management Contract. Finally, the feasibility study projects that no deferrals will occur. Thus, although the deferred elements of the Manager's compensation do not satisfy the requirements of Rev. Proc. 97-13, 5.03(1), on balance, these deferred elements do not indicate private business use under 1.141-3(b)(4)."

In a later ruling, the IRS addressed a compensation arrangement that included an incentive fee that was payable only if three tests were met, one of which required that the manager "meet a stated net operating surplus/deficit level for the applicable fiscal year that is established in advance of each fiscal year of the term of the Management Contract in the approved budget for such fiscal year." Ltr. Rul. 201145005 (Aug. 4, 2011). Only if all three tests were met, the manager was entitled to a set incentive fee; the fee did not vary based on the level of the surplus/deficit. In its analysis, the IRS first stated that the contract did not meet the requirements of 97-13. However, it then applied a facts and circumstances analysis to conclude that the contract did not result in private business use. While its reasoning isn't entirely clear, the IRS appears to have concluded that the provision described above did not result in compensation based on net profits because the incentive payment did not vary based on the level of surplus or deficit.

While these rulings provide authoritative guidance only to the issuers receiving them, bond counsel regularly study these rulings and interpret the underlying law and regulations with these rulings in mind. As a practical matter, bond counsel have no choice but to place some importance on letter rulings given the dearth of authority in the tax-exempt bond area.

The question that bond counsel now face is whether Rev. Proc. 2016-44 backtracks from these favorable conclusions. As quoted above, 2016-44 states that a compensation arrangement does not violate the net profits prohibition if no "element" of the compensation takes into account, or is contingent upon, the managed property's net profits. And for this purpose, 2016-44 states that the elements of the compensation are the **eligibility for** (arguably violated in Ltr. Rul. 201145005), the amount of, and the **timing of** (almost certainly violated in Ltr. Rul. 200222006) the payment of the compensation.

Was it the IRS's intent in Rev. Proc. 2016-44 to signal a reversal of the above letter rulings? While this would be a plausible conclusion, I do not believe it is warranted. It appears that Treasury was reflecting its knowledge and experience gained in addressing various compensation arrangements in the ruling context, and that it sought in 2016-44 to make clear, if it was not clear already, that provisions of the sort addressed in the above rulings disqualify the contract from the safe harbor. Exclusion from the safe harbor of contracts where eligibility for, or timing of, compensation is contingent upon sufficient net cash flow is consistent with the position of the IRS expressed in these rulings, where the IRS applied a facts and circumstances test. Whether those contracts give rise to private business use depends now, as it did before, on the facts and circumstances test. So, just as

the compensation provisions addressed in the above pre-2016-44 rulings, taken in the overall context of the respective contract, did not violate the net profits prohibition under a facts and circumstances analysis, the same conclusion should be reached under the facts and circumstances test of Rev. Proc. 2016-44.

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