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Tax Exempt Organizations Alert

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IRS revisits safe harbors for management contracts with tax-exempt borrowers

Late in 2016, the Internal Revenue Service (IRS) issued Revenue Procedure 2016-44, which modified and expanded certain safe harbors for management contracts with tax-exempt entities. We detailed the terms of Revenue Procedure 2016-44 in an update available here. The IRS has now returned to the issue of management contracts, and in Revenue Procedure 2017-13 has further clarified its guidance regarding safe harbors.

Under the Internal Revenue Code, there are limits on the amount of use that may be made of facilities financed with tax-exempt bonds by non-exempt entities. If such "private use" exceeds certain thresholds, the interest on the bonds which were sold to finance the facility becomes taxable. Private use includes contracts and other arrangements with physician groups to operate or manage hospital departments and laboratories, agreements relating to food, parking management, laundry, and other services provided to hospitals and schools, and sponsored research agreements.

The IRS originally established various "safe harbors" for management contracts in 1997. These original safe harbors significantly limited the duration of any management contract where the contract compensation was based upon a percentage of revenue, capitation, or per unit basis. Longer term management contracts were permissible only where compensation was based upon fees that were largely fixed.

Revenue Procedure 2016-44 broadened the safe harbors available for management contracts, stating that a management contract meeting the following requirements does not give rise to private use:

1. The payments to the service provider are reasonable compensation for the services rendered during the term of the contract.

2. The contract does not provide the service provider with a share of net profits from the operation of the facility.

3. The contract does not impose upon the service provider the burden of bearing any share of net losses from the operation of the facility.

4. The term of the contract, including all renewal options, is not greater than the lesser of (i) 30 years, or (ii) 80% of the weighted average reasonably expected useful economic life of the facility.

5. The tax-exempt borrower must exercise a "significant degree of control" over the facility, including control over the rates charged for use of the facility.

6. The tax-exempt borrower must retain the risk of loss upon damage or destruction of the facility.

7. The service provider must agree not to take any tax position inconsistent with any of the foregoing (for example, by claiming depreciation with respect to any portion of the facility).

8. The service provider must not have any role or relationship with the tax-exempt borrower that limits the tax-exempt borrower's ability to exercise its rights under the contract.

While Revenue Procedure 2016-44 was widely welcomed by the tax-exempt community, certain questions remained. Specifically, there were questions as to whether management contracts which were clearly permissible under the 1997 rules, but which could arguably be interpreted as sharing net profits or losses, would run afoul of the net profit and loss sharing provisions of the 2016 rules. Revenue Procedure 2017-13 clarifies that any arrangement satisfying the 1997 safe harbors remains permissible and does not give rise to private use.

The new Revenue Procedure also provides for more flexibility in the timing of payments. Prior to the issuance of Revenue Procedure 2016-44, the IRS had approved several arrangements wherein the timing of payments varied due to cash flow issues. Again, there were questions as to whether such arrangements were permissible under the net profit and loss sharing limitations of the 2016 rules. Revenue Procedure 2017-13 specifically permits payment deferral due to inadequate net cash flows, so long as (i) compensation is payable at least annually, (ii) there are reasonable consequences for late payment (such as interest and/or late payment fees), and (iii) in any event, all required compensation, together with any interest and fees, is payable within five years.

The new Revenue Procedure also clarifies the safe harbor relating to maximum contract duration (the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the facility). Under the 2016 rules, the formula adopted for computing the economic life of a facility excluded the economic life of financed land. Revenue Procedure 2017-13 states that land will be treated as having an economic life of 30 years, as long as at least 25% of the net proceeds of the underlying financing were spent on land.

Finally, the new Revenue Procedure clarifies that it is not necessary for an exempt borrower to set each and every rate charged in order to be exercising "a significant degree of control" over the facility. It is enough that the exempt borrower either establishes a general method for the setting of rates, or requires that the service provider charge rates that are "reasonable and customary" based upon a determination by, or negotiation with, an independent third party (such as an insurance company).

The new rules apply to any management contract entered into on or after Jan. 17, 2017, and may also be applied by an exempt borrower to any contract entered into prior to that date. Exempt borrowers may also opt to apply the original 1997 safe harbors to any management contract entered into prior to Aug. 18, 2017. After that date, all new management contracts and all management contracts which undergo material modifications will be subject to the new rule.

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