New Tax-Exempt Bond Management Contract Safe Harbors: Rev. Proc. 2016-44

Opportunities and Pitfalls

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Why is the new guidance important?

- Application to tax-exempt governmental bonds and qualified 501(c)(3) bonds
- 10% or 5% limits on private business use apply, subject to other rules
- “Management contract” is the term used for virtually all service contracts
- Avoiding private business use contracts is often easier than monitoring and measuring private business use
- For certain types of tax-exempt bonds, analysis of whether a management contract results in private business use is the most important tax question

Overview

- The new guidance sets forth a different framework than the existing guidance (Rev. Proc. 97-13, as amended)
- The new guidance is in many ways much more flexible than Rev. Proc. 97-13, but in other ways more restrictive
- In general, the new guidance is more favorable for longer term management contracts (such as contracts for infrastructure), but could be more burdensome for certain types of shorter term contracts

Effective dates

- The new Rev. Proc. 2016-44 safe harbors can be used immediately
- Rev. Proc. 97-13, as amended, can be relied upon for contracts entered into before August 18, 2017 and not materially modified after that date
- A special transition rule also provides grandfathering for contracts extended pursuant to an option in the contract
- The original end date for transition relief (February 18, 2017) was extended six months, reflecting an IRS acknowledgement that the new safe harbors could result in some tax compliance problems

Brief history of management contract safe harbor guidance

- First revenue procedures in early 1980s
- Management contracts described as a type of private business use in legislative history
- Section 1301(e) of the Tax Reform Act of 1986 directed a safe harbor for 5-year contracts having 50% fixed fee compensation
- Major private business use regulations and Rev. Proc. 97-13 were published at the same time in 1997
- Notice 2014-67 provided more flexible safe harbors for contracts having a term not more than five years

What does a "safe harbor" mean?

- The substantive standard in the regulations has not changed since 1997
- Provides protections to issuers and borrowers, but should not properly be used by IRS agents as the standard for what is private business use
- The rules in the regulations have priority over a revenue procedure safe harbor
- Contracts not meeting all of the new requirements could still be reasonably determined not to result in private business use

What do the regulations say?

- "A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services based, in whole or in part, on a share of net profits from the operation of the facility"
- Certain contracts meet exceptions (e.g., contracts that are "solely incidental"; contracts where the only compensation is "reimbursement to the service provide of actual and direct expenses")
- A management contract results in private business use "if the service provider is treated as the lessee or owner of financed property for federal income tax purposes"
- Otherwise, a vague "facts and circumstances" test applies
- Rev. Proc. 2016-44 does not change the rules in the regulations, and must be considered in the context of these regulations

A new "principles-based" framework

- Safe harbors based on "fixed fee" compensation are superseded
- Up to 30-year term permitted
- Rule that the contract can't have a term more than 80% of the reasonably expected economic life of the managed property is retained and extended
- New requirements relating to (1) control, (2) no bearing of net losses, (3) risk of loss, and (4) no inconsistent tax position

Rev. Proc. 2016-44 sets forth two new safe harbors

- Rev. Proc. 2016-44 sets forth two new safe harbors: (1) a 30-year "principles-based" safe harbor and (2) a safe harbor for "eligible expense reimbursement arrangements"
- Most of this discussion focuses on the new 30-year safe harbor, although we also will discuss the safe harbor for "eligible expense reimbursement arrangements"

"New" requirements for shorter term contracts

- The safe harbor set forth in Rev. Proc. 97-13, as amplified by Notice 2014-67, does not set forth many of the requirements in Rev. Proc. 2016-44 for contracts having a term not greater than five years
- (1) 80% economic life term limit; (2) control; (3) no bearing net losses; (4) risk of loss of managed property; (5) no inconsistent tax position
- The new requirements of "control" probably raise the most practical problems

"Net profits arrangements" – a somewhat strict rule

- "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"
- For this purpose, the elements of compensation are "*the eligibility for, the amount of, and the timing of payment for compensation*"
- This rule does not apply to reimbursement of actual and direct expenses
- Incentive compensation is permitted if the eligibility is determined by the provider's performance in meeting one or more standards "that measure quality of services, performance, or productivity" if the other requirements are met

