

# An Update on Implementation of New Management Contract Safe Harbors for Property Financed with Tax-Exempt Bonds

(Rev. Proc. 2017-13)



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## Overview

In the past few years, the IRS has changed its guidance on whether “management contracts” result in private business use for purposes of the restrictions on use of property financed with tax-exempt bonds. This update describes the new guidance and responds to questions that have arisen in their implementation.

The new rules are “safe harbors” set forth in IRS Rev. Proc. 2017-13. They apply to service contracts entered into or renewed on or after August 18, 2017 (except for certain renewals made pursuant to an option to renew).

The rules apply to tax-exempt governmental bonds issued for the benefit of State and local governments and to qualified 501(c)(3) bonds issued for the benefit of section 501(c)(3) organizations. Although the rules refer to “management contracts,” they apply to most types of service contracts.

The rules need to be applied by the users of property financed with tax-exempt bonds, which usually are the governmental issuers, in the case of governmental bonds, or exempt organization borrowers, but can also include other users, such as affiliates of an issuer or borrower. All such users are referred to as “borrowers” in this update.



- **Fewer bright lines.** The application of the new safe harbors generally requires more judgment and legal review than in the past to determine whether a service contract results in private business use. The new approach is based more on legal principles and provides fewer simple bright lines. This means --
- Reliance on checklists is now more difficult.
- A checklist focusing on a specific type of service contract is more likely to be helpful than a general checklist for all types of contracts.
- Tax covenants requiring strict compliance with safe harbors may be more burdensome, and less advisable, than in the past.
- **Mostly more flexible, but not always.** The new safe harbors are mostly more flexible than the prior safe harbors, but not always. The new safe harbors often require that different questions be asked and answered than under the prior safe harbors.
- **Longer term permitted, subject to limitations.** The new safe harbors permit service contracts having a term up to 30 years, but expand a rule limiting the term to no more than 80 percent of the weighted economic life of the managed property. This means --
- There is much more flexibility for structuring long-term contracts,
- But the 80% rule now applies even to short-term contracts, and may be burdensome for those contracts.
- **No “net profits” arrangements.** A main focus of the new safe harbors is whether compensation is based on a share of “net profits.” The new safe harbors state the prohibition more strictly than in the past in a manner that, among other things, does not permit any type of compensation to be triggered by a net profits measure.
- **Not focused on fixed compensation.** The new safe harbors otherwise permit many types of fixed and variable compensation.

## Highlights

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### Some Key Questions for Issue Spotting under the New Safe Harbors

- Is the contract with a board member, CEO or other person in a position to exercise substantial influence over the borrower?
- Is compensation based on “net profits” or otherwise based on both revenues and expenses?
- Does the contract provide for payment based on gross revenues, and require the service provider to bear the borrower’s operating costs?
- Does the contract permit deferral of payment of compensation?
- Does the contract require the service provider to bear any operating loss or loss to property?
- Does the contract give the borrower control over the property that is managed, including providing a standard for rates charged?
- Does the contract include a specific provision to the effect that the service provider will not take any inconsistent tax position?
- Does the contract have a term not greater than 80% of economic life of the managed property (or otherwise have a term not greater than a short period, such as three years)?

- **Control requirement.** The new safe harbors include new requirements concerning whether the borrower controls the property. The control requirement is met if the borrower has the right to approve the annual budget, significant capital expenditures, significant dispositions, rates charged and the general nature and type of use of the managed property.
- **Risk of loss from operations requirement.** The new safe harbors include new requirements concerning whether the issuer or service provider bears risk of loss. These “risk of loss” rules tend to be more important for longer-term contracts than shorter-term contracts.
- **Contracts “grandfathered” under old safe harbors.** Service contracts entered into before August 18, 2017 can be eligible for either the prior safe harbors (Rev. Proc. 97-13) or the new safe harbors (Rev. Proc. 2017-13). An important question for borrowers is whether to implement procedures to identify “grandfathered” service contracts.
- Many management contracts that have been customarily treated as within the old safe harbors may not exactly meet the new safe harbors.
- Borrowers need new practices to review service contracts for tax-exempt bond financed property that are entered into, materially modified or in certain cases renewed on or after August 18, 2017.
- **Special considerations for 501(c)(3) organizations not addressed.** The new safe harbors apply only for purposes of the tax-exempt bond requirements, and do not apply for purposes of the other federal income tax restrictions that apply to 501(c)(3) organizations. In some cases, the rules that apply to 501(c)(3) organizations may be more restrictive than the new safe harbors.

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## Description of the New Safe Harbors

### ***What are the Consequences if a Service Contract Results in “Private Business Use”?***

Private business use of property may preclude, or result in the loss of, tax-exempt status of interest on the tax-exempt bonds issued to finance the property. Although a small amount of private business use is permitted for the property financed with each bond issue (usually, 5 percent for qualified 501(c)(3) bonds, treating the percentage used for costs of issuance as private business use, and 5 or 10 percent for governmental bonds), the tracking and computation of the amount of private business use can be complex. Accordingly, the general policy of many borrowers is that service contracts involving use of property financed with tax-exempt bonds be framed in a manner not to result in private business use.

### ***What is the Idea Behind the New Safe Harbors?***

IRS regulations contemplate that a service contract may be a service contract in name only and can in some circumstances be treated by the IRS as, in substance, another type of contractual arrangement – such as a lease of property to the service provider by the borrower, a joint venture or partnership between the service provider and the borrower, or the transfer of ownership by the borrower to the service provider. A lease, joint venture or ownership typically results in private business use. The new safe harbors can reasonably be viewed as describing circumstances under which a borrower can be certain that the IRS will respect a contract as a service contract in substance (that is, not a lease, not a joint venture, not a transfer of ownership, or reasonably similar to any of those arrangements, which would result in private business use).

The new safe harbors seek to better reflect legal tax principles and authorities concerning when a “service contract” will not be treated by the IRS as a service contract in name only and another type of arrangement in substance. Accordingly, the new safe harbors contain detailed safe harbor rules concerning control of the managed property (which are mostly intended to establish that a service contract will not be treated as a lease), concerning who bears risk of loss from the property or the operation of the property (which are mostly intended to establish that a service contract will not be treated as a lease or as a joint venture), and concerning the term of the contract (which are mostly intended to establish that the service provider will not be treated as owning the property).

