

HAWKINS ADVISORY

MODIFIED QUALIFIED MANAGEMENT CONTRACT RULES - REVENUE PROCEDURE 2017-13

On January 17, 2017, the Internal Revenue Service (the “**IRS**”) released Revenue Procedure 2017-13 (“**Rev. Proc. 2017-13**”), which addresses the treatment of management contracts involving property financed with tax-exempt bond proceeds. Rev. Proc. 2017-13 modifies and supersedes recently released Revenue Procedure 2016-44 (“**Rev. Proc. 2016-44**”).

Relevant provisions of the Internal Revenue Code of 1986, as amended (the “**Code**”), and applicable U.S. Treasury Department regulations impose limitations on the amount of proceeds of tax-exempt governmental bonds and tax-exempt qualified 501(c)(3) bonds that may be used in a private trade or business use.* In order to provide guidance to state and local government units and 501(c)(3) organizations (each, a “**qualified user**”) benefitting from the issuance of tax-exempt bonds, the IRS has issued a series of pronouncements, including revenue procedures, describing situations in which a management contract that conforms to the requirements articulated in such guidance (a “**qualifying contract**”) would not result in private trade or business use of the managed property by the manager or the service provider (the “**service provider**”).

Background

In Revenue Procedure 97-13 (“**Rev. Proc. 97-13**”), the IRS provided specific formulaic guidelines based, generally, on the type of compensation and the term of the management contract that, if satisfied, would not result in private trade or business use of the managed property. In October 2014, the IRS issued Notice 2014-67 (the “**Notice**”), which amplified the description of arrangements that would satisfy the safe harbor guidelines under Rev. Proc. 97-13 and provided interim guidance to qualified users participating in the Medicare Shared Savings Program described in the Patient Protection and Affordable Care Act.

In August 2016, the IRS released Rev. Proc. 2016-44. Rather than setting forth specified compensation methods and contract terms like Rev. Proc. 97-13, Rev. Proc. 2016-44 sets forth *general principles*, which if satisfied, would result in a qualifying contract. Although Rev. Proc. 2016-44 generally allowed service providers to enter into contracts for the management of bond-financed property that have longer terms and a broader range of variable compensation arrangements than permitted previously, the lack of specified compensation methods and other formulaic rules raised questions as to the application of such general principles. In particular, qualified users were not certain as to whether previously permitted compensation methods would conform to the principles of Rev. Proc. 2016-44. Rev. Proc. 2017-13 addresses some of these concerns.

Rev. Proc. 2017-13

A qualifying contract under Rev. Proc. 2017-13 must conform to the same general principles set forth in Rev. Proc. 2016-44; however, Rev. Proc. 2017-13 also provides guidance as to the application of such principles and expressly reinstates some of the formulaic compensation methods that had been permitted under Rev. Proc. 97-13. A management contract is considered a qualifying contract under Rev. Proc. 2017-13 if it provides for:

- compensation that is reasonable and in no way based on the net profits derived from the operation of the managed property, and the service provider does not, in substance, bear any share of net losses from the operation of the managed property;
- the qualified user to exercise a significant degree of control over the use of the managed property;
- a term, including renewal options, that does not exceed the lesser of 30 years or 80 percent of the

*Qualified 501(c)(3) bonds are also subject to a limitation on unrelated trade or business activities.

weighted average reasonably expected economic life of the managed property; 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.

Rev. Proc. 2017-13 also retains the requirement that the service provider 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. In addition, the qualified user, rather than the service provider, must bear the risk of loss from damage or destruction of the property. Below is a discussion of certain provisions of Rev. Proc. 2017-13.

Reasonable Compensation and no Sharing of Net Profits or Net Losses. 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. In addition, the 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. Rev. Proc. 2017-13 identifies "elements of compensation" as the eligibility for, the amount of, and the timing of the payment of compensation.

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". Importantly, reimbursements of direct and actual expenses paid by the service provider to unrelated third parties are disregarded for this purpose, *however* reimbursements of payments to or for the benefit of a service provider's employees and other persons related to the service provider are treated as "compensation" that is measured by taking into account the managed property's expenses.

Incentive compensation by a qualified user to a service provider is *not* treated as a sharing of net profits of the managed property 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 managed property. 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 managed property.

