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# IRS Releases New Management Contract Rules

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On January 17, 2017, the Internal Revenue Service (IRS) released Revenue Procedure 2017-13 (2017-13). This revenue procedure modified, amplified, and superseded Revenue Procedure 2016-44 (2016-44), which was just issued last August. In turn, 2016-44 had superseded the longstanding guidance found in Revenue Proc. 97-13 (97-13). 2016-44 and now 2017-13 replaced the formulaic approach used in 97-13 with a "principles based" approach to evaluating management agreements. But 2017-13 clarifies that the many of the specific rules found in 97-13 can still be used under the new regime. Thus, under 2017-13, a State, local government, or non-profit entity (Qualified User) that funds projects with tax-advantaged bonds will still find the greater flexibility found in 2016-44 when entering into an agreement (Management Contract) with a third party (Service Provider) to manage certain aspects of its bond-financed facilities (Managed Property) while retaining the certainty that was found in applying some of the specific rules found in 97-13. While 2017-13 clarifies some of the uncertainties found in 2016-44, no law or regulation is perfect and there will remain some new questions about the application of these rules.

Section 141 of the Internal Revenue Code (Code) generally states that a state or local government bond will not be a tax-exempt bond if the facilities financed will have excessive use by a nongovernmental, private entity. Excessive private use arises when the nongovernmental person both (i) uses more than 10% of the financed facility and (ii) pays an amount for that use that allows for the issuer of the bond to pay more than 10% of the debt service on that bond from the private payments. Section 145 of the Code applies the rules in Section 141 of the Code to qualified 501(c)(3) bonds for nonprofits, treating the nonprofit as if it were a state or local government for this purpose, but lowering the 10% threshold to 5%. Treasury Regulations § 1.141-3 (Regs) expands what constitutes private use to include certain management contracts for operation of any portion of the bond-financed facility. Certain routine contracts, such as a janitorial service contract, are deemed by the Regs not to constitute management contracts, but most other contracts are management contracts. 2017-13 provides that a Management Contract nonetheless will not give rise to private business use if the safe harbors set forth in 2017-13 are met.

The following is a very brief list of those requirements, all of which were also found in 2016-44:

(1) The compensation to the Service Provider must be reasonable.
(2) The Management Contract cannot allow for the Service Provider to share in the net profits from the operation of the Managed Property. This requirement is a holdover from 97-13.
(3) The Management Contract must not allow the Service Provider to bear any net losses from the operation of the Managed Property.
(4) The Management Contract term cannot exceed the lesser of (i) 30 years or (ii) 80% of the remaining economic life of the Managed Property.
(5) The Qualified User must exercise a significant degree of control over the Managed Property.
(6) The Qualified User must bear the risk of loss of the Managed Property (although third party insurance is not prohibited).
(7) The Service Provider cannot take a federal tax position that is contrary to or inconsistent with its status as a service provider.
(8) The Service Provider cannot have any role or relationship with the Qualified User that substantially limits the Qualified User's ability to exercise its rights under the Management Contract.

2017-13 also makes four specific additions to those principled rules, which are not found in 2016-44:

> (1) The formulaic 97-13 rules providing a safe harbor for Management Contracts using a capitation fee, a periodic fixed fee, a per-unit fee, or combinations thereof, and certain types of incentive compensation, are all expressly authorized in 2017-13. If these rules are followed, the Service Provider is determined not to have a share in net profits. A capitation fee is a fixed fee for each person to whom the Service Provider provides a service, such as a fixed annual

fee for each patient in an HMO. A periodic fixed fee is a set amount for services rendered in a specified time period, such as a charge of $1,000 per month to operate a sewage treatment plant. A per-unit fee is a set amount for each unit of service provided, such as a charge of $100 for each X-ray read by a Service Provider.

(2) Some Management Contracts allow for delayed payments of compensation to the Service Provider if the Managed Property has unexpected, insufficient cash flow to pay the fee. 2017-13 specifically approves a Management Contract that permits delayed fees in those circumstances so long as (a) the scheduled payments are at least annual, (b) there is a late interest or penalty charge added to the late payment, and (c) the late payment must be made within 5 years of the original due date.

(3) The term of a Management Contract is restricted to the lesser of 30 years or 80% of the remaining life of the Managed Property. By incorporating the rules in Section 147(b) of the Code, 2017-13 clarifies that (i) land should be included in that determination of remaining life if more than 25% of the proceeds of the bonds financed the land and (ii) if land is included in such determination, a useful life of 30 years should be assigned to the land.

(4) A Qualified User must have sufficient control of the Managed Property. In part, this control requirement mandates that the Qualified User have some control over the rates charged for use of the Managed Property, such as the room rates for a hotel. 2017-13 finds sufficient control of rates if the Qualified User expressly approves the rates or approves a general description of the methodology for setting the rates, such as setting hotel room rates using specified revenue goals based on comparable hotels.

Some observations: First, 2017-13 retains the surprising rule in 2016-44 that states that the employees of a Service Provider are related to the Service Provider. This means that Management Contracts that call for the Qualified User to reimburse the Service Provider's costs must be carefully reviewed. Second, note that the Managed Property is the portion of the "project", as defined in Regs § 1.141-6, that is bond-financed. Thus, in addition to analyzing what will constitute the project for purposes of allocating away from facilities that have private business use problems, issuers and borrowers will also need to consider the impact their definition of the "project" will have on their Management Contracts and should work with their bond counsel to consider all of the possible consequences in determining the scope of the bond financed project. Third, 2017-13 does not provide any guidance as to when a Management Contract is materially modified and therefore deemed to be a new Management Contract. Fourth, while the clarification about the life of land and when to incorporate it is helpful, 2017-13 retains the same rule that the term of a Management Contract cannot exceed 80% of the remaining life of the Managed Property. Unless the relevant bonds are already retired, this will often make it very difficult to implement a Management Contract near the end of the life of the Managed Property because the 80% constraint cannot be satisfied. Fifth, issuers and borrowers can choose to continue to use the 97-13 rules for Management Contracts executed before August 18, 2017. This date is just a few days earlier than the August 22, 2017 cut-off date previously found in 2016-44.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors.

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