Manager's Special:

IRS Issues New Rules on Management Contracts for Tax-Exempt Bond Projects

Stephen D. Berger

Lawyers advising local governments and nonprofit organizations should become acquainted with the new rules governing the eligibility of their clients' capital projects for tax-exempt financing. The Internal Revenue Service (IRS) recently issued *Rev. Proc. 2017-17* to update and revise the longstanding rules governing what provisions can be included in a management contract between (i) a state or local governmental unit (a *governmental unit*), such as a county, city, or special purpose district, or an organization exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (a *501(c)(3) organization*) and (ii) a person other than a governmental unit or a 501(c)(3) organization (each a *qualified user*) with respect to the qualified user's capital project without disqualifying the project for tax-exempt bond financing.

The term "bond financing" is used in this article to refer to any debt obligation (whether designated as a bond, note, loan agreement, or capital lease) issued by a governmental unit to finance or refinance a capital project to be owned by the governmental unit (such as a water treatment plant, solid waste disposal facility, or convention center), or by a 501(c)(3) organization (such as a hospital, human service agency, or museum), and that will be managed under a management contract between a qualified user and a person other than a qualified user. Tax-exempt financing refers to a bond financing on which the interest payable is excludable from the gross income of the holder for federal income tax purposes. Eligibility for tax-exempt financing will result in a lower interest rate and a longer amortization period than would be available for taxable financing.

The Private Business Use Limitation

Not every bond issue of a governmental unit is eligible for tax-exempt treatment of the interest payments. In order to be eligible for exclusion of the interest paid to the bondholders from gross income for federal income tax purposes, the bonds must be *qualified bonds* as defined in the Internal Revenue Code (the *Code*). This article focuses on the requirement for a qualified bond issue (the private *business use limitation*) that the extent of *private business use* of the proceeds of an issue of qualified bonds not exceed 10 percent, in the case of bonds issued to finance a capital project to be owned and used by a governmental unit (*qualified governmental bonds*), or not exceed 5 percent, in the case of bonds issued by a governmental unit to finance a capital project to be owned or used by a 501(c)(3) organization.

The federal income tax regulations (the *Regulations*) provide that *private business use* of a bond-financed property includes ownership of the property by a *nongovernmental person* or use of the property by a nongovernmental person pursuant to a lease or management agreement. The Regulations define a *nongovernmental person* as any person other than a governmental unit. In the case of bonds issued by a governmental unit (i) all of the proceeds of which are to be used to provide property to be owned by a governmental unit or by a 501(c)(3) organization and (ii) to be used by a 501(c)(3) organization (*qualified 501(c)(3) bonds*), the Code treats a 501(c)(3) organization as if it were a governmental unit for purposes of the 5 percent private business use limitation. Under the Regulations, the extent of private business use is generally measured by the portion (based, for example, on relative square footage) of the capital project that will be owned or used by a nongovernmental person.

Tracking through this maze of defined terms erected by the Code and Regulations, a lawyer (the *bond counsel*) engaged by a governmental unit to provide an unqualified opinion that interest on a proposed issue of qualified governmental bonds, or engaged by a 501(c)(3) organization to provide an unqualified opinion that interest on a proposed issue of qualified 501(c)(3) bonds, will qualify as such and therefore bear tax-exempt interest must ascertain that a management agreement for the bond-financed property entered into between the governmental unit or the 501(c)(3) organization and the for-profit manager will not run afoul of the private business use limitation so as to cause the interest on the bond issue to be taxable.

The rationale underlying the private business use limitation, and specifically the management contract restrictions discussed in this article, is Congress's intent to limit the benefits of tax-exempt financing, and thus limit the loss of federal income tax revenues (so-called tax expenditures), to governmental units and 501(3) organizations and to prevent private for-profit entities from directly or indirectly sharing in those benefits. As discussed below, the primary requirement to be a permissible management contract for a tax-exempt bond-financed property is that the manager (or to use the more inclusive term used in the Regulations, the *service provider*) may not share in the profits of the bond-financed property so as to result in the diversion to the service provider of any of the benefit of the tax-exempt status of the financing.

<u>Rev. Proc. 2017-17</u>

Issued by the IRS on January 3, 2017, Rev. Proc. 2017-17 (the *Revenue Procedure*) revises and restates the "safe harbor" criteria for management contracts that will not violate the private business use limitations. If bond counsel examines a proposed management contract for the bond-financed property and determines that the contract satisfies all of the prescribed criteria, bond counsel can take shelter in the "safe harbor" erected by the Revenue Procedure and issue an unqualified opinion that the management contract will not disqualify a state or local government bond issue that otherwise qualifies for tax exemption.

