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New Safe Harbors for Management Contracts of Tax-Exempt Financed Facilities

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Overview.

The Internal Revenue Service on August 22, 2016 released Revenue Procedure 2016-44 which revises the safe harbor guidelines for management contracts of service providers for tax-exempt financed facilities, under which the contract will not result in private business use of the managed property. The revisions provide greater flexibility for incentives in reasonable compensation arrangements and longer terms (up to 30 years, subject to an economic life limit). The compensation percentages for management contracts with different time periods that were prescribed under prior safe harbor guidelines of Rev. Proc. 97-13 and amplified by Notice 2014-67 are further broadened under Rev. Proc. 2016-44 to permit any type of fixed or variable compensation for longer term management contracts of up to 30 years that is reasonable compensation for services rendered. The sharing of net profits by a governmental entity or 501(c)(3) organization (each, a "Qualified User") with a service provider is still prohibited, but Rev. Proc. 2016-44 applies a more principle-based approach that focuses on the Qualified User's control over projects, the Qualified User bearing of risk of loss, economic lives of managed projects and the consistency or tax positions taken by the service provider. One of the aims of this Revenue Procedure, according to the Treasury Department's associate tax legislative counsel, John Cross, was "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." *Note that while Revenue Procedure 2016-44 provides greater flexibility in some areas, substantial changes from the safe harbor guidelines that have been applied since 1997 will require Qualified Users to understand, and conform prospective contracts to, the new safe harbor guidelines, and to review existing management contracts to ensure continued compliance with the applicable safe harbors, in accordance with the effective date provisions, set forth below.*

Effective Date.

Rev. Proc. 2016-44 will be published in the Internal Revenue Bulletin September 6, 2016, but the new safe harbors apply to any management contract entered into on or after August 22, 2016, and an issuer may apply these safe harbors to any management contract entered into before August 22, 2016. Further, an issuer *may* apply the safe harbors contained in Rev. Proc. 97-13, as modified by Rev. Proc. 2001-39 and amplified by Notice 2014-67, to a management contract entered into before February 18, 2017 that is not materially modified or extended on or after February 18, 2017 other than pursuant to a renewal option. Rev. Proc. 97-13 and Rev. Proc. 2001-39 are modified and superseded. Section 3.02 of Notice 2014-67 (with respect to management contracts) is modified and superseded. All other sections of Notice 2014-67 remain in effect.

Applicability.

Rev. Proc. 2016-44 applies to management, service or incentive payment contracts between (1)(a) a governmental person (for projects financed with governmental bonds), or (b) a governmental person or 501(c)(3) organization (for projects financed with qualified 501(c)(3) bonds) with respect to activities that do not constitute an unrelated trade or business, and (2) a service provider for the project or portion of a project financed with tax-exempt bonds. Management contracts for purposes of this Revenue Procedure do not include a contract or a portion of a contract for the provision of services before a managed property is placed in service, such as pre-operating services for construction design or construction management.

Safe Harbors.

A management contract that meets the safe harbors described below, or is an “eligible expense reimbursement arrangement” does not result in private business use for purposes of the private business tests under the Internal Revenue Code with respect to qualified private activity bonds or qualified hospital bonds. 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. In addition, use that is functionally related and subordinate to a management contract that meets these safe harbors does not result in private business use.

A. GENERAL FINANCIAL REQUIREMENTS:

1. *Reasonableness.* The payments to the service provider must be reasonable compensation for the services rendered under the terms of the contract. Compensation includes payments to reimburse actual and direct expenses paid by the service provider to unrelated parties and related administrative overhead expenses of the service provider.
2. *No Net Profit Arrangements.* There is to be no sharing of the net profits from the operation of the managed property with the service provider. Compensation to the service provider will not be treated as providing a share of the net profits if none of (i) the eligibility for, (ii) the amount of, or (iii) the timing of the payment of the compensation takes into account, or is contingent upon, either the net profits or both the revenues and expenses of the managed property for any fiscal period. Reimbursements of actual and direct expenses paid by the service provider to unrelated parties are disregarded for purposes of this paragraph. Incentive compensation will not be treated as providing a share of the net profits if the eligibility for the incentive is determined by the performance of the service provider in meeting standards that measure quality of service, performance, or productivity, and the amount and timing of the payment of compensation otherwise meet the requirements of this paragraph.

