HAWKINS ADVISORY

HAWKINS ADVISORY ON MODIFIED QUALIFIED MANAGEMENT CONTRACT RULES (REVENUE PROCEDURE 2016-44)

On August 22, 2016, the Internal Revenue Service (the **"IRS"**) released Revenue Procedure 2016-44 (**"Rev. Proc. 2016-44"**), which purports to modify and supersede existing revenue procedures addressing the treatment of management contracts involving property financed with tax-exempt bond proceeds. Rev. Proc. 2016-44 generally allows state and local governmental units and 501(c)(3) organizations (each a "**qualified user**") to enter into contracts for the management of bond-financed property that have longer terms and a broader range of variable compensation arrangements than allowed by such existing revenue procedures. Rev. Proc. 2016-44 also includes requirements that were not contained in such revenue procedures, such as a requirement that the service provider agree not to take any tax position that is inconsistent with its treatment as a service provider under the management agreement (*e.g.* taking depreciation deductions on managed property). The IRS will not treat a contract between a qualified user of tax-exempt bond proceeds and a service provider that conforms to the requirements of Rev. Proc. 2016-44 (a **"qualifying contract"**) as resulting in private trade or business use* of the managed property for purposes of applying limitations imposed by the Internal Revenue Code of 1986, as amended (the **"Code"**) in respect of tax-exempt bond proceeds.

BACKGROUND

The Code and applicable U.S. Treasury Department regulations (the **"Treasury Regulations"**) impose limitations on the amount of proceeds of tax-exempt governmental bonds and tax-exempt qualified 501(c)(3) bonds used in a private trade or business use, and apply a facts and circumstances test to determine whether use of bond-financed property under a management agreement by anyone other than a qualified user will result in private use. In order to provide some certainty to issuers and conduit borrowers of tax-exempt bond proceeds, the IRS issued a series of revenue procedures, including Revenue Procedure 97-13, as modified by Revenue Procedure 2001-39 (together, **"Rev. Proc. 97-13"**) and Notice 2014-67, which amplifies Rev. Proc. 97-13 (together with Rev. Proc. 97-13, the **"Prior Revenue Procedures"**), stating that the IRS would not treat a management contract that conforms to the requirements in such Prior Revenue Procedures as resulting in private trade or business use of the managed property.

A management contract conformed to the requirements of Rev. Proc. 97-13 only if it contained (i) compensation arrangements that both satisfied a general rule that no portion of such compensation could contain any element of net profits (or losses), and fit within one of the detailed compensation scenarios described in Rev Proc. 97-13, and (ii) had a maximum term, including renewal options, described in Rev. Proc. 97-13. The maximum terms permitted by Rev. Proc. 97-13 varied based on the percentage of compensation to be paid under the contract that was a stated dollar amount or periodic fixed fee, and the type of variable compensation to be paid under the contract. In addition, the service provider could not have any role or relationship with the qualified user that would limit the qualified user's ability to exercise its right under the contract. Notice 2014-67 amplified Rev. Proc. 97-13 by, among other things, adding a new category of permitted arrangements, including maximum contract terms of up to five years, provided that all of the compensation is based on (i) a percentage of gross revenues or expenses of the facility, but not both revenues and expenditures, (ii) a stated dollar amount, (iii) a periodic fixed fee, (iv) a capitation fee, (v) a per-unit fee, or (vi) any combination of the foregoing.

*Qualified 501(c)(3) Bonds are also subject to a limitation in respect of unrelated trade or business activities.

REV. PROC. 2016-44

In General. In order to conform to the requirements of Rev. Proc. 2016-44, a management contract must provide for

- the qualified user to exercise a significant degree of control over the managed property,
- compensation that is reasonable and in no way based on the net profits derived from the operation of the facility,
- a term, including renewal options, that does not exceed the lesser of 30 years or 80 percent of the economic life of the bond-financed facility, and
- an explicit agreement by the service provider to not take any tax position that is inconsistent with its role as a service provider with respect to the bond-financed property.

In addition, as in the Prior Revenue Procedures, the service provider may not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including its cancellation rights, under the contract. The contract may not impose upon the service provider a risk of loss from damage or destruction of the property. A service provider will not be treated as bearing a risk of loss or destruction of the managed property solely as a result of a penalty imposed on the service provider for failure to operate or maintain the property in accordance with the provisions of the contract.

