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IRS modifies new management contract safe harbor provisions again to respond to questions

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As previously discussed, the Internal Revenue Service released, and then modified, Rev. Proc. 2016-44 [1], which established safe harbor provisions relating to management contracts in connection with facilities financed with tax exempt bonds. In response to questions regarding some of the details of the operation of the new safe harbor provisions in particular circumstances, the IRS released Rev. Proc. 2017-13, which modifies, amplifies and supersedes Rev. Proc. 2016-44.

Generally speaking, Rev. Proc. 2017-13 represents an effort by the IRS to be helpful in clarifying the intent of Rev. Proc. 2016-44, which was to establish a more flexible, less formulaic approach to the evaluation of management contracts. For that reason, practitioners, issuers and service providers should find the promulgation of Rev. Proc. 2017-13 to add beneficial clarity to this issue. Rev. Proc. 2017-13 deals with four principal clarifications:

- The continued effectiveness of the provisions of Rev. Proc. 97-13, as well as permissible incentive compensation arrangements;
- The timing of compensation payments;
- The computation of the average weighted life of projects with significant

amounts of land; and

- The extent to which a governmental owner is required to approve rates charged by a manager under circumstances where it may not be feasible to do so.

Prior safe harbor provisions and incentive arrangements

In order to avoid characterization of a management contract as use in the trade or business of a private person, no portion of the compensation of the manager may be based on a share of net profits from the operation of the managed facility. Rev. Proc. 2016-44 also made clear that a qualified management contract could not force the service provider to bear net losses from the operation of the bond financed facility.

Before the promulgation of Rev. Proc. 2016-44, Rev. Proc. 97-13, as modified by Rev. Proc. 2001-39, specified certain compensation arrangements that did not constitute a sharing of net profits. These included (i) capitation fees (periodic fixed fees for each person served), (ii) periodic fixed fees (stated dollar amount covering a specified period of time) and (iii) per unit fees (fees based on a unit of service provided). Practitioners have wondered whether the “old” forms of compensation arrangements would still constitute arrangements that did not result in the sharing of net profits. Additionally, concerns have existed over the extent to which incentive payments to a manager based on the performance of the managed property are permissible.

Rev. Proc. 2017-13 addresses both those issues. First, it makes clear that incentive compensation arrangements based on meeting one or more standards that measure quality of services, performance or productivity are permissible, provided that the amount and timing of such compensation arrangements meet the other requirements of Rev. Proc. 2017-13.

Rev. Proc. 2017-13 also expressly provides that compensation based exclusively on capitation fees, periodic fixed fees, per unit fees or qualifying incentive compensation (as described in the previous paragraph), or any combination thereof, will not be treated as providing a share of net profits or requiring the service provider to bear a share of net losses.

Timing of compensation payments

Rev. Proc. 2016-44 provided that payment of compensation could not be contingent on the existence of net profits or net losses from operation of the facilities. This created some uncertainty with respect to arrangements where the expected source of payment of compensation was the revenues from the operation of the financed facilities. The concern was that a lack of financial success could indirectly thrust net losses of the facility upon the manager. While any amounts payable as compensation must not be based on either the net losses of the managed property or both the revenues and expenses of the property for any fiscal period, Rev. Proc. 2017-13 endeavors to remove the uncertainty by providing that annual compensation payments that have reasonable consequences for late payments will not constitute a payment contingent on net profits or net losses if such payment arrangements require any deferred compensation to be paid within five years after the original due date.

Computation of useful life – Inclusion of land

Rev. Proc. 2016-44 required that the term of a management contract, including renewal options, not exceed the lesser of 30 years or 80 percent of the weighted average reasonably expected economic lives of the managed property. The economic life calculation was to be determined as of the beginning of the contract based on Section 147(b) of the Internal Revenue Code of 1986, as amended, without regard to Section 147(b)(3)(B)(ii). This had the effect of excluding any land from the calculation of useful life. Rev. Proc. 2017-13 now provides that the calculation be made in the same manner as under Section 147(b), which has the effect of including land and treating it as having a useful life of 30 years if 25 percent or more of the net proceeds of the issue that finances the managed property is used to finance the costs of such land. The effect of this provision is to permit a longer term for a management contract than Rev. Proc. 2016-44 would have allowed for an issue that finances shorter-lived assets in addition to land when the net proceeds of the issue devoted to acquisition of the land is substantial.

Control by owner over managed property

Rev. Proc. 2016-44 required that the owner of managed property must exercise a significant degree of control over the property. Such control was deemed to exist if the management contract required the owner to approve rates, or the methodology for setting rates, charged for the use of the property, or provided that the service provider must charge reasonable and customary rates as determined by an independent third party. Practitioners have had concerns that under certain conditions, it might not be feasible to establish all of the rates to be charged at a managed facility. Rev. Proc. 2017-13 provides that express approval of rates or a general description of the methodology, such as a method that takes into account revenue goals based on comparable properties, or a requirement that the service provider charge reasonable and customary rates determined by, or negotiated with, an independent third party, constitute sufficient control. The principal benefit of this provision is that it is now clear that the parties do not necessarily need to seek a determination of a stranger to the transaction; a negotiated rate with an independent third party can is an acceptable indicia of control. Additionally, it is unnecessary for an issuer to approve each and every rate as long as there is a reasonable general description of the method used to establish the rate.

Rev. Proc. 2017-13 applies to any management contract entered into on or after January 17, 2017, and issuers may apply it to any management contract entered into before that date. The safe harbors of Rev. Proc. 97-13, as modified and amplified, may be applied to any management contract entered into before August 18, 2017 and materially modified or extended (other than through a renewal option) on or after that date.

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[1] 2016-36 IRB 316

This publication summarizes the principal revisions to the safe harbor provisions made by Rev. Proc. 2017-13. Please see the materials cited above for a detailed discussion of safe harbor provisions of Rev. Proc. 2016-44.