

# KROKIDAS & BLUESTEIN

## ATTORNEYS

### CLIENT ALERT

#### ORGANIZATIONS WITH TAX-EXEMPT BOND FINANCING

##### NEW “SAFE HARBOR” FOR MANAGEMENT & SERVICE CONTRACTS

Section 501(c)(3) organizations and governmental entities (“Qualified Users”) which have obtained tax-exempt bond financing for their facilities are subject to strict limitations on the “private business use” of these facilities under federal law. If contracts for the private business use of these facilities exceed these limitations, then the tax-exempt bonds may become taxable. Among the types of contracts which may be considered impermissible private business use are management contracts, cafeteria and food service contracts, and any contract that includes a bonus or incentive compensation. The Internal Revenue Service (“the IRS”) has developed a safe harbor rule whereby contracts of Qualified Users complying with the rule’s terms will not be considered as private business use. This Client Alert will discuss a recent revamping of this safe harbor rule.

For almost two decades, Qualified Users followed a safe harbor rule known as Rev. Proc. 97-13, which was revised slightly in 2001 and 2014. When the guidelines of Rev. Proc. 97-13 were followed, a Qualified User could be certain that its management and services contracts would not be treated as private business use. A number of Qualified Users found the guidelines of Rev. Proc. 97-13 overly restrictive in a manner that did not seem to further statutory interests. In an apparent effort to liberalize the safe harbor rules, the IRS released Rev. Proc. 2016-44, which outlined a new version of the safe harbor rules. However, Rev. Proc. 2016-44 appeared to prohibit arrangements formerly permitted by Rev. Proc. 97-13, and raised a number of other questions. To address these issues, the IRS recently released Rev. Proc. 2017-13 which modifies, amplifies and supersedes the prior revenue procedures.

Rev. Proc. 2017-13 applies to any management or services contract entered into on or after January 18, 2017. An issuer of tax exempt bonds may choose to apply Rev. Proc. 2017-13 to any management or services contract entered into before that date, or the issuer may rely on the old safe harbor under Rev. Proc. 97-13 (as modified in 2001 and 2014) until August 17, 2017. Any management or services contract materially modified or entered into on or after August 18, 2017 will be subject to new Rev. Proc. 2017-13.

##### **What has NOT changed under Rev. Proc. 2017-13?**

- *General private business use guidelines* – Rev. Proc. 2017-13 only modifies the safe harbor under which a management or services contract will not be treated as private business use. It

does not alter the substantive rules, including the exceptions to private business use set forth in the regulations issued by the U.S. Department of Treasury (the “Treasury Regulations”) regarding when use of tax-exempt bond-financed property will be treated as private business use.

- *Failure to satisfy safe harbor* – The updated safe harbor under Rev. Proc. 2017-13, like the safe harbor under Rev. Proc. 97-13, is a way to obtain certainty that a management or services contract will not be considered to constitute private business use; failure to satisfy the safe harbor does not automatically result in that contract being treated as private business use.

### **What HAS changed under Rev. Proc. 2017-13?**

The updated safe harbor rule establishes six requirements that a management or services contract must satisfy:

#### **1. General Financial Requirements:**

- A. *Compensation formula* – Under the updated safe harbor rule, a management or services contract may include any type of compensation, whether fixed or variable, as long as the compensation is reasonable for the services that are provided under the contract.
- B. *Net profits* – The management or services contract cannot provide for compensation that takes into account, or is contingent upon, the net profits or both the revenues and expenses of the portion of the tax-exempt bond-financed facility which is subject to the management or services agreement (the “Contracted Space”).
- C. *Net losses* – The management or services contract cannot impose the burden of any net loss from the operation of the Contracted Space on the person or entity contracted to provide the services (the “Service Provider”). This requirement is met if:
  - The calculation of how much the Service Provider will be paid and the portion of the expenses that the Service Provider will be expected to pay under the contract, separately and collectively, do not take into account the Contracted Space’s net losses or both the revenues and expenses of the Contracted Space; and
  - The timing of the payment to the Service Provider is not contingent upon the Contracted Space’s net losses.
- D. *Methods of compensation for services* – Rev Proc. 97-13 provided that certain methods of compensation for services would not be treated as offering a share of net profits or requiring the service provider to bear a share of net losses. New Rev. Proc. 2017-13 continues this rule. As further explained in Rev. Proc. 2017-13, the following methods of compensation continue to be permitted:
  - Compensation based solely on a capitation fee, a periodic fixed fee, or a per-unit fee;
  - Certain types of incentive compensation; or

- A combination of these types of compensation.

*E. Timing of Compensation-* A deferral of the payment of compensation due to insufficient cash flows will not cause the compensation to be treated as contingent upon net profits or net losses as long as it meets the following requirements:

- The compensation is payable at least annually;
- The Qualified User will be subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees; and
- The Qualified User will pay such deferred compensation (with interest or late payment fees) no later than the end of five years after the original payment due date.

## **2. Term of Contract**

The term of the management or services contract cannot be longer than 80% of the weighted average of the reasonably expected useful life of Contracted Space, and no longer than 30 years.

## **3. Control over Contracted Space**

The Qualified User must exercise a significant degree of control over the Contracted Space. This requirement is met if the management or services contract requires the Qualified User to approve the following items:

- The annual budget under the contract;
- Capital expenditures under the contract, or an annual budget which describes capital expenditures by functional purpose and specific maximum amounts;
- Any disposition of property that is part of the Contracted Space;
- The rates charged under the contract, or a general description of the methodology used in setting such rates; alternatively, the contract may include a requirement that the Service Provider charge reasonable and customary rates established by a third party; and
- The general nature and type of services provided pursuant to the contract.

## **4. Risk of Loss**

A management or services contract cannot require the Service Provider to bear any risk of loss if the Contracted Space is damaged or destroyed, but the Qualified User may insure against any potential loss and may impose a penalty on the Service Provider if it fails to operate the Contracted Space in accordance with the standards established under the contract.

## **5. Inconsistent Tax Position**

The Service Provider must agree in the management or services contract not to take a tax position that is inconsistent with its role of providing services or managing the Contracted

Space. For example, the service provider may not take depreciation, amortization, investment tax credit, or deduction for any payment as rent with respect to the Contracted Space.

## 6. **No Limitation on Exercise of Rights**

The Service Provider cannot have a relationship or role with the Qualified User that will substantially limit the Qualified User's ability to exercise its rights under the management or services contract. New Rev. Proc. 2017-13 makes clear that this requirement will be satisfied if:

- No more than 20% of the voting power of the Qualified User's governing board is vested in the directors, officers, shareholders, partners, members, and employees of the Service Provider and its "Related Parties" (as that term is defined in the Treasury Regulations);
- The Qualified User's governing board does not include the chief executive officer of the Service Provider and its Related Parties or the chairperson of the governing board of the Service Provider or its Related Parties; and
- The chief executive officer of the Service Provider or its Related Parties is not the chief executive officer of the Qualified User or any of that entities' Related Parties.

*Functionally related and subordinate use* - A service provider's use of a project that is functionally related and subordinate to the performance of its services under a management or services contract for the managed property that meets the safe harbors of Rev. Proc. 2017-13 does not result in private business use. For example, the use of storage areas for equipment used to perform activities required under a service contract that meets the safe harbors does not result in private business use.

For additional information or assistance with developing contract review procedures, please contact attorneys Elka Sachs at [esachs@kb-law.com](mailto:esachs@kb-law.com) or Brittany Besler at [bbesler@kb-law.com](mailto:bbesler@kb-law.com).