IRS issues new safe harbor provisions for management contracts

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The Internal Revenue Service has announced a new safe harbor for management contracts relating to certain bond-financed facilities. Rev. Proc. 2016-44 aims to provide what it characterizes as a "more flexible and less formulaic approach" to the question of whether an arrangement with a service provider could adversely affect the tax-exempt status of governmental bonds and qualified 501(c)(3) bonds under the Internal Revenue Code of 1986, as amended. The new safe harbor permits longer term arrangements between the beneficiaries of tax exempt bonds and service providers without adversely affecting the tax status of those bonds.

The Treasury Regulations[1] succinctly state the one of the principal aims of the rules relating to tax exempt bonds.

> The purpose of the private activity bond tests . . . is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person. The private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits.

The previous safe harbor of Rev. Proc. 97-13[2] (as modified by Rev. Proc. 2001-39[3] and amplified by Notice 2014-67[4]) established arrangements deemed to be acceptable uses of bond-financed property that did not run afoul of this policy. A number of permitted durations of contracts that varied depending on the amount of compensation that was fixed as well as the manner in which compensation was determined, e.g., periodic fixed fee, per capita fee etc. were established by the previous safe harbor.

Generally speaking, Rev. Proc. 2016-44 creates a safe harbor for management contracts of up to 30 years in duration when the arrangements with service providers include any type of reasonable compensation, whether fixed or variable. Facilities financed with governmental bonds under Section 141(b) and qualified 501(c)(3) bonds under Section 145 of the Code will not be considered to be used in a private trade or business for purposes of the private business use test of federal tax law.

It should be noted that Rev. Proc. 2016-44 applies to management contracts, which are defined to mean a management, service, or incentive payment contract between a qualified user (being a governmental person in the case of governmental bonds, or a governmental person or a 501(c)(3) organization in the case of qualified 501(c)(3) bonds) and a service provider under which the service provider provides services for a managed property. A management contract does not include a contract or portion of a contract for the provision of services before a managed property is placed in service (for example, pre-operating services for construction design or construction management). Additionally, a management contract that is in reality a "disguised lease" is, as is the case under the existing safe harbor, not an arrangement permitted by the safe harbor.

The new rules are effective for contracts entered into on or after August 22, 2016, however, an issuer may elect to apply them to any contract entered into before that date. Additionally, an issuer can apply the old safe harbor to contracts entered into before, and not materially modified after, August 18, 2017. An extension of the term of such a management contract after August 18, 2017 will trigger the requirement to comply with the new safe harbor requirements unless such extension is the result of the exercise of a renewal option as defined in Treasury Regulations Section 1.141-1(b).

Qualifying Management Contracts.

Management contracts can meet the safe harbor in either of two ways, namely be an "eligible expense reimbursement arrangement" or meet the all six requirements of Sections 5.02-5.07 of Rev. Proc. 2016-44. An eligible expense reimbursement arrangement means 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. Management contracts that are not eligible expense reimbursement arrangements must meet the following six requirements: the general financial requirements of the management contract, the term of the contract, control of the managed property, risk of loss of the managed property, consistent tax positions and the avoidance of limiting the exercise of rights by the issuer.

General Financial Requirements (Section 5.02)

There are three elements to the general financial requirements:

- First, compensation, including payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses must be reasonable for the services rendered during the term of the contract. Generally speaking, this provision should provide some flexibility in establishing compensation; however, it also introduces an element of subjectivity that could create evidentiary concerns.