Because Rev. Proc. 2017-17 construes the same private business use limitations as continue to be applicable under the Code and Regulations, it does not fundamentally alter the safe harbor criteria for management contracts that were previously set forth in Rev. Proc. 93-17 but resolves certain questions regarding the interpretation of those criteria that have vexed bond counsel working with the earlier revenue procedure and, as described below, allows more flexibility regarding the allowable payments to the service provider and the duration of the contract.

<u>Effective Date</u>

Rev. Proc. 2017-17 applies to management contracts entered into, or materially modified or extended, on or after January 17, 2017. Rev. Proc. 2017-17 revises and supersedes the safe harbor provisions the IRS spelled out twenty years ago in Rev. Proc. 93-17 as that earlier guidance has from time to time been subsequently modified and amplified before the issuance of Rev. Proc. 2017-17. The safe harbors prescribed in Rev. Proc. 93-17 remain in effect for any management contract entered into before, and not materially modified or extended after, January 17, 2017, but a governmental unit may elect to apply Rev. Proc. 97-13 to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended after that date (other than pursuant to a renewal option by which either party has a legally enforceable right to renew the contract).

<u>*Definition and Examples of Management Contracts*</u>

Mirroring the language of the Regulations, the new Revenue Procedure defines a "management contract" as a contract between a governmental person and a service provider under which a for-profit business provides management or other services involving all, a portion, or any function, of a bond-financed facility. The Regulations and Revenue Procedure adduce the following examples of management contracts commonly found in the health care industry, among both governmental and 501(c)(3) hospitals: a contract for the provision of management services for an entire hospital, management services for a specific department of a hospital, or physician services to hospital patients.

Beyond the health care context, common examples are a contract with a private, for-profit business for the operation of a municipal water treatment or solid waste disposal plant, a hotel and convention center owned by the local government, or affordable rental housing owned by a 501(3) organization and operated

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by a real estate management company. The recent trend to public-private partnerships (so-called *P3s*) has expanded the use of management contracts to other properties and services, such as a bridge, toll road, or airport, typically operated in the past directly by a state or local government and now managed by contract between the governmental unit and a for-profit operator chosen by competitive bidding. Rev. Proc. 2017-17 was adopted in part to provide additional guidance and flexibility in this P3 context.

General Financial Requirements

(1) In general

The payments to the service provider 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 paid by the service provider, including reimbursement of the service provider for compensation it pays to its employees, and related administrative overhead expenses of the service provider.

As in other tax law contexts, what amount of compensation is "reasonable" is a question of fact determined by reference to the amount of compensation paid by independent parties for comparable services under similar circumstances, but in practice the reasonableness of the compensation is unlikely to be an issue in view of the other safe harbor requirements discussed below and because, at least in the case of a qualified user that is a governmental unit, the service provider's compensation will most likely be set by competitive bidding or other similar procedures required by law.

(2) No net profits arrangements

The primary criterion in analyzing whether a management contract would ruin the tax exemption of a bond issue is that the contract must not provide to the service provider a share of the net profits from the operation of the managed property. The service provider's compensation must not take into account or be contingent upon either the managed property's net profits or both the managed property's revenues *and* expenses (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties, including the service provider's employees) for any fiscal period. Although Rev. Proc. 2017-17 does not say so explicitly as did Rev. Proc. 97-13, the service provider's compensation may consist of or include a percentage of the gross revenues (or gross revenues adjusted by an allowance for bad debts and trade discounts) of the managed property.

(3) Net losses of the managed property

The Revenue Procedure provides that the management contract must not impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property. A contract will not be treated as requiring the service provider to bear a share of net losses if (i) the determination of the amount of the service provider's compensation and the amount of any expenses to be paid by the service provider and not reimbursed does not take into account either the managed property's net losses or both the managed property's revenues *and* expenses for any fiscal period and (ii) the timing of payment of the compensation is not contingent upon the managed property's net losses.

A service provider whose compensation is reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) will not be treated as bearing a share of net losses as a result of such reduction.

Together with the "no inconsistent tax position" requirement discussed below, the rationale of this "no bearing of net losses" requirement is to preclude tax-exempt financing for property in which the service provider in effect has an economic ownership interest.