IRS regulations expressly provide that, in determining whether a management contract is properly characterized as a lease, it is necessary to consider all the facts and circumstances, including (1) the degree of control over the property that is exercised by the service provider; and (2) whether the service provider bears the risk of loss of the financed property. These two factors (control and risk of loss) are fleshed out in detail in the new safe harbors, but were not expressly addressed in the prior safe harbors.

In addition, the new safe harbors seek to provide more guidance on the interpretation of a rule in the IRS regulations that a service contract generally results in private business use if the compensation “is based, in whole or in part, on a share of net profits from the operation of the facility.” This specific rule in the regulations is somewhat stricter than the general federal tax law relating to when a service contract may be treated as a different type of arrangement in substance. That is, a service contract in name may be respected as a service contract in substance for general federal tax purposes, but still result in private business use if the compensation is based on a share of net profits.

Other than the no “net profits” rule and the rule that a service contract can be characterized as a lease or cause the service provider to be treated as the owner of managed property, the IRS regulations provide only that whether a service contract results in private business use is “based on all the facts and circumstances.” The vagueness of this standard may inhibit taking tax positions that service contracts that do not exactly meet safe harbors nonetheless may be permitted under the private business use rules. Because the new safe harbors are framed in a manner more tied into general federal tax principles than the prior safe harbors, however, there may often be a sounder basis for permitting service contracts “outside of” the new safe harbors, even though the vague standard in the IRS regulations remains the same.

Keeping these purposes of the new safe harbors in mind is important not only to understand them, but also to apply them in practice. In particular, it may be reasonable to take the view that the safe harbor requirements which mostly concern general principles of tax law (for example, who is the tax owner) can be interpreted in a more flexible manner than safe harbor requirements that mostly concern the particular rule in the

regulations (that is, when compensation is treated as based on “net profits”). That observation leads to the conclusion that the no “net profits” requirements in the new safe harbors need to be applied with particular attention.

The prior safe harbors in Rev. Proc. 97-13 implicitly also were concerned with these considerations, but were framed in a manner that provided more bright lines that were not as clearly based on underlying principles and did not as strongly invite tax analysis based on those principles.

Rev. Proc. 2017-13 states that it provides for a “more flexible and less formulaic approach toward variable compensation for longer-term management contracts” and “applies a more principles-based approach focusing on governmental control over projects, governmental bearing of risk of loss, economic lives of managed projects, and consistency of tax positions taken by the service provider.”

#### ***Why Does It Matter that Rev. Proc. 2017-13 is “Safe Harbor” Guidance?***

Rev. Proc. 2017-13 (like the prior Rev. Proc. 97-13) provides “safe harbors.” Neither revenue procedure changes the substantive rules in the IRS regulations for when a service contract results in private business use.

It is clear that the IRS takes the view that a service contract does not need to strictly comply with the safe harbors to avoid being treated as private business use. For example, the IRS has already released one private letter ruling (PLR 201726007) that concludes that a particular management contract not meeting the new safe harbors nonetheless does not result in private business use. Under the prior revenue procedure (Rev. Proc. 97-13), the IRS released more than a dozen private letter rulings that gave similar favorable to management contracts not meeting the prior safe harbors.

The status of the revenue procedure rules as “safe harbors” rather than substantive legal requirements now has increased importance and has a number of practical consequences. Many service contracts may not clearly fit within all of the requirements of the new safe harbors, but can be reasonably interpreted as being consistent with their principles. This means that it may not be advisable for borrowers to agree to bond

document covenants that require strict compliance with the safe harbors. It also means that interpretation of the rules in practice is greatly aided by having an informed view of which rules are most susceptible to flexible interpretation – that is, the question of when, and how much, the terms of a service contract can safely be “outside of” different requirements of the safe harbors.

#### ***Which Prior Safe Harbors Are Still Relevant?***

The safe harbors for service contracts have been recently revised in separate IRS guidance published in 2014, 2016 and 2017. The current safe harbors, which are set forth in Rev. Proc. 2017-13, supersede the prior safe harbors. The prior safe harbors are still relevant, however, because borrowers may choose to apply prior safe harbors (rather than the new safe harbors) to “grandfathered” contracts (which generally are contracts treated as entered into before August 18, 2017). Because the prior safe harbors were in part based on a statutory directive contained in the Tax Reform Act of 1986, there may also be an argument that the prior safe harbors continue to survive, at least in some form, although the new safe harbors do not expressly so state.

For many years, the IRS safe harbors for service contracts were set forth Rev. Proc. 97-13, which was published in 1997, and amended in 2011. In 2014, the IRS published guidance in Notice 2014-67 that made the safe harbors of Rev. Proc. 97-13 much more flexible. In particular, Rev. Proc. 97-13, as originally drafted, contained elaborate safe harbors for contracts having terms of not more than 2 years, 3 years and 5 years that had different types of compensation arrangements. Notice 2014-67 revised Rev. Proc. 97-13 to provide for a single, much more flexible, safe harbor for contracts having a term not more than 5 years. The references in this update to “Rev. Proc. 97-13” or to the “prior safe harbors” mean Rev. Proc. 97-13 as so revised in 2014. That is, the original Rev. Proc. 97-13 safe harbors as they existed before the 2014 revisions are no longer relevant at all, since the 2014 revisions were in all respects favorable to borrowers.

In 2016, the IRS published Rev. Proc. 2016-44, which superseded Rev. Proc. 97-13 for a period of time. In 2017, the IRS published Rev. Proc. 2017-13, which made certain generally favorable changes to Rev. Proc. 2016-44 within the same framework as the 2016 guidance. Since Rev. Proc.

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2017-13 superseded Rev. Proc. 2016-44, and is generally more favorable, Rev. Proc. 2016-44 is mostly irrelevant going forward, except in unusual cases.

Borrowers may continue to rely on Rev. Proc. 97-13 with respect to a service contract that is entered into before August 18, 2017, unless it is materially modified or in certain cases extended on or after that date. An additional effective date rule also grandfathers extensions of a management contract entered into before August 18, 2017 if the extension is pursuant to a “renewal option” provided in the contract. A renewal option is defined as a provision under which either party has a legally enforceable right to renew the contract.

