Management Contracts – New IRS Rules
Upcoming Event

WHO:
501(c)(3) organizations and state and local governments who utilize tax-exempt financing

WHEN:
November 9th and 10th, 2017

Reserve your place at the 5th Annual BLX Post-Issuance Compliance Workshop
Vdara Hotel & Spa
Las Vegas, Nevada

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BLX POST-ISSUANCE COMPLIANCE SERVICES

• Private Business Use Services
  – Analysis of the expenditure of tax-exempt bond proceeds and other available funds
  – Review of the use of all tax-exempt bond financed facilities
    ➢ Management and service contracts review
    ➢ Sponsored research review
  – Detailed calculation of private business use %
    ➢ Annual (Schedule K) Period
    ➢ Tax Measurement Period
  – Orrick legal opinion

• Final Allocation Services
• Arbitrage Rebate Compliance Services
• Secondary Market Disclosure Services
I. Background

II. Rev Proc 2017-13

III. Definitions

IV. Additional Information
Background
Many 501(c)(3) organizations and governmental entities with tax-exempt bonds seek to outsource a range of activities to third-party service providers.

Examples include:

- Food service
- Bookstores
- Medical professional service contracts
- Parking management agreements
• Non-employee service providers operating within tax-exempt bond financed space can give rise to “private business use”
• Over the years, the IRS has published “safe harbor” management contract rules which, if satisfied, provide that non-employee management and service contracts do not give rise to private business use
• 501(c)(3) bonds may have up to 5% private business use
  --The IRS wants to know about your management contracts ....
  --IRS Form 990 - Schedule K, Part III, line 3a, the IRS asks
    “whether the organization has any third party management or
    service contracts that could give rise to private business use”...
• Governmental bonds may have up to 10% private business use
  (depending on the facts, the 10% limit can be reduced to 5%)
Non-Employee Service Providers

- **Bottom line** – neither bond type permits a high level of private business use and the vast majority of 501(c)(3) organizations and governmental issuers strive to have their outside management and service contracts meet the applicable IRS safe harbor rules.

- **IRS audits** – in an IRS tax-exempt bond audit, the IRS will ask for copies of all management and service contracts.
REV PROC 97-13

• Prior IRS Guidance - Revenue Procedure 97-13 and IRS Notice 2014-67
  – Based on mechanical rules
  – Provides for range of contract structures based on term and compensation
  – The longer the term, a higher percentage of the compensation needs to be fixed
    • 15 year term
    • 10 year term
    • 5 year term
    • 3 year term
    • 2 year term
NEW IRS GUIDANCE – THE IRS HAS BEEN BUSY!

• Revenue Procedure 2016-44 -- released August 22, 2016
  – Replaced mechanical approach of Rev Proc 97-13 with a principle-based approach (now superseded)

• Revenue Procedure 2017-13 -- released January 17, 2017
  – Supersedes Rev Proc 2016-44
  – Addresses concerns raised by Rev Proc 2016-44, most notably confirming that certain Rev Proc 97-13 compliant contracts will not cause private business use under the new rules
    – Applies to contracts entered into on or after January 17, 2017

• Revenue Procedure 97-13 Lives!! -- still may be applied to contracts entered into before August 18, 2017
Incidental Contracts

Contracts for services that are solely incidental to the primary function of the financed facility are not subject to IRS rules.

Examples:

- Janitorial contracts
- Routine maintenance contracts
- Hospital billing contracts
- Landscaping contracts
• Rev Proc 2017-13 was published in response to industry questions and concerns regarding Rev Proc 2016-44

• Like Rev Proc 2016-44, Rev Proc 2017-13 also applies principle-based concepts of control, risk, and who derives the benefits and burdens of bond-financed property
  – This approach requires more legal analysis and judgement, and increases the risk of differing IRS interpretation
1. **Compensation Must be Reasonable**

   – The payments to the manager must be reasonable compensation for services provided under the terms of the contract

   – Compensation **includes** payments by the facility owner to reimburse actual and direct expenses of the manager and related administrative overhead expenses of the manager

   – Under Rev Proc 97-13, compensation **does not include** payments to reimburse actual and direct expenses of the manager and related administrative overhead expenses of the manager

   - **Treating compensation as including the reimbursement of expenses is a change from Rev Proc 97-13. We’ll discuss later in an example**
2. **Timing and Payment of Compensation**
   
   – Compensation is payable at least annually
   
   – The owner is subject to economic consequences for late payment
     
     • reasonable interest charges
     
     • late payment fees
   
   – The owner will pay any deferred compensation (with interest or late payment fees) no later than the end of 5 years after the original due date of payment
3. **Service Provider May Not Receive Share of Net Profits From Managed Property**

   - Compensation to the manager will not be treated as providing a share of net profits if no element of the compensation takes into account either the property’s net profits or both the property’s revenues and expenses.
   