(4) Types of compensation

The Revenue Procedure provides that compensation under a management contract 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 is a periodic fixed fee, a capitation fee, or a per-unit fee. In each case, the compensation may but need not include (i) reimbursement of the expenses the service provider pays to unrelated parties, including its employees, and (ii) *incentive compensation* determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity, provided that the timing of the payment of the incentive compensation satisfies the timing requirements described below. A *periodic fixed fee* is a stated dollar amount for services rendered for a specified period of time.

A *capitation fee* is a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to such persons varies substantially. For example, capitation fee arrangements include a fixed dollar amount payable per month to a group of physicians for each member of a health maintenance organization for whom the provider agrees to provide all needed medical services for a specified period of time. Capitation fees are increasingly used as a cost containment device in the health care industry, including governmental and nonprofit hospitals eligible for tax-exempt financing.

A *per-unit fee* is a fee based on a unit of service specified in the contract or otherwise specifically determined by the qualified user of the managed property or by an independent third party, such as Medicare or Medicaid or a private health insurance company. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Per-unit fee arrangements include separate billing arrangements between physicians and hospitals—for example, when a hospital bills a patient for the use of its emergency department and emergency department medical staff employed directly by the hospital, and a physicians group that has contracted with the hospital to operate the emergency department bills the patient separately for its services.

A periodic fixed fee, capitation fee, or per-unit fee may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of the managed property. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective, external standards. A capitation fee may include a variable component of up to 20 percent of the total capitation fee, designed to protect the service provider against a risk of catastrophic loss.

Rev. Proc. 2017-17 … revises and restates the "safe harbor" criteria for management contracts that will not violate the private business use limitations.

The categories of compensation described above that are expressly permitted as safe harbors by Rev. Proc. 2017-17, all of which were previously permitted as safe harbors by Rev. Proc. 97-13 and the other revenue procedures issued from time to time by the IRS modifying Rev. Proc. 97-13 before the current complete restatement in Rev. Proc. 2017-17, evidently are not meant to preclude the use of other types of compensation arrangements that may be negotiated between a qualified user and a service provider, provided the arrangement does not contravene the other requirements of Rev. Proc. 2017-17. Bond counsel will be on firmer ground, however, when they render their tax exemption opinion if they can rely on the expressly permitted safe harbors.

Rev. Proc. 97-13 prescribed different maximum terms (durations), including renewal options under which the service provider had a legally enforceable right to renew the contract, for each specified safe harbor type of compensation, ranging from not more two years for certain per-unit fee arrangements and extending to no more than 15 years for certain fixed-fee contracts. The most significant changed made by Rev. Proc. 2017-17 is that the new Revenue Procedure generally allows a qualified user and a service provider to enter into a management contract with a maximum term longer than previously would have been permitted, as described below.

(5) Timing of Compensation Payments

Deferral of the payment of compensation to the service provider due to insufficient net cash flow from the operation of the managed property will not cause the deferred compensation to be treated as contingent upon net profits or net losses if the contract includes requirements that (i) the compensation is payable at least annually; (ii) the qualified user pays the service provider reasonable interest charges or late payment fees on account of the deferred compensation; and (iii) the qualified user pays the deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of the payment—that is, the service provider has an enforceable claim against the qualified user for any deferred compensation not paid within five years.

Maximum Contract Term

The term of the contract, including all renewal options by which either party has a legally enforceable right to renew the contract, 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. A contract that is materially modified with respect to any of the safe harbor criteria of the Revenue Procedure must be re-tested as a new contract as of the date of the material modification. For this purpose, the weighted average reasonably expected economic life of property is generally the depreciation period used by the owner of the property for financial accounting purposes. Land is treated as having an economic life of 30 years if 25 percent or more of the net proceeds of the bond issue that finances the managed property is to be used to finance the costs of the land. If less than 25 percent of the net proceeds of the bond issue is to be used to finance the cost of land, the land is disregarded in determining the economic life of the property. Thus, the longer the expected life of the asset (such as infrastructure and buildings), the longer the permissible maximum term of a safe harbor management contract, subject in all cases to a maximum term of 30 years.

Since the limitation for the weighted average maturity of a tax-exempt financing is likewise 80 percent of the weighted average reasonably expected economic life of the property financed by the bond issue, a management contract with respect to all of the bond-financed property may generally remain in effect for the entire life of the bond issue. Management contracts for only the shorter-lived assets financed by the bond issue, such as equipment, may need to be re-negotiated while the bonds remain outstanding.

