

THE END OF 97-13: IRS RELEASES NEW SAFE HARBOR FOR PRIVATE BUSINESS USE RESULTING FROM MANAGEMENT AND SERVICE CONTRACTS

*Update: The IRS has modified the effective date of Rev. Proc. 2016-44 to extend the transition period by 6 months. The revision allows an issuer to apply the safe harbors in Rev. Proc. 97-13, as modified and amplified, to a management contract entered into before **August 18, 2017** and that is not materially modified or extended on or after August 18, 2017 (other than pursuant to a renewal option as defined in sec. 1.141-1(b)).*

On August 23, 2016, the IRS released Revenue Procedure 2016-44 (the "New Rev. Proc.") regarding safe harbors for avoidance of private business use for management and service contracts. The New Rev. Proc. replaces Revenue Procedure 97-13, as amended and modified ("97-13"). Generally, the New Rev. Proc. allows for contracts of much longer duration (up to 30 years) and eliminates the various formulaic approaches to compensation of 97-13, replacing them with a single safe harbor for all agreements. The New Rev. Proc. applies to contracts entered into or substantially amended on or after August 22, 2016 but may also be applied retroactively. The provisions of 97-13 may continue to be applied to contracts entered into before February 18, 2017, so long as they are not materially modified thereafter.

GENERAL ELEMENTS OF THE NEW REV. PROC.

The New Rev. Proc. provides greater flexibility for structuring management and service contracts with terms in excess of five years; however, some of the aspects of the new safe harbor are more complicated to evaluate and will require the owner of the bond-financed property (the "qualified user") to obtain certain assurances from the service provider.

A contract will meet the safe harbor of the New Rev. Proc. if:

1. Payments to the service provider are reasonable compensation for services rendered. This reasonableness must also apply to any reimbursement of actual and direct expenses paid by the service provider.
2. The service provider is not paid a share of net profits from the operation of the managed property. Compensation will not be treated as a share of net profits if no element of the compensation takes into account, or is contingent upon, the managed property's net profits OR both the managed property's revenues and expenses. All of eligibility for, amount of, and timing of, the payment of compensation are to be considered, but reimbursements of actual and direct expenses paid by the service provider to unrelated parties are not considered compensation.¹ Incentive payments are not treated as a share of net profits if eligibility for payment is based on quality of services, performance or productivity, and the amount and timing of the payment does not take into account net profits.
3. The contract does not impose on the service provider the burden of sharing any net losses from the operation of the managed property (the mirror image of (2), above).
4. The term of the contract, including all renewal options,² is no greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property.
5. The qualified user exercises 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 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 types of services)."
6. The qualified user must bear the risk of loss upon damage or destruction of the managed property.
7. The service provider must agree that it is not entitled to and will not take any tax position inconsistent with being a service provider (for example, no depreciation, amortization, investment tax credit or deduction for any payment as rent with respect to the managed property).

8. There can be no circumstances substantially limiting the qualified user's ability to exercise its rights under the contract. A safe harbor exists to demonstrate no such limitation where: (a) no more than 20 percent of the voting power of the governing body of the qualified user is vested in the directors, officers, shareholders, partners, members and employees of the service provider; (b) the governing body of the qualified user does not include the CEO, chairperson or equivalent executive of the service provider; and (c) the CEO of the service provider is not the CEO of the qualified user or any of the qualified user's related parties.

KEY CONSIDERATIONS WHEN APPLYING THE NEW REV. PROC.

Managed Property Does Not Equal Financed Property. One important difference between 97-13 and the New Rev. Proc. is that 97-13 applied to "financed property," while the safe harbor of the New Rev. Proc. is based on the concept of "managed property." Managed property is defined as the portion of a "project" with respect to which a service provider provides services. Project is defined as "one or more facilities or capital projects, including land, buildings, equipment, or other property, financed in whole or in part with the proceeds of the issue." If we consider, for example, a contract for management of a hospital emergency department, where some equipment and space has been financed with tax-exempt bonds and some has not, the managed property may be the entirety of the emergency department. This broader concept of the assets in scope may complicate the private use analysis in some instances, a few of which are discussed below.

