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Author:



Janet E. Zeigler
Shareholder
312.873.3679

jzeigler@polsinelli.com

IRS Guidelines provide Greater Flexibility to Nonprofit Borrowers

New guidelines from the Internal Revenue Service substantially overhaul safe harbors that have existed for 20 years. Specifically, the IRS recently released Revenue Procedure 2017-13 (“Rev. Proc. 2017-13”), which establishes certain safe harbors from the characterization of a management or service contract as private business use.

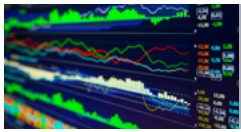
Nonprofit organizations that are exempt from federal income taxation under Section 501(c)(3) (“Tax Exempt Organizations”) of the Internal Revenue Code of 1986, as amended (the “Code”) and have assets that are financed with the proceeds of tax-exempt bonds (“Bond-Financed Property”) will likely require some revisions to their standard contract provisions to address certain requirements included within the Rev. Proc. 2017-13 safe harbors.

What is Private Business Use?

Private business use is the direct or indirect use of Bond-Financed Property, by a non-governmental person or an entity that is not a Tax Exempt Organization (collectively, “Nonexempt Users”).¹ The Code permits only a minimal amount of private business use of Bond-Financed Property (5% of the proceeds of each issue of Tax Exempt Bonds reduced by amount of costs of issuance financed with proceeds of the Tax-Exempt Bonds) or, in the case of bond issues greater than \$300 million, the lesser of 5% (reduced by costs of issuance) and \$15 million.

Nonprofit organizations that are exempt from federal income taxation under Section 501(c)(3) (“Tax Exempt Organizations”) of the Code can benefit from their ability to finance certain assets on a “tax-exempt” basis. Governmental entities serve as “conduit” issuers for Tax Exempt Organizations, issuing bonds, the interest on which is exempt from federal income taxation (“Tax Exempt Bonds”), for the benefit of a Tax Exempt Organization. Because the interest accruing on these Tax Exempt Bonds is exempt from federal income taxation, Tax Exempt Bonds typically bear interest at lower interest rates

¹ Use by a Tax Exempt Organization of property financed with proceeds of governmental bonds (rather than 501(c)(3) bonds), is also considered a private business use of that bond-financed property.



than the interest rates on comparable taxable debt, resulting in a lower cost of capital for these Tax Exempt Organizations. This benefit, however, is not without a price. The federal government considers this benefit to be a “federal subsidy” (because it forgoes the tax revenue from interest accruing to holders of Tax Exempt Bonds) and, therefore, imposes a number of restrictions on Tax Exempt Organizations relating to their ownership and use of the Bond-Financed Property.

Given the small amount of private use that may be financed with proceeds of Tax-Exempt Bonds, Tax Exempt Organizations must understand and monitor the amount of private business use of their Bond Financed Property. Private business use of Bond Financed Property may also arise from certain research arrangements, leases and activities that are considered unrelated trade or business activities. This article does not discuss private business use that may result from these activities.

Management and Service Contract Guidelines

The Income Tax Regulations² (the “Regulations”) provide generally that a “management contract” with respect to Bond Financed Property may result in private business use of that property, based on all of the facts and circumstances. Note that the references herein to “Bond Financed Property” are important – the limitations discussed in this article do not restrict a Tax Exempt Organization’s ability to use its property, other than Bond Financed Property, in a private business use.

A “Management Contract”³ is a management, service, or incentive payment contract between a governmental person and a Nonexempt User under which the Nonexempt User provides services involving all, a portion, or any function, of a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital is each treated as a management contract.

² Section 1.141-3(b)(4)(i)

³ Section 1.141-3(b)(4)(ii)

Management contracts include contractual arrangements with Non Exempt Users – e.g., hospital-based physician arrangements, food service arrangements and other arrangements where the Tax Exempt Organization enters into an agreement that gives a Non Exempt User the right to manage, operate or otherwise occupy the Tax Exempt Organization’s Bond Financed Property.

