
By Travis C. Gibbs, Mitchell Rapaport, Bruce M. Serchuk, Carla A. Young, Praveen Ayyagari, Amy Phuong Pham


Private business use and management contracts

The Internal Revenue Code of 1986 (Code) and the Treasury Regulations thereunder impose restrictions on the amount of private business use that can occur at facilities financed with tax-exempt governmental bonds and bonds issued for the benefit of nonprofit 501(c)(3) organizations. Private business use may occur as a result of a management or service contract with a party that is not, in the case of governmental bonds, a governmental entity; or in the case of bonds issued for the benefit of 501(c)(3) organizations, a governmental entity or a 501(c)(3) organization (in each case, a “non-qualified user”).

Previous IRS safe harbors for structuring management contracts were set forth in Revenue Procedure 97-13, as modified by Revenue Procedure 2001-39 and amplified by Notice 2014-67. Under these “prior safe harbors”, a contract entered into by a governmental person or a qualified 501(c)(3) organization (referred to as a “qualified user”) with a non-qualified user that met the requirements of the safe harbor did not result in private business use of a bond-financed facility. Prior to the release of Rev. Proc. 2016-44, the safe harbors focused generally on the nature of the compensation paid to the non-qualified user and the length of the contract. For example, the maximum term of a management contract under the prior rules was 15 years (20 years for utility projects) and, except in the case of contracts with terms of not more than five years, a specified
portion of the manager’s compensation had to be in the form of a periodic fixed fee. No portion of such compensation could be based, in whole or in part, on the net profits from the operation of the bond-financed facility. Under the new rules in Rev. Proc. 2016-44, as modified by Rev. Proc. 2017-13 (the “Rev. Procs.”), constraints on net profit arrangements are retained but the maximum term has been extended to as much as 30 years and none of the manager’s compensation has to be fixed in amount.

New rules for management contracts

General rule. The most significant change made by the Rev. Procs. is in the general approach to management contracts. The Rev. Procs. greatly simplify the existing rules related to compensation by eliminating minimum amounts of fixed compensation, limits on bonuses and other formulaic requirements. The Rev. Procs. generally permit any type of fixed or variable compensation that is reasonable compensation for services rendered under the contract. There are generally no specific limits on the manner in which the manager can be compensated, provided the manager may not be compensated on the basis of the net profits of the project and the manager’s compensation may not bear the burden of any net losses from the operation of the project. Further, if the other requirements described below are satisfied, a management contract may have a term of up to 30 years or 80 percent of the expected useful life of the managed project, if shorter. The 80 percent limitation could present problems for projects in the later years of their useful lives.

No sharing of net profits and losses. As under the prior safe harbors, the Rev. Procs. provide that the manager cannot be compensated based on a share of net profits from operating the project. Under this rule, the eligibility, amount and timing of compensation cannot be affected by the net profits of the project. Reimbursement of actual and direct expenses paid to unrelated parties is not taken into account for this purpose, although, in a change from the interpretation of prior safe harbors, employees of the manager are treated as related persons. This treatment may result in payments to employees being treated as compensation that is subject to a reasonableness determination under the general compensation rule contained in the Rev. Procs. Incentive fees based on standards that measure quality of service, performance or productivity are permitted.

— Rev. Proc. 2017-13 incorporates definitions of capitation fees, periodic fixed fees and per unit fees and clarifies that the payment of these fees (and incentive fees described above) will not be treated as providing a share of net profits, or requiring the service provider to bear a share of net losses, without regard to whether the service provider pays expenses with respect to the operation of the managed property that are not reimbursed by the qualified user.

In addition to the prohibition on sharing net profits, the Rev. Procs. contain new rules that prevent the manager from bearing the burden of any share of the net losses from the project. The Rev. Procs. state that one requirement for satisfying this net loss limitation is that the timing of the payment of compensation may not be contingent on the managed property’s net losses.

— Rev. Proc. 2017-13 provides a helpful clarification of the timing rule by providing that deferred compensation due to insufficient net cash flows from the operation of the managed property will not cause the compensation to be contingent upon net profits or net losses if the contract includes the following requirements (1) the compensation is payable at least annually, (2) the qualified user is subject to reasonable consequences for late payment (such as reasonable interest charges or late payment fees), and (3) the qualified user will pay such deferred compensation (with interest or late fees) no later than the end of five years after the original due date of the payment.
The qualified user must have significant control over the project. One of the most important new limitations is that the qualified user must exercise a “significant degree of control over the use” of the project. This requirement is treated as satisfied if the contract requires the qualified user to approve each of the following regarding the project: (1) the annual budget, (2) capital expenditures, (3) each disposition of property, (4) rates charged for use of the property, and (5) the general nature and type of use of the project (e.g., the type of services provided).