Control by Qualified User. The limitations imposed under the applicable provisions of the Code on private trade or business use in connection with issuances of governmental bonds and/or qualified 501(c)(3) bonds were meant to preclude qualified users of such bonds from passing along the benefits of tax-exempt financing to a non-exempt person, except as specifically provided for by the Code. As a result, property that is leased, licensed or generally under the possession and control of non-exempt persons is treated as used for a private trade or business use under the Code. Rev. Proc. 2016-44 explicitly requires a qualified user to exercise a significant degree of control over the use of the managed property (the **"Control Requirement"**), and describes circumstances in which the Control Requirement will be satisfied. For example, the Control Requirement will be "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 (e.g., the type of services)" to be performed by the service provider. Inclusion of schedules to a contract setting forth rates and charges for the services to be performed by the service provider, together with language providing for the service provider to approve any changes to the schedules, will evidence approval of such rates and charges. Approval of rates and charges may also be evidenced by setting forth in the contract a method for automatic changes to the rates and charges, or a provision in the contract requiring that the service provider charge rates that are reasonable and customary as specifically determined by an independent third party.

Permitted Term. Under Rev. Proc. 2016-44, the term of the contract, including all renewal options unilaterally exercisable by the service provider, may not exceed the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property (exclusive of land), as of the beginning of the term of the contract. While this standard is more flexible than the term limitations set forth in the Prior Revenue Procedures, questions are likely to arise when analyzing a contract involving a facility nearing the end of its economic life. Material modifications to a service contract will cause the term of the contract to be retested to determine compliance with the term limitation under Rev. Proc. 2016-44.

Rev. Proc. 2016-44 by its terms relates to only that term of a management contract in effect *after* the managed property has been placed in service.

Additional guidance may be needed to determine how the weighted average reasonably expected economic life of the managed property is measured. For example, questions are likely to arise as to the effect of ordinary maintenance expenditures on the economic life of the managed property, or the manner in which capital improvements to a portion of the managed property should be weighed in computing the weighted economic life of the managed property.

Compensation. Compensation under a service contract must be reasonable; importantly, no portion of the compensation may be based, in whole or in part, on a sharing of the net profits derived 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 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 purposes of this definition, Rev. Proc. 2016-44 identifies as "elements of compensation" the eligibility for, the amount of, and the timing of the payment of compensation. Payments to reimburse actual and direct expenses paid by the service provider to an unrelated party, and related administrative expenses of the service provider are disregarded. Unrelated parties are defined as "persons other than a related party [a member of the qualified user's controlled group] or a service provider's employees".

Incentive compensation by a qualified user to a service provider is not treated as a sharing of the net profits of the financed facility if eligibility for the payment is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance or productivity, provided that the amount and timing of the compensation are not based on the amount or existence of net profits or losses from operation of the facility. Incentive payments, especially incentive payments based on productivity targets, will need to be carefully drafted to refute any assertion that any element of the payments is based on the amount or existence of net profits or losses from the operation of the facility.

Sharing of Net Losses. A contract under Rev. Proc. 2016-44 "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". However, an arrangement will not be treated as requiring a service provider to share in the net losses from the financed facility if: (i) the amount of the service provider's compensation is not affected by net losses from the operation of the managed property, or both the revenues and expenses of operation of the managed property, and (ii) the timing of the service provider's compensation is not contingent on net losses from the operation of the managed property.

The reduction of a service provider's compensation by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) will not, in and of itself, cause the service provider to be treated as bearing a share of net losses from the operation of the financed property.

Unrelated Person Requirement. Like the Prior Revenue Procedures, a contract will not conform to the requirements of Rev. Proc. 2016-44 if the service provider has any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract. Under Rev. Proc. 2016-44, no such role or relationship will be deemed to exist if: (i) no more than 20 percent of the voting power of the governing board of the qualified user is vested in the directors, officers, shareholders, partners, members and employees of the service provider; (ii) neither the chief executive officer or the chairperson (or equivalent executive) of the service provider is a member of the governing body of the qualified user; and (iii) the chief executive officer of the service provider (or any person with equivalent management responsibilities) is not the chief executive officer of the qualified user or any entity that is part of the same "controlled group" as the qualified user. For these purposes, an entity is part of the same controlled group as the qualified user if one entity has either (a) the right or power both to approve and remove, without cause, a controlling portion of the governing body of the other entity, or (b) the right or power to

require the use of funds or assets of the controlled entity for any purpose of the controlling entity.

No Inconsistent Tax Position. Finally, Rev. Proc. 2016-44 contains an explicit requirement that the service provider agree that it will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property; e.g., 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. All management contracts, including extensions to management contracts that conformed to Prior Revenue Procedures, must contain such language.

Effective Dates. The provisions of Rev. Proc. 2016-44 apply to any management contract that is entered into on or after August 22, 2016, and an issuer may apply these provisions to any management contract that was entered into before August 22, 2016. Rev. Proc. 2016-44 further states that an issuer may apply the safe harbors in the Prior Revenue Procedures to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended (other than pursuant to the exercise of a renewal action at the unilateral option of the service provider) on or after August 18, 2017.

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