501(c)(3) Bonds and Qualified Management Contracts

When a facility is financed with the proceeds of governmental bonds or qualified 501(c)(3) bonds, the facility is subject to certain limits on private business use. Private business use can result from a number of different arrangements, including a management contract, incentive pay contract, operation or service contract involving all, a portion of, or any function of the facility (a "Management Contract"). For example, with respect to a bond-financed hospital, a contract to provide management services for the entire hospital, a contract for management services for a specific department of the hospital, and an incentive payment contract for physician services to patients of the hospital are each treated as a Management Contract. Other examples include a concessions arrangement for an arena or stadium or a little league ballpark; an operations agreement with respect to a campus bookstore or a cafeteria at a school; or an operations agreement with respect to a treatment facility for a public wastewater system.

A Management Contract generally results in private business use of the managed property if (i) the contract gives the service provider an ownership or leasehold interest in the managed property (or an interest in the nature of an ownership or leasehold interest) or (ii) the contract provides for compensation for services based, in whole or in part, on a share of net profits from the operation of the managed property. However, a Management Contract does *not* result in private business use if it meets all of the "safe harbor" requirements established by the IRS. In Revenue Procedure 2017-13, the IRS updated the safe harbor requirements for all Management Contracts entered into or materially modified after August 18, 2017.

The current safe harbor requirements relate to: (1) general financial terms, (2) term of the contract, (3) control of the property, (4) risk of loss, (5) consistent tax positions and (6) exercise of rights.

Requirement 1: General Financial Terms.

First, the service provider's compensation must be reasonable and must not be based, in whole or in part, on a share of "net profits" from the operation of the managed property. Compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation (including eligibility for, the amount of, and the timing of the payment) takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses for any fiscal period. For this purpose, any reimbursements of the service provider for actual and direct expenses paid by the service provider to unrelated parties ("Reimbursements") are disregarded as compensation. Incentive compensation will not be treated as providing 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, and the amount and the timing of the payment of the compensation otherwise meet the requirements of the safe harbor.

Revenue Procedure 2017-13 makes clear that compensation (a) based solely on a capitation fee, a periodic fixed fee, or a per-unit fee; (b) certain types of incentive compensation; or (c) a combination of these types of compensation will not be treated as providing net profits. Capitation fee means a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to such persons varies substantially. For example, a capitation fee includes a fixed dollar amount payable per month to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified period. Periodic fixed fee means a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. Per-unit fee means a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Another example of a per-unit fee is a stated dollar amount per meal purchased in a cafeteria.

In a departure from some previous IRS guidance, Revenue Procedure 2017-13 does not directly address gross revenue compensation. Some gross revenue arrangements may not create private business use under the safe harbors; however, many Management Contracts that compensate the service provider with a percentage of gross revenues also require some payment of expenses by the service provider. These arrangements need to be carefully analyzed to determine if they actually provide a share of net profits.

Second, the Management Contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property. An arrangement does not share the burden of net losses if (i) the determination of the amount of the service provider's compensation and the amount of any expenses to be 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 (ii) the timing of the payment of compensation is not contingent upon the managed property's net losses. Deferral of payments due to insufficient net cash flows will not be treated as contingent if: (a) the compensation is payable at least annually; (b) the "Issuer" (either a state or local government or, in the case of qualified 501(c)(3) bonds, a conduit borrower) is subject to reasonable consequences for late payment of compensation, such as reasonable interest charges or late payment fees; and (c) the Issuer pays such deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of the payment.

Requirement 2: Term of the Contract.

The term of the Management Contract, including all renewal options (as defined below), must not be greater than the lesser of 30 years or 80% of the weighted average reasonably expected economic life of

the managed property. For this purpose, economic life is determined as of the beginning of the term of the contract. If 25% or more of the net proceeds of the bonds were used to purchase land, the land is given an economic life of 30 years. “Renewal option” means a provision under which either the service provider or the Issuer has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for one-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

If a Management Contract is materially modified with respect to any matters relevant to the safe harbor provisions, it is retested as a new contract as of the date of the material modification.