Accordingly, during a long transitional period, an important consideration in reviewing certain management contract extensions will be whether the extension is pursuant to the terms of the contract.

Attached as Appendix 3 is a listing of some of the situations for which it may be helpful to borrowers to apply the prior safe harbors rather than the new safe harbors.

### ***A Contract Term Up To 30 Years Is Permitted, but What Limitations Apply?***

Under the new safe harbors, the term of the service contract may be no greater than the lesser of 30 years or 80% of the “weighted average reasonably expected economic life of the managed property.” By comparison, the prior Rev. Proc. 97-13 establishes separate safe harbors for management contracts with terms not exceeding 5 years, 10 years, 15 years, and, 20 years. The new safe harbor applies the 80% economic life limit to contracts with any term, although the prior safe harbors do not apply the 80% limit to contracts having a term of five years or less.

In addition, the rule in the prior safe harbors refers to not more than 80% of the economic life of the “financed property.” The new safe harbors refer to the “managed property” rather than the “financed property,” which may be a helpful clarification, because it possibly can be read as focusing on the economic life of the property that is managed, and not the assets that are financed by a particular bond issue. The new safe harbors also include some clarifications about how to apply the 80% test.

In particular, land is treated as having a 30-year economic life in cases where more than 25% of proceeds of a bond issue finance land.

In spite of these “clarifications,” the 80% rule can be burdensome to apply and proper application of the rule can be unclear.

The new safe harbors subject service contracts of five years or less to the 80% of economic life requirement. Attempting to literally apply this safe harbor rule to many shorter-term contracts can be burdensome, particularly when the managed property includes equipment. Keeping in mind the purpose of this requirement can be helpful for addressing this rule in practice. The new safe harbors are written in a manner that indicates that the main purpose of the term limitation is to provide assurance that the borrower will be treated as the owner of the property and that the service provider is not the owner in substance.

Under federal tax law, the question of who is the “tax owner” of property is based on a number of different facts and circumstances and not only based on who is the legal holder of title. The term of a service contract is just one of many relevant facts. In particular, the right of the legal owner to substitute property may be a strong indication that it will be treated as the owner for tax purposes.

In that light, one reasonable way to consider applying the 80% rule may be to apply it flexibly for short-term contracts (for example, with a term of five years or less), unless the contract contains particular provisions that may call into question tax ownership (such as a contract that does not give the borrower the right to substitute equipment). For longer-term contracts, however, the 80% rule generally may need to be more rigorously applied.

### ***What Types of Compensation are Permitted?***

If a service contract meets the other requirements of the new safe harbors, most types of variable or fixed compensation are permitted (other than net-profit sharing). The Rev. Proc. 97-13 safe harbors historically were based on the extent to which compensation is fixed. That fixed fee framework no longer applies under Rev. Proc. 2017-13.



No **“Net Profits Arrangements.”** The new safe harbors rely more heavily on the rule in the IRS regulations that states that a management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation based, in whole or in part, on a share of net profits from the operation of the facility. The new safe harbors provide an additional gloss on this continuing standard, which may or may not be helpful to borrowers.

Specifically, the new safe harbors state that 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 or expenses for any fiscal period.” For this purpose, the elements of compensation are “the eligibility for, the amount of, and the timing of the payment of the compensation.” Accordingly, the new safe harbors do not permit a “trigger” that is based on a net profits standard for the payment of compensation, even if the compensation is not itself a share of net profits.

This interpretation of the no “net profits” standard is seemingly stricter than under the prior safe harbors. By comparison, in a private letter ruling (PLR 20162203) interpreting Rev. Proc. 97-13, the IRS concluded that a hotel management contract did not give rise to private business use, even though the contract provided for additional compensation triggered by a benchmark that was “a variant of net profits.” In that case, the IRS permitted favorable treatment of the contract, in part because the amount of the payment was not based on net profits. Such a private letter ruling only applies to the specific issuer that requested it, and it is unclear whether its favorable conclusion would still apply under the reframed standards of Rev. Proc. 2017-13.

The new guidance also states that “incentive compensation will not be treated as providing a share of net profits if the eligibility for incentive compensation is determined by the service provider’s performance in meeting one or more standards that measure quality of services, performance or productivity,” but only if the amount and timing of the payment meets the requirements set forth above.

One important point is that reviewing a contract under the no “net profits” rule requires considering the payment terms of a contract as a whole, including the provisions relating to basic compensation, incentives, and payment of expenses. Merely reviewing the section of a contract labeled “compensation” is often insufficient. Indeed, the most difficult questions often arise from a close review of incentive compensation provisions and provisions concerning payment of expenses. This is one reason why it is sometimes perilous to rely only on a checklist approach without legal review. The new safe harbors provide that incentive compensation will not be treated as based on “net profits” if the eligibility for the incentive compensation is determined by the service provider’s performance in meeting one or more standards that measure quality of service, performance or productivity. The new safe harbors also helpfully clarify that compensation arrangements (which were described in the old safe harbors) are not treated as based on “net profits” if they are based solely on a capitation fee, a periodic fixed fee, a per-unit fee, or permitted incentive compensation, or any combination of these.

The new safe harbors do not provide similar favorable treatment for compensation that is based on a share of gross revenues or gross expenses. Such arrangements are common for many types of service contracts, and in many cases do not result in private business use, but such compensation arrangements need to be carefully considered. In particular, IRS officials have indicated that a service contract may be treated as providing for compensation based on a share of “net profits” if the service provider receives compensation as a share of gross revenues and is required to pay operating costs of the financed facility.

#### ***When, If Ever, Can the Service Provider Bear Net Losses from Operations?***

A service contract does not meet the new safe harbors if it, in substance, imposes on the service provider “the burden of bearing any share of net losses from the operation of the managed property.” For this purpose, a contract will not be treated as requiring the service provider to bear a share of net losses if: (1) the determination of the amount of the service provider’s compensation and the amount of any expenses paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed

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property's net losses or both the managed property's revenues and expenses for any fiscal period; and (2) the timing of the payment of compensation is not contingent upon the managed property's net losses.

The new safe harbors helpfully provide, as an example, that a service provider whose compensation is reduced 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 be treated as bearing a share of net losses as a result of this reduction.

