New Management Contract Safe Harbors

Public Finance Alert

09.01.2016

Related People:
Jeannette M. Bond

The Internal Revenue Service (the “IRS”) released Revenue Procedure 2016-44 (“Rev. Proc. 2016-44”) on August 22, 2016 to provide new safe harbors for management contracts to avoid characterization of such contracts as private business uses of bond-financed property. The new safe harbors reflect an acknowledgment by the IRS that current guidance has not kept pace with the trends in infrastructure and other financing, including public-private partnerships.   This Revenue Procedure will replace Revenue Procedure 97-13, as modified by Revenue Procedure 2001-39 and as amplified by Section 3.02 of Internal Revenue Service in Notice 2014-67 (the “Rev. Proc. 97-13 Guidelines”) but continues its constraints on sharing of net profits and relationships between the parties. It provides a more flexible approach toward compensation for contracts up to 30 years long. It also imposes new requirements for the contracts relating to risk of operational and physical loss, qualified user control over use of property and consistency of tax positions taken by the service provider.

Rev. Proc. 2016-44 abandons the formulaic approach of the Rev. Proc. 97-13 Guidelines that provided for safe harbors for contracts having a term of two to 15 years, depending upon the type of variable fee compensation and the percentage of the compensation that was paid on a fixed fee basis. It establishes in effect two safe harbors from private use. The first safe harbor is an eligible expense reimbursement arrangement, defined as a management contract under which the only compensation consists of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider.

The second safe harbor is a management contract that meets eight requirements. The first three requirements, under the category of general financial requirements, address reasonableness of compensation, no sharing of net profits and no transfer to the service provider of any share of net losses. The term of the contract is limited to the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the property determined at the beginning of the term of the contract. The qualified user must exercise a significant degree of control over the use of the property and must bear the risk of loss upon damage or destruction of the property. The service provider must agree not to take a tax position that is inconsistent with being a service provider. Finally, similar to the Rev. Pro. 97-13 Guidelines, the service provider must not have any role or relationship with the qualified user that substantially limits the qualified user’s ability to exercise its rights under the contract. The new safe harbors are effective with respect to contracts entered into on and after August 22, 2016, but also can be applied to contracts entered into before such date. Issuers and nonprofit 501(c)(3) borrowers may continue to apply the Rev. Proc. 97-13 Guidelines to contracts entered into before August 18, 2017 that are not materially amended or extended on or after that date.