3. *No Bearing of Net Losses of the Managed Property.* The contract must not, in substance, impose upon the service provider a share of the net losses from the operation of the managed property. An arrangement will not be treated as requiring the service provider to bear a share of net losses if (i) the determination of the service provider’s compensation and the amount of any non-reimbursable expenses to be paid by the service provider, separately and collectively, do not take into account either the net losses or both the revenues and expenses of the managed property for any fiscal period, and (ii) the timing of the payment of the compensation is not contingent upon the managed property’s net losses. The Revenue Procedure gives, as an example of a contract that meets this safe harbor (and is therefore not treated as imposing a share of the net losses on the service provider), a contract that provides that the service provider’s compensation is reduced by a stated dollar amount (or one of a multiple stated dollar amounts) for failure to keep the managed property’s expenses below a specified target (or one of multiple specified targets).

B. TERM OF THE CONTRACT AND REVISIONS.

The term of the contract including all renewal options, is not greater than the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property as of the beginning of the term of the contract. Economic life is determined in the same manner as under §147(b) of the Internal Revenue Code of 1986, as amended (the “Code”), except that land is not taken into account.

C. CONTROL OVER USE OF THE MANAGED

PROPERTY. The Qualified User must exercise significant control over the use of the managed property. Such control requirement is met if, with respect to the managed property, the contract requires the Qualified User to approve the annual budget, the capital expenditures, each disposition of property, rates charged for use, and the general nature and type of use of the managed property, such as the type of services. An example of an approval of capital expenditures (and, similarly, dispositions of property) is given as the approval of an annual budget for capital expenditures described by functional purpose and specific maximum amounts.

The Revenue Procedure further exemplifies the approval of rates by the Qualified User either through express approval of such rates or the methodology for rate-setting, or by including a requirement in the contract that the rates charged by the service provider are reasonable and customary as specifically determined by an independent third party.

- D. **RISK OF LOSS.** The Qualified User must bear the risk of loss upon damage or destruction of the managed property. However, the Qualified User may insure against such risk of loss through a third party, or by imposing upon the service provider a penalty for failure to operate the managed property in accordance with standards set forth in the management contract.
- E. **NO INCONSISTENT TAX POSITION.** The service provider must agree that it is not entitled to and will not take any tax position inconsistent with being a service provider. For example, the service provider must agree not to take any depreciation, amortization, investment tax credit, or deduction for any rent payment, with respect to the managed property.
- F. **NO LIMITING THE EXERCISE OF RIGHTS OF THE QUALIFIED USER.** The service provider cannot have any role or relationship with the Qualified User that, in effect, substantially limits the Qualified User's rights under the contract, based on all the facts and circumstances. A service provider will not be treated as having the prohibited role or relationship with the Qualified User if (i) no more than 20% of the voting power of the governing body of the qualified user in the aggregate is vested in the directors, officers, shareholders, partners, members, and employees of the service provider,

(ii) the governing body of the Qualified User does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body, and (iii) the chief executive officer of the service provider is not the chief executive officer of the Qualified User or any of the Qualified User's related parties. For purposes of this paragraph, a "service provider" includes related parties and "chief executive officer" includes a person with equivalent management responsibilities. "Related party" means, for governmental entities and 501(c)(3) organizations, any member of the same controlled group. For entities other than governmental entities and 501(c)(3) organizations, a person is a related person to another if the relationship between such parties would result in a disallowance of losses under §267 or §707(b) of the Code, or such persons are members of the same controlled group of corporations (as defined in §1563(a) of the Code, except that "more than 50%" shall be substituted for "at least 80%" each place it appears therein).

- G. **FUNCTIONALLY RELATED AND SUBORDINATE.** A service provider's use of a project that is functionally related and subordinate to the performance of its services under a management contract for the managed property that meets the safe harbors of this Revenue Procedure does not result in private business use. For example, the use of storage areas to store equipment used to perform activities required under a service contract that meets the safe harbors does not result in private business use.

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