Certain Exceptions. The following arrangements are not considered to be management contracts that create private business use:

(A) contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services);

(B) the mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services if those privileges are available to all qualified physicians in the area, consistent with the size and nature of the hospital’s facilities;

(C) a contract to provide for the operation of a facility or system of facilities that consists primarily of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the Nonexempt User and reasonable administrative overhead expenses of the Nonexempt User; and

(D) a contract to provide for services, if the only compensation is the reimbursement of the Nonexempt User for actual and direct expenses paid by the Nonexempt User to unrelated parties and reasonable overhead expenses of the Nonexempt User.

No Net Profits Arrangements. A management contract with respect to Bond Financed Property generally results in private business use if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operations of the facility.





Safe Harbors. While the Code and the Regulations provide that the determination of whether a management contract creates private business use is dependent upon a review of all of the facts and circumstances, the IRS has created certain safe harbors and has indicated that contracts falling within these “safe harbors” will not create private business use.

Rev. Proc. 97-13, which until recently was the operative guidance, created safe harbors for management contracts that varied depending upon the term of the contract, the type of compensation and the relationship between the parties. Under Rev. Proc. 97-13, contracts that had high percentages of fixed compensation in each year could have a longer term (e.g., if at least 95% of the compensation in each annual period was fixed in advance, then the contract term could be 15 years).

Rev. Proc. 2017-13 provides a more flexible approach to management contracts, focusing less on the overall term and fixed vs. variable nature of the compensation, and more on elements of maintaining control of the Bond Financed Property.

General Requirements of Rev. Proc. 2017-13.

Reasonable compensation. The payments to the Nonexempt User under the contract must be reasonable compensation for the services rendered during the term of the contract. Compensation includes payments to reimburse actual and direct expenses paid by the Nonexempt User and related administrative overhead expenses of the Nonexempt User.

No net profits. The contract cannot provide for any sharing of net profits from the operation of the managed property. No element of the compensation can take into account, or be contingent upon, net profits, or based upon a percentage of revenues and expenses for any fiscal period. For this purpose, the elements of the compensation are the eligibility for, the amount of, and the timing of the payment of the compensation.

Incentive compensation. Incentive compensation will not be treated as providing a share of net profits if the eligibility for the incentive compensation is determined by the Nonexempt

User’s performance in meeting one or more standards that measure quality of services, performance, or productivity, and the amount and the timing of the payment of the compensation meet the requirements for “no net profits” described above.

No bearing of loss for Bond Financed Property. The contract cannot impose upon the Nonexempt User any share of net losses from the operation of the managed property. An arrangement will not be treated as requiring the Nonexempt User to bear a share of net losses if:

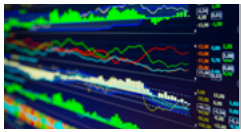
- The determination of the amount of the Nonexempt User’s compensation and the amount of any expenses to be paid by the Nonexempt User (and not reimbursed), separately and collectively, do not take into account either the managed property’s net losses or both the managed property’s revenues and expenses for any fiscal period; and
- The timing of the payment of compensation is not contingent upon the managed property’s net losses.

For example, a Nonexempt User 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.

Deferred Compensation. While certain deferred compensation arrangements are permissible, payments must not be contingent upon net profits or net losses. Deferral of the compensation due to insufficient net cash flows from the operation of the managed property will not cause the deferred compensation to be treated as contingent upon net profits or net losses if the contract includes requirements that:

- The compensation is payable at least annually;
- The Tax-Exempt Organization is subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees; and





- The Tax-Exempt Organization 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.

Term of the contract and revisions. The term of the contract is no greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property.

Control over use of the managed property. The Tax Exempt Organization must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the Tax Exempt Organization 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 (for example, the type of services).

For this purpose, for example, a Tax Exempt Organization 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 a Tax Exempt Organization may show approval of dispositions of property that is part of the managed property in a similar manner. Further, a Tax Exempt Organization may show approval of rates charged for use of the managed property 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 Nonexempt User charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (such as a

medical insurance company).