Requirement 3: Control of the Property.

The Issuer must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the Issuer to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part 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 (for example, the type of services). For example, the Issuer may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts; and the Issuer may show approval of dispositions of property that is part of the managed property in a similar manner. Further, the Issuer may show approval of rates charged for use of the managed property 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.

Requirement 4: Risk of Loss.

The Issuer must bear the risk of loss upon damage or destruction of the managed property (for example, upon force majeure). However, 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 the standards set forth in the Management Contract will not cause the Issuer to fail to meet this requirement.

Requirement 5: Consistent Tax Positions.

The Management Contract must state that the service provider is not entitled to and will not take any tax position that is inconsistent with being a service provider to the Issuer with respect to the managed property. 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. Many existing Management Contracts will not have this statement, so it should be included in any new contracts and added to existing contracts upon renewal.

Requirement 6: Exercise of Rights.

The service provider must not have any relationship with the Issuer that substantially limits the Issuer's ability to exercise its rights under the contract. The safe harbor requires that:

- No more than 20% of the voting power of the governing body of the Issuer (the "Governing Body") may be vested in the service provider and its shareholders, directors, officers, partners, members, and employees;
- The chief executive officer of the service provider or the chairperson of its governing body may not be on the Governing Body; and
- The chief executive officer of the service provider may not be the chairperson of the Governing Body or the chief executive officer of the Issuer or any of the Issuer's related parties.

Other Exceptions.

In addition, the following arrangements are not treated as Management Contracts giving rise to private business use:

- Incidental Contracts. A contract that is solely incidental to the primary governmental function of a financed facility, including contracts for janitorial, office equipment repair, hospital billing, or similar services.
- Hospital Admitting Privileges. The mere granting of admitting privileges by a hospital to a doctor is not a Management Contract if those privileges are available to all qualified physicians in the area consistent with the size and nature of its facilities.
- Reimbursement Contracts. A contract to provide for services if the only compensation is Reimbursements to the service provider.
- Eligible Expense Reimbursement Arrangement. A contract to provide for services if the only compensation is Reimbursements plus reasonable related administrative overhead expenses of the service provider.

More Flexibility; Fewer Bright Lines.

As compared to previous guidance on Management Contracts, Revenue Procedure 2017-13 offers more flexibility (at least in terms of compensation arrangements) and fewer bright line tests. Although lacking in flexibility, the bright line tests for compensation and contract term provided in previous guidance were generally easy to follow and apply; there was little question about whether a particular compensation arrangement met the terms of the safe harbors. In contrast, determining whether a net profits arrangement exists or whether the qualified user exercises significant control over the property under Revenue Procedure 2017-13 may require a fair amount of legal and factual analysis. This is the price of the additional flexibility of the new safe harbors.

Facts and Circumstances.

The Treasury Regulations state that a Management Contract may result in private business use of the managed property based on all of the "facts and circumstances." Revenue Procedure 2017-13 sets forth safe harbors and guidance for avoiding private business use but does not change the substantive law found in the Code or the Treasury Regulations. As a result, even if a Management Contract does not meet the safe harbors of Revenue Procedure 2017-13, it may not cause private business use problems based on all of the facts and circumstances. In some cases, bond counsel may be comfortable that a Management Contract does not create private business use based on the facts and circumstances. In other cases, an issuer may choose to seek a private letter ruling from the IRS addressing private use issues for Management Contracts outside the safe harbors.

New and Amended Contracts.

Management Contracts entered into or materially modified after August 18, 2017, are subject to the safe harbors in Revenue Procedure 2017-13. Issuers should review any Management Contracts with respect to bond-financed property carefully and consult with bond counsel regarding potential private business use concerns.

If you have any questions regarding the safe harbors for management contracts, please contact us.

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