- Second, the contract must not give the service provider a share of net profits from the operation of the managed property. The eligibility for compensation, as well as the amount and timing of payments, may not take into account, or be contingent upon, either the managed property's net profits or both the managed property's revenues and expenses for any fiscal period. For purposes of this requirement, reimbursements of actual and direct expenses paid by the service provider to unrelated parties are disregarded. Incentive compensation is permitted if the eligibility such compensation is determined by the performance of the service provider in meeting one or more standards that measure quality of services, performance, or productivity. The amount and the timing of the payment of the compensation meet also satisfy the requirements of this Section.
- Third, the management contract must not, in substance, force the service provider to bear any share of net losses from the operation of the managed property. This requirement is met if, in determining the service provider's compensation or unreimbursed expenses, the net losses of the managed property or both the revenues and expenses of the property for any fiscal period are not taken into account, separately and collectively and the timing of the payment is not contingent on such net losses. Rev. Proc. 2016-44 includes as an example of a permissible arrangement one in which a service provider's compensation is reduced by a stated dollar amount (or one of multiple amounts) for failing to keep expenses within specified limits.

Term of Contract (Section 5.03)

Unlike the existing safe harbor, Rev. Proc. 2016-44 permits the term of a management contract, including renewal options, to run for the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. Material modifications of the matters relevant to Section 5 of Rev. Proc. 2016-44 will require a retesting under Section 5 as of the date of such material modification.

It is worth noting that the determination of the average weighted economic lives of the assets financed is to be determined in accordance with Section 147(b) of the Code but using the date of issuance of the bonds as the start of the term of the contract. Such calculation may not always be a regular part of the tax diligence of the issuer in connection with a bond issue so attention to this point should be borne in mind in the event a management contract arrangement is planned for in connection with a financing.

As with the prior safe harbor, the definition of "renewal option" remains the same, namely, a provision under which either party has a legally enforceable right to renew the contract. Automatic renewal absent cancellation by either party is not a renewal option (even if the contract is expected to be renewed).

No definition is given for what constitutes a "material modification," but one would expect that would mean an action that is both material and a modification under general federal income tax principles.

Control over use of the managed property. (Section 5.04)

The qualified user must exercise a significant degree of control over the use of the managed property. 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
- the general nature and type of use of the managed property (for example, the type of services).

Several examples are given for procedures that comply with the forgoing, including approval of an annual budget for capital expenditures described by functional purpose and specific maximum amounts, approval of similar dispositions of the managed property, express approval of rates or the methodology for determining rates charged for use of the managed property or including a requirement that reasonable and customary rates are to be specifically determined by an independent third party. Since some of these elements may not be present in the actual management contract, care should be exercised in structuring transactions so that no related documents contradict any of the foregoing requirements and tax counsel will want to verify that qualified user possesses each of the foregoing powers.

Risk of loss of the managed property. (Section 5.05)

The qualified user must bear the risk of loss upon damage or destruction of the managed property. Insuring against risk of loss through a third party or imposing upon the service provider a penalty for failure to operate the managed property in accordance with the standards set forth in the management contract are acceptable actions under this provision.

No inconsistent tax position. (Section 5.06)

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. For example, tax benefits normally associated with tax ownership of property, such as depreciation, cannot be taken by the service provider. The qualified user will likely require an express covenant to this effect in the management contract.

No circumstances substantially limiting exercise of rights. (Section 5.07)

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, based on all the facts and circumstances. There is a safe harbor for purposes of this requirement that provides that no such impermissible role or relationship will exist if (i) no more than 20 percent 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 or related persons (as determined by Treasury Regulations Section 1.150-1(b)) (ii) and the governing body of the qualified user does not include the chief executive officer (or person with equivalent management responsibilities) of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and (iii) the chief executive officer (or equivalent executive) of the service provider is not the chief executive officer (or equivalent executive) of the qualified user or its related parties.

Functionally related and subordinate use.

Section 5.08 continues the concept contained in the existing safe harbor that functionally related and subordinate use under a qualifying management contract does not result in private business use. An example is provided wherein the use of storage areas to store equipment used to perform activities required under a qualifying management contract does not result in private business use, is unchanged from the existing safe harbor. While this provision does not represent a liberalization of the safe harbor provisions, it nevertheless continues a practice that has long been understood not to create a significant regulatory concern.

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[1] Treas. Regs. Section 1.141-2(a)

[2] 1997-1 C.B. 632

[3] 2001-2 C.B. 38

[4] 2014-46 I.R.B. 822