This new requirement is not set forth in prior safe harbors. In general it is framed in a manner similar to the provision concerning net profits arrangements. Accordingly, in a manner similar to review for "net profits" compensation, review of whether a contract requires the service provider to bear net losses requires consideration of all terms of the contract providing for payments, which often requires a review of several different provisions regarded as a whole.

The no "bearing of net losses" requirement commonly tends to be a particularly important issue for long-term service contracts for hotels, convention centers and infrastructure. As a business matter, borrowers commonly prefer the service provider to have "skin in the game" – which can mean bearing the risk of operating loss. In those cases, there is often a tension between the requirement of the tax safe harbors and the business objective.

#### ***What Types of Deferral of Compensation Are Permitted?***

The new safe harbors include a new provision that permits deferral of compensation provided that: (1) the compensation is payable at least annually; (2) the borrower is subject to reasonable consequences for late payment; and (3) the borrower will pay such deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of the payment.

This five-year deferral safe harbor is framed as a further interpretation of the no "net profits" compensation rule and the "no bearing of net losses" rule.

The five-year period is somewhat arbitrary, in the sense that it is not informed by substantive case law or the Code. As a practical matter, however, it can be expected that the five-year rule will in most cases be viewed as an outside limit for unqualified tax opinions, and in that sense likely to be subject to little flexibility.

#### ***What Control Does A Borrower Need to Have Over the Managed Property?***

A core provision of the new safe harbor is a requirement that the borrower "must exercise a significant degree of control over use of the managed property." This new requirement is not set forth in the prior safe harbors. The new safe harbors state that 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
- The general nature and type of use of the managed property (for example, the type of services)

The new safe harbors are framed in a manner that suggests that the requirement to meet the safe harbor is generally whether the borrower exercises a "significant degree of control" and that the five listed specific elements of control are one way to meet that standard. Accordingly, a reasonable reading of the new safe harbors is that the "significant degree of control" requirement can be established in other ways. For example, it may be possible to conclude that a contract including most of the listed control rights, but not all, can still meet the control safe harbor, particularly if there are other factors indicating control by the borrower.

The new safe harbors provide helpful clarification of what is meant by certain of the listed control rights. As an example, a borrower 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 may show approval of dispositions of property in a similar manner.

Further, a borrower may show approval of rates charged for use by “expressly approving such rates or a general description of the methodology for setting such rates (such as a method that establishes hotel room rates using specified revenue goals based on comparable properties), or by requiring that the service provider charge rates that are reasonable and customary as determined by, or negotiated with, an independent third party (such as a medical insurance company).” The rate control requirement was made significantly more flexible in the 2017 revisions to the new safe harbors and importantly can be met by approval of a “methodology” for setting rates rather than the actual rates charged.

As is discussed above, IRS regulations have long provided that borrower control of managed property is an important factor in evaluating whether a service contract results in private business use. Accordingly, the rule that control is a relevant factor to consider is not new. The prior safe harbors, however, did not address any of the five control rights listed in the new safe harbors. One important question is whether these five listed control rights are equally important. One reasonable reading is that the right to approve the “general nature and type of use” of the managed property is the most important, because failure to have such fundamental control could be particularly indicative of an arrangement that is a lease in substance. The right to approve significant dispositions would also appear to have considerable weight, because the right to control significant dispositions is indicative of ownership. On the other hand, one reasonable reading is that the right to approve rates, although plainly an important factor in many situations, is not always a requirement for a bona fide service contract.

These new control rights requirements, and in particular the requirement that the borrower control rates, may raise many questions and require a change in practices for management contracts entered into, materially modified or in certain cases extended on or after August 18, 2017. For example, in the case of physician contracts for hospitals financed with tax-exempt bonds, many existing “separate billing” arrangements that have been treated as within the Rev. Proc. 97-13 safe harbors may not be exactly within the new safe harbors, unless the contracts are reframed to reflect these new requirements.

### ***When, If Ever, Can the Service Provider Bear Risk of Loss of the Managed Property?***

In order to meet the new safe harbor, the borrower must bear the risk of loss of the managed property (for example, upon force majeure). This requirement is in addition to the requirement that the service provider not bear the risk of losses from operations. This requirement rather refers to the risk of loss of the actual physical property that is managed.

A borrower does not fail to meet this risk of loss requirement as a result of insuring against risk of loss through a third party or imposing on the service provider a penalty for failure to operate the managed property in accordance with standards set forth in the management contract.

This is another new requirement not addressed in the prior safe harbors (but may have been implicit in a general way).

### ***Are There Specific Provisions that Now Need to be in Service Contracts?***

*No Inconsistent Tax Position.* Another new requirement is that the service provider must agree “that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property.” As an example, 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. This express agreement needs to be included in contracts under the new safe harbor.

One example of the form of contract provision required to meet this safe harbor requirement is attached as Appendix 4.

This new requirement is another provision that will likely require a change from current prevailing practices for service contracts entered into, materially modified or in certain cases extended after August 18, 2017. Many if not most existing contracts that are treated as within the Rev. Proc. 97-13 safe harbors do not contain such an express agreement. Specific agreements regarding tax treatment of the type required by the new safe harbor may have been included in some long-term management contracts as a matter of prevailing practice, but have been less common in shorter-term contracts because the tax treatment has been regarded as implicit.

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### ***What Special Requirements Apply if the Borrower and the Service Provider Have a Governance Relationship?***

#### ***No Circumstances Substantially Limiting Exercise of Rights.***

The new safe harbors continue a general requirement that the service provider must not have 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. This same general requirement is contained in the prior safe harbors with somewhat stricter detailed rules.

The new safe harbors provide that this requirement is met if: (1) no more than 20% of the governing body of the borrower is vested in persons having a role with the service provider; (2) the governing body of the borrower does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and (3) the chief executive officer of the service provider is not the chief executive officer of the borrower or any of the borrower's related parties. For the purpose of this safe harbor, "service provider" now expressly includes related parties to the service provider. In addition "chief executive officer" includes any person with equivalent management responsibilities.

The prior safe harbors provide for similar rules that are framed in a slightly different manner. The requirement under the prior safe harbors is met if: (1) not more than 20% of the voting power of the governing body of the borrower is vested in the service provider and its directors, officers, shareholders, and employees; (2) overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and (3) the borrower and the service provider are not related parties.

