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## IRS Issues New Management Contract Safe Harbors

Almost 20 years ago, the IRS released Rev. Proc. 97-13, outlining multiple safe harbors under which a management contract would not result in private business use of bond-financed proceeds. These safe harbors, while helpful, were somewhat rigid. The IRS provided issuers with more flexibility in compensation arrangements and ease of application with an additional safe harbor set forth in Notice 2014-67.

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With its recent release of [Rev. Proc. 2016-44](#), the IRS has revised the management contract safe harbors once again to further liberalize permissible compensation arrangements. However, this liberalization is coupled with some additional constraints and considerations.

### Background on Management Contract Safe Harbors

Under Rev. Proc. 97-13, the analysis of whether a management contract gave rise to private business use required calculating the percentages of fixed and variable compensation, with permissible ratios dependent on the term of the contract. Notice 2014-67 offered a more user-friendly and less formulaic approach, granting safe harbor to any combination of acceptable compensation arrangements so long as the term of the contract did not exceed five years. Under no circumstances could compensation to a service provider be based on net profits of the operation of the facility. In addition, the service provider could not have any role or relationship with the issuer, which substantially limited the issuer's ability to exercise its rights under the contract.

### New Safe Harbor Provisions and Requirements

- **Form of Payment and Contract Length.** Unlike earlier guidance, which specified the forms of payment and the maximum terms of the contracts related to each form, the safe harbor under Rev. Proc. 2016-44 permits any type of reasonable fixed or variable compensation for services provided pursuant to a management contract with a term of up to the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property.
- **Payment Cannot Be Based on Net Profits.** Payments still are subject to the requirement that they not be based on a share of net profits. For this purpose, however, incentive compensation is not treated as based on a share of net profits if the eligibility for the incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity (subject, of course, to the general rules relating to reasonable compensation and the length of the contract).
- **Expense Reimbursements Are Excluded.** In addition, Rev. Proc. 2016-44 specifies that an "eligible expense reimbursement arrangement" does not give rise to private business use. An eligible expense reimbursement arrangement is one in which a service provider is compensated only by reimbursement of its actual and direct expenses paid to unrelated parties and its reasonably related overhead expenses.

## Additional Requirements

The IRS, however, added a few additional requirements.

(1) **Service Provider Cannot Bear Net Losses.** The prohibition against compensation based on net profits of the facility's operation remains in place. But the new safe harbor also requires that the service provider cannot bear the burden of any net losses from the operation of the managed property. This requirement will be met if (a) the service provider's compensation is not based on net losses or both revenues and expenses of the managed property, and (b) the timing of compensation payments to the service provider are not dependent on the property's net losses. A contractual reduction in compensation by a stated dollar amount due to a provider's failure to maintain expenses below a specified target is permitted.

(2) **Qualified User Bears Risk of Property Loss.** The qualified user (generally, the §501(c)(3) borrower or governmental user) and not the service provider must bear the risk of loss due to damage or destruction of the managed property. The qualified user may insure against this loss and may also impose a penalty upon the service provider for failure to operate the managed property according to contractual standards.

(3) **Qualified User Must Control Use of the Property.** The qualified user must be able to demonstrate that it has a significant degree of control over the use of the managed property. This requirement is met if, with respect to the managed property, the contract requires the qualified user to approve the annual budget, capital expenditures, each disposition of related property, rates charged for use, and the general nature and type of use (e.g., the type of services provided to the managed property).

(4) **No Inconsistent Tax Positions by the Service Provider.** The service provider may not take any tax position inconsistent with being a service provider (e.g., the service provider cannot take any depreciation or amortization with respect to the managed property).

(5) **Relationship Between the Parties.** Rev. Proc. 2016-44 restates that the service provider cannot have any role or relationship with the issuer that could substantially limit the issuer's ability to exercise its rights under the contract. To meet the safe harbor for this requirement: (a) the service provider may not have more than 20% of the voting power of the governing body of the issuer, (b) neither the CEO of the service provider nor the chairperson of the governing body of the service provider serves on the governing body of the issuer, and (3) the CEO of the service provider is not the CEO of the issuer or any of the issuer's related parties.

(6) **No Safe Harbor for Pre-Operating Services.** The definition of management contract under Rev. Proc. 2016-44 specifically excludes any contract or portion of a contract for services provided before a managed property is placed in service (e.g., contracts for construction management).

**Functionally Related and Subordinate Property.** Finally, Rev. Proc. 2016-44 clarifies that any use of property by a service provider that is functionally related and subordinate to its services under a compliant management contract does not give rise to private business use (e.g., use of storage areas to store necessary equipment).

## Effective Date

Rev. Proc. 2016-44 applies to any contracts entered into on or after August 22, 2016, and may be applied to any contracts entered into before August 22, 2016. The prior safe harbors in Rev. Proc. 97-13 and Section 3.02 of Notice 2014-67 may continue to be applied to management contracts entered into prior to August 18, 2017 (if not materially modified or extended after such date). This revision made by the IRS, as of September 2, 2016, reflects a six month extension from the previous date of February 18, 2017.

## Possible Pitfalls

The new safe harbor is a significant improvement over the current guidance, and generally provides guidelines that are flexible and easy to administer. However, the safe harbor raises new questions, such as (1) how the qualified user assures itself that the amount of compensation paid is reasonable, (2) the determination of the amount of control that the qualified user must exercise on an ongoing basis over the service provider's activities with respect to the bond-financed property, and (3) what happens if the qualified user enters into the management contract near the end of the managed useful life? As with all new guidance and regulations issued by the IRS, only time will tell how these aspects of the new rules will be applied and interpreted.

If you have any questions about Rev. Proc. 2016-44 or about private business use and management contracts in general, please contact [Loretta Richard](#) or [Amy Goebel](#).