— Rev. Proc. 2017-13 provides a helpful clarification of the rate approval requirement for situations where it may not be feasible for the qualified user to approve each specific rate charged, such as for a physician’s professional services at a hospital or hotel room rates at a hotel. Rev. Proc. 2017-13 clarifies that a qualified user may satisfy the approval of rates requirement by approving a reasonable general description of the method used to set the rates (such as a method that establishes hotel room rates using specified revenue goals based on comparable properties) or by requiring that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (such as a medical insurance company).

The qualified user must bear the risk of loss of the project. Another new limitation is that the qualified user must bear the risk of loss from damage or destruction of the project (for example, from force majeure). The Rev. Procs. provide that the qualified user will meet this requirement even if it insures the project through a third party or imposes a penalty on the manager for failing to operate the project according to specified standards. It is not clear, however, whether the manager can be required to insure the property (rather than the qualified user).

Consistent tax positions. The Rev. Procs. require that the manager must treat itself as the service provider (rather than the owner or lessee) for tax purposes and must agree that it will not claim any depreciation or amortization deductions, tax credits or rent deductions with respect to the bond-financed project.

No circumstances limiting exercise of rights. Similar to the prior safe harbors, the manager must not have a role or relationship with the qualified user that substantially limits the qualified user’s rights under the contract. This requirement is met if (1) not more than 20 percent of the voting power of the governing body of the qualified user is vested in officers, directors, employees, etc. of the manager; (2) the governing body of the qualified user does not include the chief executive officer of the manager or the chair of its governing board; and (3) the chief executive officer of the manager is not the chief executive officer of the qualified user or any party that is related to the qualified user. The Rev. Procs. add the third prong restricting overlapping chief executive officers and remove the prior safe harbor requirement that the qualified user and the service provider be unrelated parties.

Eligible expense reimbursement arrangement. In addition to the foregoing safe harbor, the Rev. Procs. provide that a management contract that is an “eligible expense reimbursement arrangement” does not result in private business use. This is defined as a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the manager to unrelated parties and reasonable related administrative overhead expenses of the manager.

— Rev. Proc. 2017-13 clarifies that the definition of “unrelated parties” treats the manager’s employees as related for this purpose, which may result in many arrangements of this type having to be tested.
under the factors described above.

**Affordable Care Act**

In Notice 2014-67 (the “Notice”), the IRS provided special rules related to the Patient Protection and Affordable Care Act under the private business use limitations, including whether participating in a Shared Savings Program with a non-qualified user results in private business use. Those provisions of the Notice were not modified by the Rev. Procs. As further detailed in the Notice and our prior Public Finance Alert (entitled “IRS issues new rules for management contracts and ACO participation” dated October 29, 2014), participation by a qualified user in the Shared Savings Program through an accountable care organization (ACO) will not result in private business use if all of the following conditions are met: (1) the terms of the qualified user’s participation are set forth in advance in a written agreement negotiated at arm’s length; (2) CMS has accepted the ACO into, and has not terminated the ACO from, the Shared Savings Program; (3) the qualified user’s share of economic benefits derived from the ACO is proportional to the benefits or contributions the qualified user provides to the ACO; (4) the qualified user’s share of the ACO’s losses does not exceed the share of ACO economic benefits to which the qualified user is entitled; (5) all contracts and transactions entered into by the qualified user with the ACO and the ACO’s participants, and by the ACO with the ACO’s participants and any other parties, are at fair market value; and (6) the qualified user does not contribute or otherwise transfer the property financed with tax-exempt bonds to the ACO unless the ACO is an entity that is a qualified user.

**Effective date**

The provisions of Rev. Proc. 2016-44 apply to management contracts entered into on or after August 22, 2016, and could apply to contracts entered into before that date. The provisions of Rev. Proc. 2017-13 apply to management contracts entered into on or after January 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 August 18, 2017, and that are not materially modified or extended on or after August 18, 2017.

For more information on the content of this alert, please contact your regular Nixon Peabody attorney or:

- Travis C. Gibbs at tgbbs@nixonpeabody.com or 415-984-8336
- Mitchell Rapaport at mrhapaport@nixonpeabody.com or 202-585-8305
- Bruce M. Serchuk at bserchuk@nixonpeabody.com or 202-585-8267
- Carla A. Young at cyoung@nixonpeabody.com or 202-585-8340
- Praveen Ayyagari at ppayagari@nixonpeabody.com or 202-585-8025
- Amy Phuong Pham at apham@nixonpeabody.com or 213-629-6091