Control of the Managed Property

The qualified user 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). A qualified user may evidence its approval of the rates charged for use of the managed property by expressly approving such rates or approving a general description of the methodology for setting such 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).

Risk of Loss of the Managed Property

The qualified user must bear the risk of loss upon damage or destruction of the managed property, but it may purchase insurance for the risk of loss.

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 qualified user with respect to the managed property. For example, the service provider must agree not to claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the managed property. Because this is a new safe harbor requirement added by Rev. Proc. 2017-17, contracts executed or materially modified after the effective date of the new Revenue Procedure will need to include a provision conforming to this new requirement. As stated above, the rationale for this requirement is that a service provider may not have in effect an economic ownership interest in the managed property.

No Circumstances Substantially Limiting Exercise of Qualified User's Rights

The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract, based on all the facts and circumstances. A service provider is not treated as having a prohibited role or relationship if (i) no more than 20 percent of the voting power of the governing body of the qualified user is vested in the directors, officers, shareholders, partners, members, and employees of the service provider, in the aggregate; (ii) the governing body of the qualified user does not include the chief executive officer of the service provider or the chair of the service provider's governing body; and (iii) the chief executive officer of the service provider is not the chief executive officer of the qualified user or any related party to the qualified user. As is generally the case for tax purposes, one entity is considered a related party to another, such as parent and subsidiary corporations, if they are connected by more than 50 percent ownership.

Functionally Related and Subordinate Use

A service provider's use of bond–financed property that is functionally related and subordinate to performance of its services under a management contract for the managed property, such as its use of storage areas to store equipment it uses to perform services under the management contract, does not result in private business use of the bond-financed property.

Concluding Practice Point

The closer a qualified user (local governmental body or 501(3) organization) can come to negotiating with its service providers contracts that conform to the safe harbor requirements provided under Rev. Proc. 2017-17, the easier it will be for bond counsel to render an unqualified opinion that interest on the proposed bond issue will be excludable from gross income for federal income tax purposes. The farther such contracts diverge from the safe harbor, the greater the risk of an IRS determination that the bonds are not entitled to tax exemption.

Steve Berger is a public finance and tax law partner at Wyatt, Tarrant & Combs and a Fellow of the American College of Bond Counsel. ■

MEETING SCHEDULES

Associations of Legal Administrators

The Kentucky Chapter Association of Legal Administrators will host their annual Spring Retreat March 23–24, at Wooded Glen Retreat and Conference Center in Henryville, Indiana. Information will be sent to KYALA members in advance. Questions can be directed to Debbie Snellen, Retreat Committee Chairperson, *dsnellen@rwsvlaw.com* or (502) 589-1000. ■

Legal Assistants of Louisville

The next regularly scheduled meeting of the Legal Assistants of Louisville will be held on Tuesday, March 21, at 11:30 a.m. at the Bristol Bar & Grille located at 614 W. Main Street. Our speaker will be Micah Jorrisch, the Director of Corporate and Community Partnerships for Family and Children's Place, a local non-profit organization that works with thousands of children every year in Louisville and the surrounding region who've been traumatized by abuse, neglect, and other forms of trauma. He will speak about issues pertaining to family law and the legal journey many of his clients face. The cost of the luncheon is $19 per person. For more information about the organization or to RSVP for the meeting (by noon on Tuesday, March 14), please contact Mary Ruckriegel, president, at (502) 589-5980. ■

Section Meetings

All meetings are held at noon at the Louisville Bar Center, 600 W. Main Street.

Tuesday, March 14: Intellectual Property Law
Real Estate Law
Wednesday, March 29: Young Lawyers

Please watch for announcements in eBriefs or check the LBA website, *www.loubar.org*, for additional section meeting dates. Meetings are tentative until confirmed on the LBA website.

Guests are welcome to attend a meeting before joining the section. For reservations or to join a section, call (502) 583-5314 or visit *www.loubar.org*. ■

Louisville Association of Paralegals

The Louisville Association of Paralegals' Education Committee will host a CLE* program on Friday, March 10, at noon, at the Jefferson County Public Law Library. The topic will be "*Ethics in the Criminal Justice Process*" and it will be presented by Commonwealth's Attorney Thomas B. Wine. The program is to be an overview of ethical issues that arise from arrest to post-conviction. To register for the program, go to our website, *www.loupara.org*. *This program is not attorney CLE accredited, it is for Certified Kentucky Paralegals education credit. ■

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