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February 2017

IRS Provides More Flexibility for Management Contracts

On Jan. 17, 2017, the Internal Revenue Service (IRS) issued Revenue Procedure 2017-13, which sets forth safe harbors for when a management contract between a qualified user and service provider will not give rise to private business use under the private business use test in section 141(b)(1) of the Internal Revenue Code of 1986, as amended, for property financed with governmental tax-exempt bonds under Code section 141(b), or under the modified private business use test of Code section 145(a)(2)(B) for property financed with qualified 501(c)(3) bonds. This revenue procedure modifies, amplifies, and supersedes Rev. Proc. 2016-44, which modified and superseded Rev. Proc. 97-13 (as supplemented by Rev. Proc. 2001-39 and section 3.02 of Notice 2014-67). The progression of revenue procedures and the Notice reflect IRS attempts to address changes in how management contracts have been structured since Rev. Proc. 97-13 and provide greater flexibility in permitted management contracts. This *GT Alert* summarizes changes made by Revenue Procedures 2016-44 and 2017-13.

Prior Management Contract Safe Harbors

Rev. Proc. 97-13 used a formulaic approach to its management contract safe harbors. Specific types of compensation arrangements were allowed depending on the length of the management contract. These arrangements were: 1) capitation fees, 2) periodic fixed fees, and 3) per-unit fees. Generally, longer contracts were permitted when the arrangement provided for a greater percentage of fixed compensation. Notice 2014-67 expanded the 1997 safe harbors to address changes in management contracts needed for affordable care organizations acting under the Affordable Care Act and to allow a broader range of compensation arrangements for contracts with terms of up to five years.

Revenue Procedure 2016-44

Rev. Proc. 2016-44 shifted from the formulaic to a more flexible approach. The Rev. Proc. provided that a management contract in which the only compensation was reimbursement of actual and direct expenses the service provider paid to unrelated parties (not service provider employees) and reasonable related administrative overhead expenses did not give rise to private business use. In addition, a contract did not result in private business use if the following requirements were met.

1) *Reasonable compensation.* Payments to the service provider under the contract had to be reasonable compensation for the services provided. Compensation included payments reimbursing the service provider for actual and direct expenses and the service provider's related administrative overhead expenses.

2) *No share of profits*. The contract could not provide the service provider with a share of net profits in the managed property. This was met if no element of the compensation took into account, or was contingent upon, the property's net profits or its revenues and expenses. For this requirement, reimbursement of actual or direct expenses the service provider paid to unrelated parties was disregarded compensation and elements of compensation considered were eligibility for, amount of, and timing of compensation payments. Incentive compensation was permitted if eligibility was determined by the provider's performance in meeting one or more standards (note the revenue procedure does not say standards provided in the contract) measuring quality, performance, or productivity, and the amount and timing of the payment met the revenue procedure standard for not being a net profit arrangement.

3) *No share of net losses.* The contract could not, in substance, impose any share of net losses from the managed property on the service provider. A safe harbor applied when the amount of compensation and unreimbursed expenses the service provider paid did not collectively and separately take into account net losses or both revenues and expenses for any fiscal period and timing of the compensation payment was not contingent upon the property's net losses.

4) *Longer contracts.* The length of the contract, with all renewal options, could be no greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property, using the rules in Code section 147(b), without regard to section 147(b)(3)(B)(ii) (which provides a 30 year life when at least 25 percent of the net proceeds are to be used for land), determined as of the beginning of the contract.

5) *Qualified user controls facility*. The qualified user had to exercise significant control over the managed property. That control was found if the contract required the qualified user to approve the annual budget of the managed property, capital expenditures for the managed property, each disposition of property that was part of the managed property, rates charged for use of the property, and the general nature and type of use of the managed property. The revenue procedure set forth examples of methods for meeting certain of these elements.

6) *Qualified user's rights could not be limited*. The service provider could not have any role or relationship with the qualified user that, in effect, substantially limited the qualified user from exercising its rights under the contract. A safe harbor was provided generally limiting the service provider's voting power on the qualified user's board to 20 percent, and preventing the service provider's board chairperson from serving on the qualified user's board and the service provider's chief executive officer from serving on the qualified user's board or being the CEO of the qualified user or its related parties. For this purpose, service provider included related parties.

7) *Qualified user bears risk of loss.* The qualified user had to bear the risk of loss if the managed property was damaged or destroyed. Penalties on the service provider for failing to follow contract operating standards were permitted.

8) *Consistent tax positions covenant*. The service provider had to agree it was not entitled to and would not take a tax position inconsistent with it being a service provider on the managed property (*e.g.*, depreciation or investment tax credit).

9) *Material modifications may require retesting.* Material modifications to the contract could require the contract to be retested under the safe harbor on the date modified.

If a management contract met the safe harbor, the service provider could use the project (of which the managed property was a part) for uses that were functionally related and subordinate to performance of its services without giving rise to private business use.

The revenue procedure was effective for management contracts entered into on or after Aug. 22, 2016, and issuers could apply the safe harbors in the revenue procedures to contracts entered into before that date. A contract entered into before Aug. 18, 2017, may be prohibited from applying prior rules if it was materially modified or extended after that date (other than through a renewal option).

Revenue Procedure 2017-13

The IRS issued Rev. Proc. 2017-13 in response to industry comments on Rev. Proc. 2016-44. Rev. Proc. 2017-13 follows Rev. Proc. 2016-44 with the following modifications.

1) *Safe harbors from Rev. Proc. 97-13 continue*. It confirms that without regard to whether the service provider pays unreimbursed expenses for the managed property, compensation is not a share of net profits or net losses if it is:
    a. Based solely on compensation arrangements permitted in Rev. Proc. 97-13 (*i.e.*, capitation fees, fixed fees, and per unit fees);
    b. A permitted incentive under Rev. Proc. 2017-13 (see, number 2 above); or
    c. A combination of b. and c.

2) *Deferred compensation permitted.* It confirms that deferred compensation to the service provider because of insufficient cash flows from the managed property is permitted if:
    a. Compensation is payable at least annually;
    b. The qualified user has reasonable consequences for paying late (*e.g.*, interest charges or late fees); and
    c. The qualified user pays deferred compensation (with interest or late fees) within 5 years of the original date due.

3) *Useful life of land*. It clarifies that in determining the economic life of the managed property, land is considered with a 30 year life if 25 percent or more of net proceeds are to be used to finance the cost of the land.

4) *How rates are approved*. It clarifies that the qualified user does not need to approve every rate charged to have sufficient control over the property. The qualified user may approve a reasonable general description of the method used to set the rates or require the service provider charge reasonable and customary rates, as determined by an independent third party.

Effective Dates: Rev. Proc. 2017-13 applies to management contracts entered into on or after Jan. 17, 2017, but an issuer may apply it to contracts entered into before that date. As with Rev. Proc. 2016-44, substantial modifications or extensions of contracts entered into before Aug. 18, 2017, may prevent earlier rules from applying to the contract.

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