One of the main differences between the new safe harbors and the prior safe harbors is that the prior safe harbors do not permit the service provider to be a related party to the borrower. The new safe harbors do not carry forward that rule, presumably because there are instances in which the borrower and the service provider can be related, but in which the service provider exercises no control at all over the borrower (such as when the service provider is a 100% controlled subsidiary of the borrower).

Because the specific requirements concerning overlapping board members continue to be framed as a "safe harbor within a safe harbor," issuers should be able to reasonably meet the substantive requirement based on other factors.

This requirement of the safe harbors may lend itself to the most flexible interpretation. The safe harbors are not reasonably read to imply that a service contract necessarily results in private business use only because the service provider is a person in a position by governance role to exercise substantial influence over the borrower. Service contracts are, in fact, commonly entered into with persons that are related parties to a borrower or that have such a governance relationship. The more important point is that any service contract needs to be subject to special review and special procedures to avoid conflict of interest, if the service provider is in a position to exercise substantial influence over the borrower.

### ***When is a Service Provider Permitted to Have "Lease-Like" Rights?***

***Functionally Related and Subordinate Use.*** The new guidance contains a helpful new provision relating to "functionally related and subordinate use." Under this new rule, a service provider's use of a project that is functionally related and subordinate to performance of its services under a management contract does not result in private business use, if the contract meets all of the requirements of the new guidance. An example is use of storage areas to store equipment used to perform activities under a management contract.



### ***What Rules in IRS Regulations Are Important That Are Not Addressed in the Safe Harbors?***

**Anti-Abuse Rules.** The safe harbors do not override any of the provisions of the IRS regulations. Accordingly, it is important to continue to interpret the safe harbors in the context of the rules of the IRS regulations. In particular, the anti-abuse rules in the IRS regulations provide that, in certain circumstances, an arrangement that directly or indirectly passes through to private persons the financial benefit of tax-exempt interest rates may result in private business use, even if the arrangement would not otherwise result in private business use under the regulations. This anti-abuse rule may continue to be an important consideration in reviewing certain management contracts.

### ***What Important Questions Aren't Addressed in the New Safe Harbors?***

The new safe harbors address more questions than the prior safe harbors, but do not address all questions relevant to the treatment of service contracts that commonly arise in practice.

**When do two contracts need to be tested as a single contract?** It is not uncommon for a borrower to enter into several contracts with a service provider. In some cases, two or more contracts may be so interrelated that they need to be treated as a single contract for private business use purposes. The safe harbors do not address this important question in any manner.

**What special considerations apply to bonds issued for the benefit of 501(c)(3) organizations?** The safe harbors apply to bonds issued for the benefit of State and local governments as well as 501(c)(3) organizations. A number of special tax requirements and rules apply to 501(c)(3) organizations that generally do not apply to State or local governments. The safe harbors do not meaningfully address these special considerations.

**When can an arrangement for use of bond-financed property by the service provider result in private business use, even if the service contract otherwise meets the safe harbors?** In certain types of service contracts the service provider has the responsibility to enter into contracts with end-users of the managed property. For example, in the case of a management contract for a convention center, the manager may be responsible for entering into contracts with the end-users of the

convention center. In such cases, the manager is acting as the agent of the borrower (or at least in a role similar to an agent). Even if the management contract itself meets the safe harbor requirements, the contracts entered into by the manager can result in private business use. The safe harbors do not attempt to address or describe the circumstances under which the actions of the manager to permit use of the managed property can result in private business use. That is, however, a critically important question in framing many types of management contracts.

### ***What Future Developments May Be Expected?***

As is discussed above, the IRS safe harbors for service contracts were revised to be significantly more flexible in 2014, fundamentally changed in 2016, and further revised in 2017. Because the IRS has recently devoted significant resources to revising the rules for service contracts, further revisions in the near future are not expected.

It is possible, however, that the service contract rules could be revisited, and perhaps made more flexible, in the context of legislative or regulatory infrastructure initiatives. For example, in February 2018, the White House released a "Legislative Outline for Rebuilding Infrastructure in America." Included in that Legislative Outline are several proposals to facilitate tax-exempt bond financing for public-private partnerships. Among other things, the Legislative Outline proposes a new safe harbor under which a borrower will be treated as the owner of infrastructure property if the term of a lease is not greater than 95% of the economic life of the leased property (rather than 80%). If such a rule is adopted for leases, it might be expected that a new, more flexible the safe harbors for service contracts for infrastructure property would be considered.

Also, a general theme of the Legislative Outline would be to permit new types of tax-exempt bonds for infrastructure that are available for general public use, even if the infrastructure is treated as used for private business use. If any such legislative proposals are enacted, the safe harbors for service contracts would likely become less important for infrastructure projects.

Finally, it can be expected that the IRS will continue to issue private letter rulings concerning service contracts that do not meet all requirements of the new safe harbors.

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### ***Separate Safe Harbor for “Eligible Expense Reimbursement Arrangements”***

A separate safe harbor is established for “eligible expense reimbursement arrangements.” An “eligible expense reimbursement arrangement” is defined as a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider. An eligible expense reimbursement arrangement does not result in private business use, regardless of whether the other requirements of the new guidance are met.

This separate safe harbor is an expansion of an exception set forth in the IRS regulations from private business use that previously applied only to management contracts for public utility property.

The references in this update to the “new safe harbors” refer to the new general safe harbors, and not to this special rule, which has more limited applications.

### ***What Special Considerations Apply to Exempt Organization Borrowers?***

As is discussed above, the safe harbors apply to both bonds issued for the benefit of State and local governments (so called “governmental” bonds) and bonds treated as issued for the benefit of Section 501(c)(3) exempt organizations (so-called “qualified 501(c)(3) bonds”).

A number of special rules apply to qualified 501(c)(3) bonds under Section 145 of the Code that do not apply to governmental bonds. In addition, 501(c)(3) organizations are subject to a number of federal tax rules that do not apply to State and local governments, including rules relating to private benefit, private inurement and unrelated trade or business use.

***Unrelated Trade or Business Use.*** A service contract that results in an activity being treated as an unrelated trade or business activity of the borrower is treated as private business use for purposes of the tax-exempt bond rules, regardless of the terms of the contract (and regardless of whether the contract meets the safe harbors). This is not usually a problem, but needs to be carefully considered in some cases.