A qualifying contract must not, in substance, impose on the service provider the burden of bearing any share of the net losses from the operation of the managed facility, and 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. Rev. Proc. 2017-13 also states that an "arrangement will not be treated as requiring the service provider to bear a share 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 (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". These standards raise questions as to the treatment of contracts providing for the service provider to pay expenses, including compensation of its employees, for which it will not be reimbursed.

Rev. Proc. 2017-13 addresses these questions, in part, by providing that the following types of compensation arrangements will not result in either a sharing of net profits or the service provider bearing a share of the net losses from the operation of the managed property, regardless of whether the service provider pays expenses with respect to the managed property that are not reimbursed by the qualified user:

- A capitation fee, which is a fixed periodic amount for each person for whom the qualified user or the service provider 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. A capitation fee may include a variable component of up to 20 percent of the total capitation fee designed to

protect the service provider against risk such as catastrophic loss;

- A periodic fixed fee, which is a stated dollar amount for services rendered for a specific period of time. The stated dollar amount may automatically increase according to a specified objective external standard (e.g., the Consumer Price Index or similar external indices) that is not linked to the output or efficiency of the managed property;
- A per-unit fee, which is a fee based on a unit of service provided that is specified in the contract or otherwise specifically determined by an independent third party; or
- A combination of a capitation fee, a periodic fixed fee and/or a per-unit fee.

Importantly, contracts containing compensation methods that are based on the percentage of gross revenues of the managed facility are not specifically addressed in Rev. Proc. 2017-13, and no guidance is provided as to whether payments by the service provider of expenses either to its own employees or third parties that are not reimbursed by the qualified user would cause a service provider receiving a percentage of a managed property's gross revenues to be treated as either sharing net profits of the managed property or bearing a share of the losses from the managed property's operations.

Deferrals of compensation amounts that otherwise satisfy the requirements set forth above will not be treated as contingent on net profits or nets losses if the contract expressly requires that the compensation is payable at least annually, the qualified user is subject to reasonable consequences for late payments, such as reasonable interest charges or late payment fees, and the deferred compensation, including all interest and late payment fees, are required to be paid no later than the fifth anniversary of the original due date of the payment.

Control by Qualified User. The qualified user must exercise a significant degree of control over the use of the managed property; such control is manifested in approval of annual budgets, including acquisitions and dispositions of capital assets, rates charged for the use of the property and the types of services to be provided. 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 qualified user's approval of any changes to the schedules, will evidence approval of such rates and charges. A qualified user may also satisfy the approval of rates requirement by approving a reasonable general description of the method used to set the rates or by requiring that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party.

Permitted Terms. The term of the contract, including all renewal options the service provider may exercise unilaterally, may not exceed the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. Economic life is measured as of the beginning of the term of the contract. Land is generally not taken into account, however, Rev. Proc. 2017-13 provides that if 25 percent or more of the proceeds of any bond issue is used to acquire land, land is taken into account in the calculation and treated as having a 30-year life. In addition, 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. 2017-13.

Rev. Proc. 2017-13 by its terms relates to only that term of a management contract in effect after the managed property has been placed in service.

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. For example, the text of Rev. Proc. 2017-13 suggests that the permitted term of a contract involving managed property financed by two or more bond issues should be calculated separately for each bond issue. Additional guidance may be issued to address these questions.

No Inconsistent Tax Position. A qualifying contract must include an express statement that the service provider agree not to take any tax position that is inconsistent with being a service provider, e.g., the service provider must agree not to claim any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property.

Unrelated Person Requirement. A contract will not conform to the requirements of Rev. Proc. 2017-13 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. 2017-13, 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 nor 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.

Functionally Related and Subordinate Property.

Finally, use by a service provider of property that is functionally related and subordinate to performance of its services under a qualifying contract (e.g., use of storage areas to store equipment used in connection with a qualifying contract) will not result in private trade or business use of that property.

Effective Dates. The provisions of Rev. Proc. 2017-13 apply to any management contract that is entered into on or after January 17, 2017, and an issuer may apply these provisions to any management contract that was entered into before January 17, 2017. Rev. Proc. 2017-13 further states that an issuer may apply the safe harbors set forth in Rev. Proc. 97-13 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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