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IRS Issues New Rules for Management Contracts involving Tax-Exempt Financed Facilities

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The Internal Revenue Service (IRS) issued Revenue Procedure 2017-13 (Rev. Proc. 2017-13) on Jan. 17, 2017. The procedure provides more flexible, modern rules for structuring management contracts involving tax-exempt financed facilities. Twenty years after the IRS released Revenue Procedure 97-13 (Rev. Proc. 97-13), which helped to establish the previous safe harbor framework for management contracts, Rev. Proc. 2017-13 modifies, amplifies and supersedes Rev. Proc. 97-13, Notice 2014-67, and the most recent safe harbor published in Notice 2016-44.

Private Business Use and the History of Safe Harbor Management Contracts

The Internal Revenue Code of 1986 (the Code) and the Treasury Regulations prohibit a certain amount of "private business use," or use by non-governmental or 501(c)(3) entities (in the case of qualified 501(c)(3) bonds) of facilities financed or refinanced with the proceeds of tax-exempt or tax-advantaged bonds. Management contracts between a government unit (or 501(c)(3) borrower) and non-governmental service provider involving all, or a portion of, a bond-financed facility may cause private business use. Management contracts include, for example, food service agreements, facility management contracts and incentive payment contracts of physician services at a hospital. A management contract with respect to a bond-financed facility generally will result in private business use if the service provider is compensated in whole, or in part, based on a share of net profits from the operations of the facility.

Rev. Proc. 97-13, together with previous IRS rulings, and as amplified by Revenue Procedure 2001-39 and Notice 2014-67, established several safe harbors for management contracts, which if met, would not result in private business use of the managed facility. In general, the safe harbors were based on the nature of the compensation paid to the service provider and the length of the contract. For example, if the contract term was 10 years, then, in order to meet a safe harbor in Rev. Proc. 97-13, 80 percent of the compensation to the provider had to be on a fixed fee basis. The shorter the term, the more variability there could be in the compensation, as long as the compensation was not based on net profits.

While Rev. Proc. 2017-13 still prohibits compensation to the service provider based on net profits of the managed property, it condenses Rev. Proc. 97-13, and its subsequent amendments, into one safe harbor, which is intended to clarify ambiguities in Rev. Proc. 97-13 and provide greater flexibility for long-term arrangements. Rev. Proc. 2017-13 generally permits either fixed or variable compensation, subject to certain restrictions as described below.

Rev. Proc. 2017-13 Safe Harbor

Rev. Proc. 2017-13 provides that if a management contract meets the seven criteria set forth briefly below, then the arrangement will not result in private business use.

> (1) Payments to the service provider must be reasonable, and cannot be based on a share of net profits from the operation of the bond-financed facility. Incentive compensation is permissible if based on the service provider's performance on meeting one or more standards that measure quality of services, performance or productivity;

(2) The contract must not pass on the burden of bearing any share of net losses from the operation of the bond-financed facility to the service provider;

(3) The term of the contract cannot be greater than 30 years or 80 percent of the useful life of the facility (if shorter), including all renewal options;

(4) The issuer or the borrower must exercise a significant degree of control over the use of the managed property. The safe harbor provides that the issuer or the borrower retains control if it approves the budget of the managed property, capital expenditures with respect to the managed property, each disposition of property, rates charged for the use of the managed property, and the general nature and type of the managed property;

(5) The issue or the borrower must bear the risk of loss upon damage or destruction of the managed property;

(6) 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 issuer or the borrower with respect to the bond-financed property; and

(7) The service provider must not have any role or relationship, such as holding more than 20 percent of the voting power on the governing body of the issuer or acting as chief executive officer of the organization, which substantially limits the ability of the issuer or borrower to exercise its rights under the contract.

Summary and Effective Date

The provisions of Rev. Proc. 2017-13 apply to management contracts entered into on or after Jan. 17, 2017, and may be applied to contracts entered into before that date. The prior safe harbors may continue to be used for contracts entered into before Aug. 18, 2017, and not materially modified or extended on or after Aug. 18, 2017.

While this alert is intended to describe the goal of the IRS to broaden and clarify Rev. Proc. 97-13 and its progeny, and provide a brief summary of the new safe harbor applicable to management contracts, there are several safe harbors within the general safe harbor described above, and whether or not a management contract results in private business use continues to be based on a facts and circumstances test.

For more information concerning Rev. Proc. 2017-13, or private use with respect to your tax-exempt financed facilities, please contact us.

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