***Private Benefit and Private Inurement.*** The private benefit and private inurement rules generally require that a 501(c)(3) organization pay a private provider of services not more than reasonable compensation. The possible consequences of failing to meet these rules (loss of 501(c)(3) status) could be catastrophic for most organizations, and would generally cause bonds issued for the benefit of such organizations to fail to qualify as tax-exempt.

The new safe harbors for service contracts concern only the IRS rules relating to tax-exempt bonds and are not safe harbors for private benefit or private inurement purposes (or any other tax purposes). This means that the application of the private benefit and private inurement rules could limit the permissible terms of a service contract, even if the terms would otherwise be permitted under Rev. Proc. 2017-13.

In particular, long-term service contracts may raise difficult questions under the private benefit and private inurement rules, because the longer the term of a contract is, the more difficult it may be to establish that the compensation is reasonable over its term. Certain variable and incentive payment compensation arrangements may also raise difficult questions under the private benefit and private inurement rules.

***Private Inurement, Excess Benefit Transactions and Disqualified Persons.*** The safe harbor requirement that the service provider must not have any role or relationship with the borrower that, in effect, substantially limits the borrower’s ability to exercise its rights under the service contract raises other special considerations when applied to 501(c)(3) organizations. That is because 501(c)(3) organizations are subject to a number of special federal tax rules concerning dealings with insiders or “disqualified persons.”

Under Section 4958 of the Code the IRS can impose special excise taxes in connection with “excess benefit transactions.” An excess benefit transaction generally is any transaction in which an economic benefit is provided by a tax-exempt organization to or for the use of a “disqualified person” if the value of the economic benefit exceeds the value of the consideration given in exchange. A “disqualified person” generally is any person who was, at any time during the 5-year period ending on the date of the transaction, “in a

position to exercise substantial influence over the affairs of the organization,” and certain other persons deemed to be related to such a person under detailed rules.

Notably, neither the private inurement rules nor the excess benefit transaction rules prohibit dealings between a 501(c)(3) public charity and an insider or disqualified person. Instead, the rules effectively provide that such dealings must be carefully reviewed to establish that they provide for no more than reasonable benefit to the insider or disqualified person for service rendered or property provided.

The regulations under the excess benefit transaction rules establish a procedural approach that is somewhat akin to a safe harbor concerning how a tax-exempt organization can enter into a transaction with a disqualified person. This “rebuttable presumption” rule provides a roadmap for approving any such transactions and establishing that the benefit to the disqualified person is not more than reasonable. In general, to meet this rebuttable presumption rule: (1) the arrangement must be approved in advance by an authorized body of the tax-exempt organization composed of individuals who do not have a conflict of interest; (2) the authorized body must have obtained and relied upon appropriate data as to comparability of the arrangement prior to making its determining; and (3) the authorized body must adequately document the basis for its determination.

The rules for “disqualified persons” overlap with the rule in the Rev. Proc. 2017-13 safe harbors relating to “no role or relationship limiting exercise of rights,” but the rules are different in scope. In particular, in many cases, a service provider could meet the safe harbor under Rev. Proc. 2017-13 but still be treated as a “disqualified person.” For example, a physician that is the head of a hospital department that is a major source of patients admitted to the hospital may be treated as a “disqualified person” with respect to the hospital, even if the physician has no formal governance rights. In addition, a service provider could become a “disqualified person” by virtue of management rights under a service contract.

Rev. Proc. 2017-13 makes no reference to any of these rules that apply to 501(c)(3) organizations. One reasonable approach, however, may be to, in effect, apply the “rebuttable presumption” rules to any service contract in a broad manner. Under such an approach, procedures to avoid possible conflict of interest would be applied not only when a service contract is entered into, but also in any circumstance in which the tax-exempt organization seeks to enforce its rights under the service contract.

## Appendix 1

### Comparison of Safe Harbors: Rev. Proc. 97-13 and Rev Proc. 2017-13

Requirement	Rev. Proc. 97-13	Rev. Proc. 2017-13	Comments
Term of Contract	Different term limits for different types of compensation arrangements (5-year, 10-year, 15 year and 20-year)	30-year permitted, but not longer than 80% of economic life of managed property	2017-13 generally permits longer terms, but subjects contracts having a term of 5 years or less to the 80% economic life test; other factors could permit a flexible interpretation for shorter-term contracts
No “Net Profits” Compensation	Must not be based on a “share of net profits”; must not be based on both revenues and expenses	Must not be based on a “share of net profits”; must not be based on both revenues and expenses; eligibility for, the amount of, or the timing or the payment of compensation must not take into account or be contingent on net profits	The rule is more strictly stated in 2017-13 to not permit any net profits “trigger” for compensation, even if the amount of compensation is not a share of net profits
Fixed/ Variable Compensation	Fixed fee required for 80% of annual compensation for 10-year contracts; 95% for 15-year contracts and certain 20-year contracts	No fixed compensation requirement	The rejection of the prior “fixed fee” framework is one of the most helpful 2017-13 changes; greater emphasis on no “net profits” rule
Incentive Fees	Productivity award permitted if (1) the eligibility is based on quality of services provides, rather than increases in revenues or decreases in expenses; and (2) the amount of the award is a stated dollar amount, a periodic fixed fee or a tiers system of stated dollar amounts and or periodic fixed fees; number of rewards limited for contracts over 5 years (because of the fixed fee requirements)	Incentive compensation permitted if eligibility is determined by the service provider’s performance in meeting one or more standards that measure quality of services, performance, or productivity and the amount and timing of the payment does not cause the compensation to fail to meet the no “net profits” rule	2017-13 is framed in a manner that is more flexible, but also expressly requires that incentive compensation be taken into account under the no “net profits” rule