Risk of loss of the managed property. The Tax Exempt Organization must bear the risk of loss upon damage or destruction of the managed property (for example, upon force majeure). A Tax Exempt Organization 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 upon the Nonexempt User a penalty for failure to operate the managed property in accordance with the standards set forth in the management contract.

No inconsistent tax position. The Nonexempt User must agree that it is not entitled to and will not take any tax position that is inconsistent with being a Nonexempt User to the Tax Exempt Organization with respect to the managed property. For example, the Nonexempt User 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.

No circumstances substantially limiting exercise of rights. The Nonexempt User must not have any role or relationship with the Tax Exempt Organization that, in effect, substantially limits the Tax Exempt Organization's ability to exercise its rights under the contract, based on all the facts and circumstances. As a safe harbor, a Nonexempt User will not be treated as having a role or relationship prohibited under Rev. Proc. 2017-13 if:

- No more than 20 percent of the voting power of the governing body of the Tax Exempt Organization in the aggregate is vested in the directors, officers, shareholders, partners, members, and employees of the Nonexempt User;
- The governing body of the Tax Exempt Organization does not include the chief executive officer of the Nonexempt User or the chairperson (or equivalent executive) of the Nonexempt User's governing body; and
- The chief executive officer of the Nonexempt User is not the chief executive officer of the Tax Exempt Organization or any of the Tax Exempt Organization's related parties.



Functionally related and subordinate use. A Nonexempt User's use of Bond Financed Property that is functionally related and subordinate to performance of its services under a management contract that meets the safe harbor requirements of Rev. Proc. 2017-13 (for example, use of storage areas to store equipment used to perform activities required under a management contract) does not result in private business use).

Takeaways

While Rev. Proc. 2017-13 is clearly more flexible in its approach to private business use, there are a few unanswered questions that remain, and a few practical considerations.

- Rev. Proc. 2017-13 provides that the Nonexempt User must agree that it is not entitled to and will not take any tax position that is inconsistent with being a Nonexempt User (for example, no depreciation, amortization, investment tax credit or deduction for any payment as rent with respect to the managed property). Therefore, unless the IRS provides further clarification regarding this element of the safe harbor, the safest course of action for now is to include this language in your new or amended agreements. We would suggest including language similar to the following in any new or amended management agreements.

“[NONEXEMPT USER] agrees that it is not entitled to take any tax position that is inconsistent with its role as a Nonexempt User to [HOSPITAL], including any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the [MANAGED PROPERTY].”

- Incentive compensation (and compensation generally) still needs to be based upon metrics other than net profits. Standards that measure quality of services, performance or productivity are not treated as providing a share of net profits, but any incentive compensation that is based upon revenues and expenses should be carefully reviewed to consider whether the arrangement

would be treated as a “net profits” arrangement (there are some private letter rulings that may provide helpful guidance on these arrangements, but this is a highly “facts and circumstances” analysis, so you should consult your advisors where there may be a concern that the compensation is tied to both revenues and expenses).

- Rev. Proc. 2017-13 requires that the Tax Exempt Organization maintain control over rates charged for the use of the managed property. In any contract where the fees charged by the Nonexempt User are not set forth in the contract, your contract should include a general description of the methodology for setting such rates, or a requirement that the Nonexempt User charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (such as a medical insurance company). Bond counsel may take different views regarding what language is necessary to comply with this requirement, so we would recommend that parties reach out to their bond counsel to understand their position with respect to this control provision.

Effective Dates

The new safe harbors take effect immediately for management contracts entered into, or materially modified, on or after January 17, 2017. However, during an initial transition period ending August 18, 2017, issuers and borrowers may apply either the Rev. Proc. 97-13 safe harbors or the new Rev. Proc. 2017-13 safe harbors. In addition, issuers and borrowers may elect to apply the new safe harbors to management contracts entered into before January 17, 2017.



For More Information

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