Implications of the "no net profits arrangements" rule

- The new rule broadly treats any provision that triggers compensation based on a net profits standard as not meeting the safe harbor; the compensation itself does not need to be a percentage of net profits
- The IRS released a private letter ruling in 2016 under which such a "net profits" trigger was permitted under Rev. Proc. 97-13
- IRS officials have stated that the conclusion in the 2016 private letter ruling would still apply, but that conclusion is not clear under the new wording in Rev. Proc. 2016-44
- This rule in the safe harbor should not necessarily be read as an interpretation of the rule in the regulations

Control over use 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 financed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for use of the managed property, and the general nature and type of use of the managed property (for example, the type of services)
- The five listed "control" factors appear to be requirements; that is, the five factors apparently are not a safe harbor within the safe harbor

Control over use of managed property further explained

- Rev. Proc. 2016-44 sets forth a further explanation of the five factors that apparently is intended to somewhat soften the strictness of the control requirement
- A qualified user may show approval of capital expenditures by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts
- A qualified user may show approval of dispositions of property in a similar manner
- A qualified user may show approval of rates charged "by either expressly approving such rates (or the methodology for setting such rates) or by including in the contract a requirement that the service provider charge rates that are reasonable and customary as specifically determined by an independent third party"

The control requirement: interpretation and implications

- May be the new requirement that raises the most questions
- Many shorter term contracts customarily treated as meeting a Rev. Proc. 97-13 safe harbor do not appear to meet all factors of this control requirement (for example, approval of rates)
- For approval of rates, what contract terms will qualify as a "methodology for setting" rates? What types of entities will qualify as an "independent third party" to approve rates that are required to be "reasonable and customary"?
- Further public statements by IRS and Treasury officials may be important
- Standards may be developed for positions that contracts do not necessarily need to meet all of the control factors, if other facts and circumstances are present

No bearing of risk of net losses of the managed property

- The contract must not, in substance, impose on the service provider the burden of bearing any share of net losses from the operation of the managed property
- An arrangement will not be treated as requiring the service provider to bear a share of net losses if (1) the determination of the amount of the service provider's compensation and the amount of any expenses paid by the service provider (and not reimbursed), separately and collectively, do 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 (2) the timing of the payment of compensation is not contingent upon the managed property's net losses
- This requirement is framed in a manner similar to the "no net profits arrangement" requirement, and also does not permit provisions that trigger compensation, but are not based in amount on net losses

No bearing of net losses further explained

- Rev. Proc. 2016-44 sets forth a further explanation of the no bearing of net losses requirement apparently is intended to somewhat soften the strictness of the requirement
- A service provider whose compensation is reduced by a stated dollar amount (or one or more 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 this reduction

Risk of loss of the managed property

- The qualified user must bear the risk of loss upon damage or destruction of the managed property
- A qualified user does not fail to meet this risk of loss requirement as a result of insuring against risk of loss through a third party or imposing upon the service provider a penalty for failure to operate the managed property in accordance with standards set forth in the contract

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
- For example, the service provider must agree not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property
- This appears to require that specific provisions be included in management contracts that do not appear in many existing management contracts
- Question: is it now a good idea to include these "magic words" in all service contracts, regardless of term?

Expanded application of the "80% of economic life" rule

- For contracts having a term of 10 years and longer, the Rev. Proc. 97-13 safe harbors require that the contract term not be greater than 80% of the reasonably expected useful life of the financed property
- Rev. Proc. 2016-44 requires for all contracts, regardless of term, that the term not be greater than 80% of the "weighted average reasonably expected economic life of the managed property"
- Rev. Proc. 97-13 refers to 80% of the "useful life of the financed property"; the implications of this reframing of the requirement are not entirely clear
- Rev. Proc. 2016-44 further provides that average weighted reasonably expected economic life is determined in the same manner as the bond maturity limitations (the "120% test) that applies to qualified 501(c)(3) bonds and that a contract that is materially modified is "retested as a new contract"
- Application of this rule to shorter term contracts possibly will raise compliance burdens

No circumstances substantially limiting the exercise of rights

- Like Rev. Proc. 97-13, Rev. Proc. 2016-44 requires that 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
- Also like Rev. Proc. 97-13, Rev. Proc. 2016-44 provides for a "safe harbor within the safe harbor" focusing on whether the service provider has any significant control relationships over the qualified user
- Rev. Proc. 2016-44 continues the rule that the "safe harbor within the safe harbor" is met if the qualified user has no more than 20% of the control of the governing board of the qualified user and if there is no overlap involving the chief executive officer or chairperson
- Rev. Proc. 2016-44, however, frames this "safe harbor within the safe harbor" somewhat more strictly, because it now refers to taking into account related parties for this purpose, and refers to executives that are equivalent to the chairperson or chief executive officer
- Because the somewhat stricter rule in Rev. Proc. 2016-44 are contained in the "safe harbor within the safe harbor", this rule will likely be interpreted more flexibly than the other requirements of Rev. Proc. 2016-44

