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IRS Releases New Management Contract Safe Harbors For Bond-Financed Property

By: Todd L. Cooper, Jennifer C. Mendonca and Mark-David Adams

On August 22, 2016, the Internal Revenue Service (IRS) released Revenue Procedure 2016-44 (2016-44) and then modified 2016-44 on September 2, 2016. This revenue procedure was a response from the IRS to a longstanding request from the issuers of tax-advantaged bonds to modernize the old and overly restrictive management contract safe harbors found in the now superseded Rev. Proc. 97-13 (97-13), including the modestly helpful subsequent modifications of 97-13. A State, local government, or non-profit entity (Qualified User) that funds projects with tax-advantaged bonds will find far greater flexibility from the new safe harbors 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 no law or regulation is perfect and there will be many new questions, the tax-advantaged bond community was uniform in its praise of 2016-44 as a significant step forward.

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. 2016-44 provides that a Management Contract nonetheless will not give rise to private business use if the safe harbors set forth in 2016-44 are met.

The following is a very brief list of those requirements:

1. The compensation to the Service Provider must be reasonable.
2. The Management Contract cannot allow the Service Provider to share in the net profits of the Managed Property. This requirement is a holdover from 97-13.
3. The Management Contract must not require the Service Provider to bear any net losses from 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 for 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.



Some observations: First, while 2016-44 generally provides greater flexibility from a legal perspective, Qualified Users should not necessarily alter their sound business practices in negotiating contract terms as a result of the existence of these safe harbors. Second, 2016-44 may require redrafting of certain provisions in existing management contracts if the Qualified User chooses to apply these new safe harbors to those contracts. Third, please note that in many cases the property that is managed by a Service Provider may only be partially bond-financed property. Conversely, the Managed Property may only be a portion of what is bond financed. For instance, a large university may have bond financed a portion of its student union, while the entire student union is managed by a Service Provider. In measuring private business use where there is a non-compliant contract, the Qualified User may need to analyze how bond-financed facilities overlay managed facilities. Fourth, 2016-44 was designed to and should help facilitate greater interaction between Qualified Users and private partners when that is desirable. This interaction often takes the form of what are broadly described as Public-Private Partnerships or P3's, including (i) greater integration of hospitals and non-employee physicians in providing healthcare services and (ii) bringing private expertise to the design, construction and operation of publicly owned facilities such as bridges, toll roads, airports, seaports, water treatment and distribution facilities, and sewage treatment and collection facilities.

Like all of the other aspects of 2016-44, the effective date provisions are very flexible. 2016-44 is effective for contracts entered into on or after August 22, 2016. But a Qualified User may choose to apply these safe harbors to a contract executed prior to August 22, 2016. On the other hand, while it is not likely to be chosen in most circumstances, a Qualified User may continue to apply 97-13, as modified and amplified, to contracts executed prior to August 18, 2017 and not materially modified or extended on or after that date.

The discussion above is intended only as a brief summary of a complex rule and does not constitute legal advice. Please contact any of the Locke Lord public finance tax lawyers listed below or your Locke Lord bond lawyer for further information and analysis of the application of 2016-44.

Todd L. Cooper | 513-688-8434 or 617-239-0160 | todd.cooper@lockelord.com

Jennifer C. Mendonca | 617-239-0845 | jennifer.mendonca@lockelord.com

Mark-David Adams | 561-820-0281 | mark.adams@lockelord.com



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