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DEPARTMENT OF THE TREASURY RELEASES MANAGEMENT AND SERVICE CONTRACT GUIDANCE

On August 22, 2016, the Department of the Treasury ("Treasury") published Revenue Procedure 2016-44 (the "Revenue Procedure") providing guidance regarding management and service contracts. This memorandum summarizes the Revenue Procedure which can be found electronically <u>here</u>.

Background

Interest on a state or local bond is not excluded from gross income if the bond is part of an issue of "private activity bonds" unless the bonds meet additional requirements to be qualified private activity bonds. Bonds are private activity bonds if the bonds and/or the property financed with bond proceeds (a) meets both the private business use test and the private security or payment test, or (b) meets the private loan financing test. The Revenue Procedure addresses components of the private business use test. The private business use test is generally met if more than 10 percent of the proceeds of an issue (5 percent for unrelated uses) are used for a private business use (low limits exist for certain types of use of the proceeds of tax-exempt bonds for 501(c)(3) organizations). Private business use is a broad concept, and encompasses certain uses, such as leases, certain operating or service contracts, and concession arrangements, among others, by persons or entities of bond proceeds, or property financed with bond proceeds, who are not state or local governmental units or users of property as members of the general public.

The Treasury Department and the IRS have always recognized that private entities can play important roles in providing services to state and local governments and nonprofits, such as organizations described under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended ("Qualified Users") with respect to their bond-financed facilities. Certain safe harbors were created in order to allow Qualified Users to enter into management and service contracts (collectively, "Management Contracts") with private entities ("Managers") without creating private business use. Those safe harbors are highly technical, particularly as they relate to compensation and term requirements and limitations.

The Revenue Procedure

The Treasury Department released the Revenue Procedure in response to industry comments, requesting longer, more flexible safe-harbors for Management Contracts to address current needs of Qualified Users, including to facilitate certain public/private partnerships. The Revenue Procedure creates a more principles-based approach to Management Contract safe harbors. There are two primary safe harbors set forth in the Revenue Procedure. First, an "expense reimbursement" contract safe harbor, and second, a more general safe harbor.

- (a) Expense reimbursement contract safe harbor. The first safe harbor provided under the Revenue Procedure is an expense-based contract safe harbor (the "Reimbursement Contract Safe Harbor"). Under the Reimbursement Contract Safe Harbor, a Management Contract will not create private business use if the only compensation paid to the Manager under the contract consists of reimbursements of actual and direct expenses paid by the Manager to unrelated parties and reasonable related overhead expenses of the Manager. There is no term limit specified for this safe harbor.
- (b) General safe harbor. Under the more general safe harbor provided under the Revenue Procedure, a Management Contract will not create private business use if the contract meets each of the following elements:

- (i) <u>Financial requirements</u>. All compensation paid to the Manager under the contract must be reasonable, and no portion of the compensation can be based on a share of the net profits from the bond-financed property. Incentive compensation is allowed, so long as the incentive is tied to the Manager's performance in meeting, generally, qualitative metrics. Additionally, the Manager may not bear the risk of sharing in any net losses from the operation of the financed property. A safe harbor is provided for determining whether the Manager bears the risk of net losses from the operation of the financed property. This requirement is more flexible than previous IRS safe-harbors that specified detailed formulas for compensation. Thus, the Revenue Procedure appears to permit gross revenue sharing, fixed fees, unit fee pricing, and certain availability fee (P3) arrangements, among others arrangements.
- (ii) <u>Term Limitation</u>. The term of the Management Contract may not exceed the lesser of 30 years or 80% of the weighted average economic life of the financed property. The longer potential term length is markedly different from previous safe-harbors.
- (iii) <u>Control of Managed Property</u>. The Qualified User must exercise a significant degree of control over the financed property. This requirement is treated as met where the Qualified User is required to approve the annual budget of the managed property, capital expenditures with respect to the managed property, disposition of any portion of the managed property, rates charged for the use of the managed property, and the general nature and type of use of the managed property. These control factors are typically retained by governmental issuers; however, this is a new requirement.
- (iv) <u>Risk of Loss</u>. The Qualified User must bear the risk of loss of the managed property. The Qualified User can generally insure such risk without violating the safe harbor.
- (v) <u>No Inconsistent Tax Positions by Manager</u>. The Manager must agree to not take any tax position that is inconsistent with being a service provider. For example, the Manager cannot take depreciation with respect to the financed facility.
- (vi) <u>No Limiting of Qualified User's Rights</u>. The Qualified User's rights with respect to the managed property cannot be substantially limited. Generally, this element is treated as satisfied if the Manager and the Qualified User do not have any significant overlap in officers and board members (generally, no more than 20% overlap in board members, and no overlap of the CEO or the equivalent officer of the Manager).
- (vii) <u>Functionally Related and Subordinate Use</u>. Use of financed property that is functionally related and subordinate to use of property pursuant to a Management Contract that meets one of the safe harbors described above is not private use of that property. For example, use of storage space to store equipment that is used in performance of services pursuant to a Management Contract that satisfies one of the safe harbors will not be treated as private business use.

Effective Date

The Revenue Procedure is effective for Management Contracts entered into on or after August 22, 2016. While a Qualified User may elect to apply the new safe harbors, it may also utilize the previously released safe-harbors for contracts entered into before August 22, 2016. A Qualified User may also generally apply the previous safe harbors to arrangements entered into before February 18, 2017 that are not materially modified after such date.

Conclusion

The new Revenue Procedure presents opportunities for Qualified Users to adopt more flexible, longer-term, arrangements with Managers. Seeking expert guidance is prudent when considering potential arrangements involving tax-exempt bond financed property. We note that, in addition to the Revenue Procedure, other exceptions exist to avoid satisfying the private business use test, such as for certain short-term arrangements of fifty days or less. For questions about the Revenue Procedure or any other matters, please contact your primary Stradling public finance attorney, Carol L. Lew at clew@sycr.com or (949) 725-4237 or Darren C. McHugh at dmchugh@sycr.com or (720) 616-6980.