August 14, 2017

New Management Contract Rules Affect Tax-Exempt Bond-Financed Projects

Beginning August 19, all newly entered or materially modified management contracts will be subject to the Internal Revenue Service's new safe harbor guidelines for determining whether such management contracts result in private business use of property financed with tax-exempt obligations. Revenue Procedure 2017-13, which modifies Revenue Procedure 2016-44, supersedes and replaces the safe harbors provided under prior IRS guidance. A determination that a management contract results in private business use may have an adverse impact on the ability to finance the property with tax-exempt bonds or impact the tax exemption of previously issued bonds. The following is a summary of the new safe harbor conditions.

Reasonable Compensation. Payments made under the contract must be reasonable compensation for services rendered during the term of the contract. Compensation includes payments to reimburse actual and direct expenses and for related administrative overhead expenses of the service provider.

No Net Profit Arrangements. The contract may not provide for the payment to the service provider of a share of the net profits from the operation of the managed property. No element of the compensation may take into account, or be contingent on, either (1) net profits or (2) both revenues and expenses for any fiscal period. Incentive compensation is permitted in certain instances.

No Bearing of Net Losses by Service Provider. The contract must not, in substance, impose on the service provider the burden of bearing any share of net losses from the operation of the managed property. Compensation and the amount of any expenses not reimbursed, separately and collectively, may not take into account either (1) net losses or (2) both revenues and expenses for any fiscal period. In addition, the timing of the payment of compensation may not be contingent on net losses.

Certain Types of Compensation. Compensation for services will not be treated as providing a share of net profits or requiring the service provider to bear a share of net losses if the compensation is (1) based solely on a capitation fee, a periodic fixed fee or a per-unit fee; (2) is a permitted incentive compensation; or (3) is a combination of the types of compensation in (1) or (2).

Timing of Payments. In order for the deferral of payments due to insufficient net cash flow not to be treated as contingent on net profits or net losses, the management contract must include requirements that the compensation is payable at least annually; the governmental or tax-exempt entity owning the financed property (the "owner") is subject to reasonable consequences, such as interest charges or fees, for late payment; and the owner will pay the deferred compensation (with interest or late payment fees) no later than five years after the payment was originally due.

Term of Contract. The term of the contract, including all renewal options, must not be greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. Materially modified contracts are required to be retested as new contracts as of the date of the modification.

Control Over the Property. The owner must exercise a significant degree of control over the use of the managed property. Indicia of this control include approval of capital expenditures, approval of dispositions of property and approval of rates charged.

Risk of Loss of the Managed Property. The owner must bear the risk of loss upon damage or destruction of the managed property. However, the owner may insure against risk of loss through a third party or may impose on the service provider a penalty for failure to operate the managed property in accordance with the standards set forth in the contract.

No Inconsistent Tax Position. 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 owner with respect to the managed property. Such prohibited tax positions include depreciation or amortization deductions, investment tax credits and deductions for any payment as rent.

No Substantial Limitation of Rights. The service provider must not have any role or relationship with the owner that in effect substantially limits the owner's ability to exercise its rights under the management contract, based on all the facts and circumstances.

Management contracts entered into on or before August 18, 2017, that meet one of the safe harbors set forth in the prior guidance (Revenue Procedure 97-13) will continue to avoid treatment as private business use, but all new and renegotiated contracts will be required to comply with the new rules.

These changes are significant, and failure to comply with the new rules may have an adverse effect on both outstanding and future tax-exempt financings of managed property. Before completing any contract for management services concerning property financed with tax-exempt obligations, issuers and/or borrowers should consult with bond counsel.

This article also appeared in the Fall 2017 issue of Day Pitney's Nonprofit Newsletter.

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