Requirement	Rev. Proc. 97-13	Rev. Proc. 2017-13	Comments
Risk of Loss from Operation of the Facility	No express provision, although referred to as a factor in IRS regulations	The contract must not impose on the service provider the burden of bearing any share of net losses from operations	Commonly a key requirement to review in longer-term contracts for hotels, convention centers and infrastructure, because the borrower may want, as a business matter, for the service provider to share risk of operating loss
Deferral of Compensation	No express provision, but a requirement of payment at least by the end of the term may be implied	Deferral of compensation is permitted if (1) the compensation is payable at least annually; (2) the borrower must pay reasonable interest charges or late fees; and (3) the borrower will pay the deferred computation no later than five years after original due date	The new deferral of compensation rule is framed as an exception to the rules relating to the no “net profits” compensation rule and the rule not permitting the service provider to bear operating losses; in most cases, the five-year deferral period may be treated as the outside limit, even though a safe harbor
General Control Requirement	No express provision, although referred to as a factor in IRS regulations	The borrower must exercise a significant degree of control over the use of the managed property	A general requirement of significant borrower control is likely implicit under the old safe harbors and is not new; the five listed control rights, however, are new
Control Over General Nature and Type of Use	No express provision, although perhaps implicit	The borrower must approve the general nature and type of use	Probably the most important control right

Requirement	Rev. Proc. 97-13	Rev. Proc. 2017-13	Comments
Control Over Significant Dispositions	No express provision	The borrower must approve significant dispositions	The new safe harbors permit dispositions up to an approved maximum amount without borrower approval of each specific disposition
Control Over Capital Expenditures	No express provision	The borrower must approve significant capital expenditures	The new safe harbors permit capital expenditures up to a maximum stated amount without borrower approval of each specific expenditure
Control Over Rates	No express provision	Borrower must approve rates charged; may be shown by approving rates or a general methodology for setting rates or by requiring that the rates are reasonable and customary as determined by a third party	The different ways to meet the rate control requirement are flexible but raise questions, particularly regarding approval of a “methodology”; not present in many existing contracts
Risk of loss	No express provision, although referred to as a factor in IRS regulations	The borrower must bear the risk of loss upon damage or destruction of the managed property. Permits insuring risks through a third party and imposing on the service provider a penalty for failure to operate in accordance with standards	A new requirement, although possibly implicit in the regulations; distinct from the rule regarding bearing of operating loss
No role or relationship substantially limiting borrower’s exercise of rights	The service provider must not have any role or relationship with the borrower that, in effect, substantially limits the borrower’s ability to exercise its rights under the contract	The service provider must not have any role or relationship with the borrower that, in effect, substantially limits the borrower’s ability to exercise its rights under the contract	The general requirement is the same; the detailed requirements under the new safe harbors are framed in a manner slightly different than the old same harbors

Requirement	Rev. Proc. 97-13	Rev. Proc. 2017-13	Comments
20% voting power rule	Not more than 20% of the voting power of the governing body of the borrower is vested in the service provider and its directors, officers, shareholders and employees	No more than 20% of voting power of the governing body of the borrower is vested in the officers, directors, shareholders, partners, members and employees of the service provider, in the aggregate	The Rev. Proc. 2017-13 rule is essentially the same as the prior safe harbor, but stated in a slightly broader manner
Overlapping board members must not include CEOs	Overlapping board members must not include the CEOs of the service provider or its governing body or the borrower or its governing body	The governing body of the borrower must not include the CEO (or equivalent executive) of the service provider or the chairperson (or equivalent executive) of the service provider's governing body	The Rev. Proc. 2017-13 rule is similar, but stated in a slightly broader manner
Overlapping CEOs	No express rule, except as covered by the above	CEO of the service provider is not CEO of the borrower or any related party	The Rev. Proc. 2017-13 rule is broader
Not related parties	The borrower and the service provider are not related parties	No rule based on related parties	The Rev. Proc. 2017-13 rule is narrower

## Appendix 2

### Some Reasons Why It Can Be Helpful to Test Grandfathered Service Contracts Under Rev. Proc. 97-13

Requirement	Rev. Proc. 97-13	Rev. Proc. 2017-13	Comments
Application of 80% of Economic Life Test, Particularly for Short-Term Contracts	No limit of term to 80% of economic life of financed property for contracts of 5 years or less	Limits term of all service contracts to 80% of economic life of managed property	Testing short-term contracts for compliance with the 80% rule could be an administrative burden
Application of Rate Control Requirement, Particularly for Short-Term Contracts	No express requirement of control of rates by the borrower, but the general principle that control is an important factor is set forth in IRS regulations	Expressly requires the borrower to control the managed property, including approval of annual budget, significant capital expenditures, significant dispositions, rates charged and general nature and type of use	Many existing contracts do not meet all of the control requirements, particularly the rate control requirement
Risk of Loss from Operations	No express requirement regarding risk of operating loss, but the general principle that risk of loss is an important factor is set forth in IRS regulations	Expressly requires that the service provider not bear operating loss	Some degree of bearing operating loss could reasonably be consistent with Rev. Proc. 97-13, depending on the facts and circumstances
Contract Provision Regarding “No Inconsistent Tax Position”	No provision required	Expressly requires that the service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider with respect to the managed property	A best practice is to include the required provision in all new contracts and renewals; most existing contracts, however, do not contain the required provision



## Appendix 3

### A View of Service Contract Safe Harbor Requirements From Most Flexible to Least Flexible

A service contract containing any provision not within the safe harbors should be subject to special review, but failure to meet one of the requirements does not necessarily mean that a service contract results in private business use. The different safe harbor requirements are based on different underlying concerns, and it is reasonable to address them differently in that light. In particular, one question that often arises is whether a service contract that does not meet one or more of the specific safe harbors nonetheless may be treated as not resulting in private business use. The following is one view of which specific safe harbors are most flexible (that is, when is it usually most possible to “go outside of” the safe harbors).

Requirement	Comments
No service provider control of 20% of governing body/ no overlapping CEOs	The safe harbors are not reasonably read as necessarily implying that any service contract results in private business use if the service provider is a person in a position to exercise substantial influence over the borrower; in most such cases, safeguards to prevent any conflict of interest should suffice, provided they apply with respect not only to entering into the contract but also to enforcement of contract terms
Contract includes specific provision that the service provider will not take any tax position inconsistent with being a service provider	Including the required wording is a best practice for all new contracts and renewals; in many shorter-term contracts, however, the tax position of the service provider is clear from context; including the specific provision is more important if one or more other safe harbor requirements is not met (particularly the 80% test)
Contract term is not more than 80% of economic life of managed property	Appropriately viewed as a “tax ownership” safe harbor; tax ownership can reasonably be established by considering other factors, particularly for short-term contracts; cumbersome to apply in many cases
Compensation to service provider is not based both on revenues and expenses	A compensation arrangement that technically is based on both revenues and expenses in limited respects could reasonably be determined to be remote from a “net profits” arrangement, based on particular circumstances