   - “Incentive compensation” is not treated as based on net profits if eligibility is determined by the manager’s performance in meeting one or more standards that measure –

     - Quality
     - Performance
     - Productivity
3. **Service Provider May Not Receive Share of Net Profits From Managed Property**

   – Back to the Future ..... 

   – Rev Proc 2017-13 states that the following compensation structures from Rev Proc 97-13 do not result in a share of net profits:

   • Per-unit fee
   • Capitation fee
   • Periodic-fixed fee
   • Any combination of the foregoing
4. **No Bearing of Net Loss to Manager**
   - The contract may not impose on the manager the obligation to bear any share of net losses on the managed property
   - A contract will not violate this prohibition if:
     a. The timing of the compensation payment is not contingent upon the property’s net losses
     b. The amount of the manager’s compensation does not take into account either the property’s net losses or both revenues and expenses
   - Compensation penalty: the loss sharing prohibition will not be violated if compensation is reduced by a stated dollar amount(s) for failure to keep the property’s expenses below a specified target
4. **No Bearing of Net Loss to Manager**

– Unless otherwise noted, non-reimbursement of a manager’s expenses by the owner (so-called “all-in” contracts) are viewed by the IRS as shifting net losses to the manager

➤ *The policy of Rev Proc 2017-13 is to promote contract structures which include (i) reimbursement to the manager for actual costs and expenses, and (ii) a separate management fee*
5. **Term of the Contract**

   – The term of the contract, including all renewal options, must not exceed the lesser of:
     
     - 30 years, or
     - 80% of the weighted average expected economic life of the bond-financed managed property
6. **Control Over the Use of Managed Property**

   – Facility owner must exercise a “significant degree of control” over use of managed property

   – Control requirement is met if the contract requires the issuer/borrower to approve –
     
     - the annual budget of the managed property
     - capital expenditures of the managed property
     - each disposition of property that is part of the managed property
     - rates charged for the use of the managed property
     - the general use and services of the managed property
7. **No Risk of Loss to the Manager**
   - The owner must bear the risk of loss upon damage or destruction of the managed property

8. **No Inconsistent Tax Positions**
   - The manager must agree that it is not entitled to, and will not take, any tax position inconsistent with the bond-financed property
     » e.g., take depreciation with respect to the property or characterize payments to the qualified user as deductible rent
9. **Owners Exercise of Rights**

   – There must not be any relationship that would substantially limit the owner’s ability to exercise its rights under the contract

   – A “safe harbor” is provided-

     » No more than 20% of the voting power of the governing body of the owner is vested in the directors, officers etc., of the manager;

     » The governing body of the owner does not include the chief executive officer of the manager or the chairperson of the managers governing body; and

     » the chief executive officer of the manager is not the chief executive officer of the owner
EXAMPLE 1 - REIMBURSEMENT OF MANAGER’S EXPENSES

• Governmental issuer enters into food service agreement with third party provider

• The governmental issuer pays a fixed fee of $200,000 a year AND reimburses the manager for food, salaries and related expenses

• As with any food service agreement, payments for food, salaries and related expenses will fluctuate
EXAMPLE 1 - REIMBURSEMENT OF MANAGER’S EXPENSES

• Under Rev Proc 97-13 – the contract is treated as a periodic fixed fee agreement

• Under Rev Proc 2017-13 – the contract is treated as a variable compensation contract

➢ Unlike under Rev Proc 97-13, the reimbursement of expenses is treated as compensation under Rev Proc 2017-13
Example 2 - Non-Reimbursement of Manager’s Expenses

• Governmental issuer enters into food service agreement with third party provider

• The governmental issuer pays a fixed fee of $400,000 a year AND does not reimburse the manager for food, salaries and related expenses

• Generally, under Rev Proc 2017-13, non-reimbursement of the managers expenses by the owner is treated as a shifting of “net losses” to the manager
EXAMPLE 2 - NON-REIMBURSEMENT OF MANAGER’S EXPENSES

- Under Rev Proc 2017-13, non-reimbursement of manager’s expenses is treated as “shifting net losses” --- other than when compensation is pursuant to one of the following methods -
  - Periodic fixed fee;
  - Per-unit fee;
  - Capitation fee; and
  - Any combination of the foregoing

Rev Proc 97-13 compensation formulations
• Flexibility on what Rev Proc to apply until **August 18, 2017**
• Rev Proc 2017-13
  – Relaxed existing formulaic safe harbor requirements
  – Lack of technical specifics
  – Principle-based concepts
  – Limited use of “all-in” contracts
• Consult with bond counsel or other tax expert
Definitions
DEFINITIONS

• Capitation fee
  – fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all services for specified period so long as the quantity and type of services varies substantially

• Periodic fixed fee
  – Stated dollar amount for services rendered for a specific period of time
  – Amount may increase according to specified, objective external standard not linked to the output or efficiency of the managed property

• Per-unit fee
  – Fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party (e.g. a stated dollar amount for each specified medical procedure performed)
  – Amount may increase according to specified, objective external standard not linked to the output or efficiency of the managed property
Additional Information
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