New favorable rule for functionally related and subordinate use

- Rev. Proc. 2016-44 provides that a service provider's use of a project that is functionally related and subordinate to performance of services under the management contract that otherwise meet a Rev. Proc. 2016-44 safe harbor does not result in private business use
- For example, use of storage areas to store equipment used to perform activities does not result in private business use

Management contracts that are leases in substance result in private business use

- Rev. Proc. 2016-44 references the rule in the regulations that provides that the lease of financed property to a nongovernmental person is private business use
- For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease
- A longstanding question, therefore, is whether any arrangements labelled as "service contracts" could be characterized as leases by the IRS

How does Rev. Proc. 2016-44 address the lease question?

- Rev. Proc. 2016-44 further references the rule in the regulations that provides that in determining whether a management contract is properly characterized as a lease, it is necessary to consider all the facts and circumstances, including the following factors: (1) the degree of control over the property that is exercised by the service provider; and (2) whether the service provider bears risk of loss of the financed property
- Rev. Proc. 2016-44 does *not* expressly provide protection on the question of whether a management contract should be treated as a lease
- Because the Rev. Proc. 2016-44 focuses on similar factors, such as control and risk of loss, however, as a practical matter any management contract meeting the requirements should be protected from such characterization
- One possible problem is that Rev. Proc. 2016-44 may heighten the IRS focus on this question for contracts not exactly meeting the new safe harbor

Eligible expense reimbursement arrangements

- Rev. Proc. 2016-44 provides for a second safe harbor for "eligible expense reimbursement arrangements"
- An eligible expense reimbursement arrangement is a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider
- This is an expansion of an exception set forth in the regulations that previously only applied in special circumstances

Dealing with Rev. Proc. 2016-44: fewer bright lines

- In general, Rev. Proc. 2016-44 sets forth fewer "bright lines" than Rev. Proc. 97-13 and likely will require more interpretation by issuers, borrowers and counsel
- The entirely new "principles-based" framework likely will raise new interpretive questions; a consideration of case law precedent may be more important than before
- There may be more need than under Rev. Proc. 97-13 to adopt positions that contracts that do not exactly meet all of the safe harbor requirements still do not result in private business use under the facts and circumstances

Dealing with Rev. Proc. 2016-44: problems for shorter term contracts?

- In general, Rev. Proc. 2016-44 is much more flexible for longer term contracts, but could create practical problems for many shorter term contracts
- The "one size fits all" approach of Rev. Proc. 2016-44 applies the same requirements, regardless of the term of the contract

Dealing with Rev. Proc. 2016-44: bond document covenants

- Tax covenants in bond documents referencing Rev. Proc. 97-13 will need to be interpreted in light of Rev. Proc. 2016-44 "superseding" Rev. Proc. 97-13
- A best practice to consider may be to avoid tax covenants that require strict compliance with management contract safe harbors, particularly because Rev. Proc. 2016-44 has fewer "bright lines" than Rev. Proc. 97-13, and may require more interpretation

Dealing with Rev. Proc. 2016-44: strategies for private business use

- Because Rev. Proc. 2016-44 possibly may cause tax compliance questions for certain types of management contracts, strategies for private business use compliance may be important
- In particular, the private business use allocation and accounting regulations published in 2015, which provide for favorable rules for eligible mixed-use projects, may be even more important for tax planning (that is, planning to allocate any possible private business use to the portions of a project financed with qualified equity)
- In some cases, issuers and borrowers may be able to reconsider whether management contracts that have been treated as resulting in private business use of outstanding bonds can now be treated as resulting in qualified use, in the context of refundings or otherwise

Getting ready for the sunset: what to do before August 18, 2017

- For the transition period, issuers and borrowers can rely on either of the safe harbors
- If the new safe harbors may raise problems for particular contracts, one approach may be to (1) enter into those contracts before August 18, 2017 and/or (2) insert renewal options into existing contracts before that date
- Issuers and borrowers might need to adopt procedures flagging which contracts are, and are not, grandfathered under Rev. Proc. 97-13
- A best practice may be to insert the “magic words” relating to the service provider’s tax position in all new contracts as soon as possible