Requirement	Comments
Borrower control over annual budget	An important factor that a service contract is not a lease in substance; in some contexts
Borrower control over rates charged	An important indicator that a service contract is not a lease in substance; in some contexts other strong control factors possibly can suffice, particularly for short-term contracts
Borrower control over capital expenditures	An important indicator of tax ownership, but possibly less important than control over dispositions
Borrower control over significant dispositions of managed property	An important indicator of tax ownership
Service provider must not bear risk of operating loss	In concept similar to the rule prohibiting compensation based on net profits, but not subject to an express rule in the regulations in the same manner as the no “net profits” compensation rule
Borrower control over nature and type of use of the managed property	Fundamental to a service provider arrangement and usually not a concern
Service provider must not bear risk of loss	Indicates that the service provider has down-side risk in the managed property itself
Compensation eligibility or timing not based on a net profits trigger, even if the compensation amount is not based on a share of net profits	IRS officials have stated that some net profits “triggers” may be permitted consistent with prior private letter ruling positions, but any such arrangements should be subject to particularly careful scrutiny
Five-year rule for deferral of compensation	The maximum five-year period is somewhat arbitrary, but in practice can be expected to be treated as a bright-line rule
No amount of compensation based on a share of net profits	Expressly prohibited by IRS regulations

## Appendix 4

### Form Service Contract Provision Regarding No Inconsistent Tax Position

#### **FEDERAL TAX MATTERS RELATING TO TAX-EXEMPT FINANCING**

The Service Provider acknowledges that it is advised by the [Borrower] that property of the [Borrower] used under this Agreement may have been financed with tax-exempt bonds issued for the benefit of the [Borrower]. Accordingly, it is the intent of the Service Provider and the [Borrower] that this Agreement be interpreted in a manner that meets an exception from “private business use” under Sections 141 and 145 of the Internal Revenue Code, and specifically meets a safe harbor from private business use under Internal Revenue Service Rev. Proc. 2017-13.

The Service Provider agrees that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the [Borrower] with respect to the property provided by the [Borrower] that is managed or otherwise used under this Agreement. For example, the Service Provider agrees not to claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the property provided by the Institute that is managed or otherwise used under this Agreement. The Service Provider specifically acknowledges and agrees that this Agreement is not a lease, and provides for no rights of any kind to the Service Provider as a lessee.

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## Learn More

To discuss the ideas presented in this update and their relevance to your organization, please contact any of the following attorneys:

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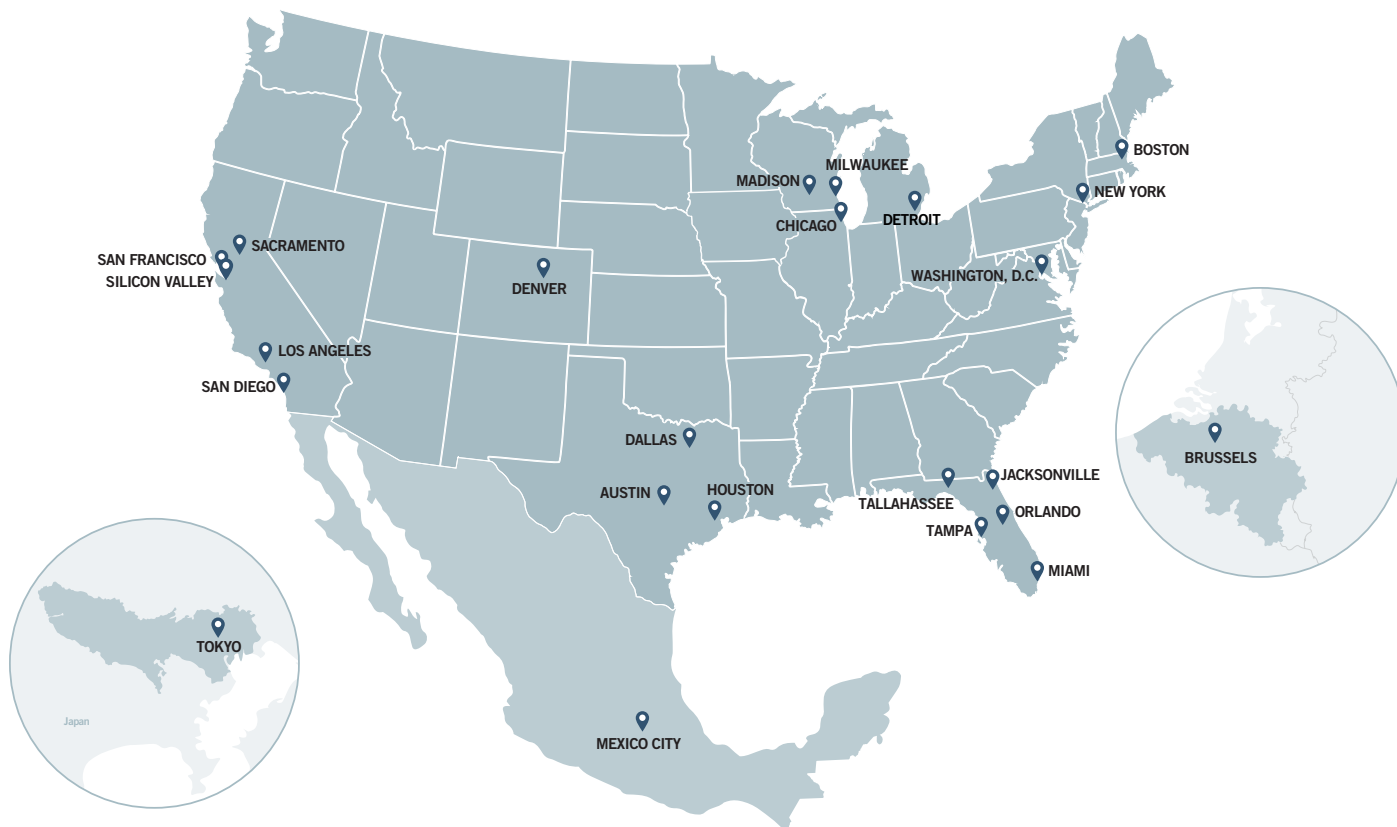
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