

TAX ALERT FOR STATE AND MUNICIPAL BOND ISSUERS: IRS UPDATES SAFE HARBOR PROVISIONS FOR MANAGEMENT CONTRACTS

Background.

Facilities financed with tax-exempt bonds for the benefit of governmental users or 501(c)(3) corporations (the “qualified users”) are subject to restrictions on private business use of the facility. Under Section 141 of the Internal Revenue Code, management contracts, which include management, service and incentive payment contracts, can give rise to private business use and need to be monitored.

For years, issuers have been relying on the safe harbors for management contracts in Revenue Procedure (“Rev. Proc.”) 97-13 to avoid private business use. The analysis under Rev. Proc. 97-13 was formulaic and based on the term of the contract and the percentages of fixed and variable compensation. Notice 2014-67 amplified the safe harbors in Rev. Proc. 97-13, and provided a slightly less formulaic approach, granting a safe harbor to a variety of compensation arrangements if the term of the contract did not exceed five years. While Notice 2014-67 was viewed as providing additional flexibility with respect to contract terms, most issuers hoped for additional guidance that would allow for longer term contracts and public-private partnership (P3) arrangements. With Rev. Proc. 2016-44, released on August 22, 2016, the IRS provided the long-awaited safe harbor provisions for longer-term contracts.

Financial and Term Requirements.

To meet the new safe harbor exception to private business use under Rev. Proc. 2016-44, a management contract must either be an eligible expense reimbursement arrangement or must meet all of the applicable compensation, term and other requirements of the Rev. Proc. 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.

Compensation. Compensation under the management contract (i) must be reasonable for the services provided, (ii) must not give the service provider a share of net profits, and (iii) must not impose the burden of sharing any of the net losses on the service provider. 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 net profits or both the revenues and expenses of the managed property for any fiscal period. For this purpose, the elements of the compensation include the eligibility for, the amount of, and the timing of the payment of the compensation. Reimbursements of actual and direct expenses paid by the service provider to unrelated parties are disregarded as compensation, and incentive compensation is generally allowed. The contract does not impose the burden of sharing net losses if (i) the service provider’s compensation is not based on net losses or both revenues and expenses of the managed property, and (ii) the timing of compensation payments to the service provider is not dependent on the property’s net losses. A contractual reduction in compensation by a stated dollar amount as a result of a provider’s failure to maintain expenses below a specified target is permitted.

Term. The contract term, including renewal options, must not be longer than the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property (the portion of the facilities to which the services relate). If contract terms relevant to the safe harbor analysis are materially modified, the contract must be retested as a new contract.

Additional Requirements.

Although Rev. Proc. 2016-44 loosens the restrictions on the length of contract term and types of consideration that can be paid to service providers, it also imposes some new restrictions relating to managed property that are described briefly below.

- The qualified user must have a significant degree of control over the use of the managed property. This requirement is met if the contract requires the qualified user to approve the annual budget, capital expenditures, each disposition of related property, rates charged for use, and the general nature and type of use (e.g., the type of services) with respect to the managed property.
- The qualified user—and not the service provider—must bear the risk of loss due to damage or destruction of the managed property. However, the qualified user may insure against this loss and may also impose a penalty upon the service provider for failure to operate the managed property according to contractual standards.
- The service provider may not take any tax position inconsistent with being a service provider; for example, the service provider cannot take any depreciation or amortization with respect to the managed property.

No Limitations on Exercise of Rights.

Like the prior guidance, Rev. Proc. 2016-44 requires that the service provider not have any role or relationship with the qualified user that could substantially limit the qualified user's ability to exercise its rights under the contract. To meet the safe harbor for this requirement: (a) the service provider may not have more than 20% of the voting power of the governing body of the qualified user, (b) neither the CEO of the service provider nor the chairperson of the governing body of the service provider may serve on the governing body of the qualified user, and (3) the CEO of the service provider may not be the CEO of the qualified user or any related parties.

Functionally Related and Subordinate Property.

Rev. Proc. 2016-44 clarifies that any use of property by a service provider that is functionally related and subordinate to its services under a compliant management contract does not give rise

to private business use (e.g., use of storage areas to store necessary equipment).

No Safe Harbor for Pre-Operating Services.

The definition of management contract under Rev. Proc. 2016-44 excludes any contract or portion of a contract for services provided before a managed property is placed in service (such as contracts for construction design or management). There is a separate private business use exception for temporary use by developers in the Regulations that may be applicable in those situations.

Effective Dates.

The revised safe harbors are effective for any management contract entered into on or after August 22, 2016, and an issuer may choose to apply these safe harbors to any management contract entered into before August 22, 2016. In addition, an issuer may continue to apply the safe harbors in Rev. Proc. 97-13, as modified by Rev. Proc. 2001-39 and amplified by Notice 2014-67, to any management contract entered into before February 18, 2017 and not materially modified or extended on or after February 18, 2017 (other than pursuant to certain renewal options).

The full Revenue Procedure is available here. For further information about the Rev. Proc. 2016-44 or management contracts in general, please consult tax partner Alison J. Bengé.

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