Chapman and Cutler LLP

Chapman Client Alert

January 18, 2017 Current Issues Relevant to Our Clients

IRS Modifies Management Contract Guidelines for Tax-Exempt Bonds

On January 17, 2017, the Internal Revenue Service released new safe harbor guidelines (the *"Management Contract Guidelines"*) for determining whether a management contract results in private business use of property for purposes of the federal income tax rules relating to tax-exempt bonds. This determination in turn affects whether the interest on bonds issued to finance facilities that are subject to such contracts will be (or will continue to be) tax exempt. This determination is important for governmental purpose bonds and qualified 501(c)(3) bonds, but is not relevant for private activity bonds (other than qualified 501(c)(3) bonds), such as exempt facility bonds issued for residential rental projects. The new guidelines modify, amplify and supersede Internal Revenue Service guidelines released in August, 2016. The new guidelines generally follow the August, 2016 guidelines, but revise those guidelines, as described below, to address (i) the treatment of certain types of compensation for purposes of the prohibition on sharing net profits or losses, (ii) the timing of the payment of compensation in the case of certain deferrals, (iii) the economic life of land for purposes of determining the safe harbor contract term and (iv) the methods of the required approval of rates charged for the use of managed property. The Management Contract Guidelines continue to broadly define management contracts to include a management, service, or incentive payment contract between a governmental entity or 501(c)(3) organization and a service provider under which the service provider provides services for a managed property.

The Management Contract Guidelines provide that a management contract generally does not result in private business use if the contract meets each of the eight requirements outlined below.

First, the payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract.

Second, the contract must not provide to the service provider a share of net profits from the operation of the managed property. Compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses (other than certain reimbursements for expenses paid to unrelated third parties) for any fiscal period.

Third, the contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property.

The January 17, 2017 Management Contract Guidelines include a new provision under which 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 for services (without regard to whether the service provider pays expenses of the managed property without reimbursement by the governmental unit or 501(c)(3) organization) is based solely on a capitation fee, a periodic fixed fee or a per-unit fee, incentive compensation that is based on the service provider's performance in meeting one or more standards that measure quality of services, performance or productivity, or a combination of these types of compensation.

The January 17, 2017 Management Contract Guidelines contain a new provision under which deferral due to insufficient net cash flows from the operation of the managed property of the payment of compensation will not cause the deferred compensation to be contingent upon net profits or net losses if the contract requires that (i) the compensation is payable at least annually, (ii) the governmental unit or 501(c)(3) organization is subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees and (iii) the governmental unit or 501(c)(3) organization will pay such deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of payment.

Fourth, the term of the contract (including renewal options) must be no greater than the lesser of 80 percent of the weighted average reasonably expected economic life of the managed property or 30 years. The January 17, 2017 Management Contract Guidelines revise the treatment of land

for purposes of the economic life determination, providing that land is treated as having an economic life of 30 years in certain circumstances; under the guidelines released in August, 2016, the economic life of land was not taken into account in determining the maximum term of the contract.

Fifth, the governmental unit or 501(c)(3) organization must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property and the general nature and type of use of the managed property (for example, the type of services). The January 17, 2017 Management Contract Guidelines contain a new provision under which the approval of rates requirement can be met through express approval of such rates, approval of a general description of the methodology for setting such rates 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).

Sixth, the governmental unit or 501(c)(3) organization must bear the risk of loss upon damage or destruction of the managed property.

Seventh, 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 governmental unit or 501(c)(3) organization with respect to the managed property.

Eighth, the service provider must not have any role or relationship with the governmental unit or 501(c)(3) organization that, in effect, substantially limits the ability of the governmental unit or 501(c)(3) organization to exercise its rights under the contract, based on all the facts and circumstances. The Management Contract Guidelines provide a safe harbor for meeting this requirement that provides limits on board membership and prohibits overlapping chief executive officers.

The new Management Contract Guidelines apply to any management contract that is entered into on or after January 17, 2017, and an issuer may apply these safe harbors to any management contract that was entered into before January 17, 2017. However, an issuer may continue to apply the prior management contract guidelines in Rev. Proc. 97-13, as modified by Rev. Proc. 2001-39 and amplified by Notice 2014-67, to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended on or after August 18, 2017.

For More Information

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