Regarding the restrictions on term, qualified users generally do not keep records of the weighted average useful life of assets that have not been financed with tax-exempt bond proceeds. Again considering our emergency department example, to prove compliance with the term test, one might need to calculate the weighted average useful life for all of the space and equipment within the department, whether or not it was tax-exempt bond-financed. Where long-lived assets, such as a building, are bond-financed, but large amounts of valuable equipment are not, such as imaging or advanced radiation therapy equipment, this provision could substantially reduce the permitted term of a contract, notwithstanding the long-lived financed assets.

Degree of Required Control. The concept of managed property, as well as the specificity of the control requirement, may also create challenges for new agreements. In most cases, a hospital approves annual budgets for a department and would restrict the general nature and type of use of the managed property, but in certain outsourcing arrangements, the hospital may not review all capital expenditures or each disposition of property. Rather, in these arrangements, the hospital would instead have such expenditures or dispositions limited by an overall budget or ceiling. The New Rev. Proc. provides that "for example, a qualified user 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 a qualified user may show approval of dispositions of property that is part of the managed property in a similar manner." It remains to be seen if establishing maximum parameters on capital expenditures and dispositions of property provides sufficient control.

No Inconsistent Tax Positions. With regards to the prohibition on the service provider taking an inconsistent tax position, we note that the New Rev. Proc. does not test the actual compliance of the service provider but rather the agreement of the service provider to do so. This is more administrable by the qualified user, but it also means that this representation needs to be made by the service provider in every management and service contract.

Continuation of Conflicts Prohibition. The New Rev. Proc. continues and emphasizes the long-standing requirement that there be no circumstances substantially limiting the qualified user's ability to exercise its rights under the contract. As with 97-13, a safe harbor is provided, which includes that (a) no more than 20 percent of the voting power of the governing body of the qualified user is with the service provider; and (b) there are not overlapping CEOs or chairpersons of the board. However, the safe harbor of 97-13 provided that the service provider and the qualified user could not themselves be related parties, while the New Rev. Proc. provides that the CEO of the service provider cannot be the CEO of the qualified user OR any of the qualified user's related parties (which is defined as any member of the same controlled group). This makes clear that a service contract with a joint venture controlled by a qualified user (a related party) is within the safe harbors but may require additional diligence where a qualified user is part of a large organization with multiple corporate entities.

While the majority of this safe harbor has been continued from 97-13, we find that clients often overlook this provision. When clients do work to comply with this restriction, establishing who is the CEO of a physician organization is sometimes challenging. Moreover, this safe harbor may be hard to meet when considering the complex board arrangements of joint ventures and numerous related parties in a large health system. Where the safe harbor cannot be met, other safeguards should be implemented to ensure the hospital's rights under the contract are not impaired by the conflict.

PRACTICAL TAKEAWAYS

We expect that discussions with the IRS and within the tax-exempt bond community will bring more clarity as to the meaning and implications of the New Rev. Proc. over the upcoming months. For now, we recommend clients:

1. Update all form agreements to include a representation by the service provider that it has not taken, and will not take, any inconsistent tax positions.
2. Review all form agreements for compliance with the control requirements of the new Rev. Proc., updating such agreements where necessary and discussing with counsel where any conflicts with the new control requirements may arise.
3. Review policies in place to prevent related party issues, and in particular overlapping CEOs or board members, from arising.

For any questions about the New Rev. Proc. or private business use of facilities financed with tax-exempt bonds, please contact:

- Your regular Hall Render attorney.

¹ The New Rev. Proc. defines an unrelated third party as "persons other than a related party (as defined in §1.150-1(b)) or a service provider's employee." It is not yet clear whether "persons other than" applies to a service provider's employees (meaning employee salaries cannot be treated as pass-through expenses) or not (meaning employee salaries can be treated as pass-through expenses). Given the reasoning of PLR 201145005, where the IRS found that reimbursement of operating expenses, including employee bonuses for employees that did not have an ownership interest, did not constitute compensation to the service provider, it is our expectation that the IRS meant to include a service provider's employees in the definition of an unrelated third party, but confirmation is needed.

² 97-13 defined renewal option as provisions under which the *service provider* has a legally enforceable right to renew the contract. The New Rev. Proc. defines a renewal option as a provision under which either party has a legally enforceable right to renew the contract.