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Bond-Financed Facilities

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IRS PROVIDES LIBERALIZED GUIDELINES FOR MANAGEMENT OF BOND-FINANCED FACILITIES

The new guidelines offer flexibility and the comfort that such contracts will not result in private business use.

***251** Section 501(c)(3) organizations that have projects financed by tax-exempt bonds must limit the use of such projects by private persons to avoid jeopardizing the tax-exempt status of the bonds. Twenty years ago, the IRS issued Rev. Proc. 97-13 (the 'existing guidelines') [1]

, providing safe harbor guidelines for certain management contracts and other professional service agreements with private users. If the requirements of the guidelines were satisfied with respect to a particular contract, the contract would not be considered to result in private business use of the facility to which it related and, thus, would not adversely affect the tax-exempt status of the bonds that had financed the facility.

Recently, the IRS issued new safe harbor guidelines in Rev. Proc. 2017-13 (the 'new guidelines') [2] to supersede the existing guidelines by offering more flexible requirements that will accommodate a wider variety of compensation arrangements and longer contract terms while still preserving the right to rely on and make use of certain of the compensation safe harbors from the existing guidelines. The new guidelines apply to contracts related to facilities financed with both government bonds and conduit bonds issued by government units for the benefit of Section 501(c)(3) tax-exempt organizations. This article limits its focus to their application to 501(c)(3) organizations.

In brief, the new guidelines contain three primary requirements that most contracts must comply with in order to fall within the safe harbor. First, the contract must *not* contain a provision allowing the service provider to share in the net profits of the facility. Second, all compensation paid under the contract must be reasonable. Finally, the contract's term cannot exceed the lesser of 30 years or 80% of the remaining economic life of the assets to which the contract relates.

The new guidelines raise many issues of interpretation that are likely to result in uncertainty in applying them to contracts that do not fit precisely within their terms. The IRS has reissued the new guidelines once already, [3] so further revision or substantial additional guidance from the IRS on their application is not to be expected in the near term.

Background

****2** In general, Section 501(c)(3) organizations are eligible to finance the acquisition, construction, and equipping of their facilities with the proceeds of ***252** tax-exempt bonds issued on a conduit basis by a government unit for the exempt organization's benefit.

In connection with the issuance of tax-exempt bonds for the benefit of 501(c)(3) organizations, the 501(c)(3) conduit borrower must certify that it will comply with all requirements necessary to establish and maintain the tax-exempt status of the interest payable on the debt. Among those requirements is that the bond-financed facilities generally must be used in furtherance of the organization's exempt purposes. Use by third parties (referred to as 'private business use') is generally prohibited. While a variety of exceptions are available to the general prohibition on private business use of tax-exempt finance facilities, this article limits its scope of discussion of those exceptions provided by the new guidelines.

When does private use arise?

Private use can arise in a variety of ways, including (1) ownership; (2) actual or beneficial use of property pursuant to a lease, a management contract, a service contract, or other form of incentive payment contract; or (3) other arrangements that convey special legal entitlements to the use of a facility. The new guidelines provide a safe harbor only with respect to the category of private use involving management and service contracts.

Private business use can result when a tax-exempt financed facility is used by a person that is neither a government unit nor a 501(c)(3) organization. It also results from unrelated trade or business use by the 501(c)(3) conduit borrower.

Private business use may result regardless of the direction in which payments flow as between a facility's 501(c)(3) and a private person. Pursuant to a lease, the third party typically would pay the exempt organization owner to obtain access to and use of a facility. Conversely, under a management contract, the exempt organization may be the payer, paying a private person to manage its facility. Or a private person merely may be permitted to use bond-financed space while being entitled to retain payments received from third-party payers (e.g., as in a service contract under which private service providers agree to manage and staff a cafeteria or hospital department in exchange for the right to retain some portion of the resulting revenues).

What contracts are covered by the private use rules?

As discussed above, management contracts, service contracts, and other forms of incentive payment contracts are among the arrangements that can give rise to private business use. Such contracts (referred to in this article collectively as 'management contracts') may trigger private business use when entered into by an exempt organization and a for-profit service provider pursuant to an agreement whereby the service provider provides services involving all, a portion, or any function of a tax-exempt financed facility.

****3** Examples of management contracts often encountered in practice include contracts: (1) for the provision of food services, such as a cafeteria in a school or hospital; (2) for the management of an auditorium or sports facility; and (3) with a professional service provider that fulfills certain needs of the exempt organization, such as a physician practice group staffing a department of a hospital or a facility manager that coordinates the promotion and use scheduling for an organization's auditorium or conference facilities. Thus, a broad range of management contracts are covered by the private use rules and may seek protection under the new guidelines.

What contracts are not problematic?

Several categories of contracts expressly are not considered to give rise to private business use, such that analysis under and compliance with the new guidelines is not necessary. An employment agreement (under which the service provider receives a Form W-2 consistent with employee status) generally will not fall within the private business use rules. Conversely, if the service provider is an independent contractor, the contract will require further vetting in order to find an exclusion that removes it from further private business use analysis.

In addition, contracts for services that are ‘solely incidental to the primary function of a facility‘ in fulfillment of the 501(c)(3) organization's exempt purposes are not considered to result in private business use. This exclusion places the vast majority of the less significant contracts with third-party service providers outside the scope of the private business use rules. For example, contracts for janitorial services, routine maintenance, landscaping services, office equipment repair, billing and other ministerial staffing, and similar services generally will not be considered to be a ‘management contract‘ that requires scrutiny for private business use.

Satisfying the new guidelines

Satisfaction of the new guidelines requires that a contract meet seven requirements. The first, no ***253** sharing of net profits, is the most important and, in many circumstances, the most difficult to interpret and apply.

1 *No net profits-based compensation.* The primary substantive requirement of the new guidelines is that none of the compensation to be paid to the service provider can be based on the net profits of the facility. Certain types of compensation arrangements that were permitted under the existing guidelines as not being based on net profits will continue to be treated as such under the new guidelines. Those arrangements include capitation fees, periodic fixed fees, and per-unit fees, each of which is defined in the new guidelines.

2 *No sharing in net losses.* The service provider must not bear any share of net losses from the operation of the facility.

3 *Permitted term.* The term of the contract must not exceed the lesser of 30 years or 80% of the remaining economic life of the facility. The economic life prong of this test requires, for example, that if a facility has bond-financed improvements with an economic life of 20 years, the contract term cannot exceed 80% of that life, or 16 years.

****4** 4 *Owner retains control.* The exempt organization must retain control over the facility as evidenced, at a minimum, by having rights to approve the facility's annual budget, capital expenditures with respect to the facility, any disposition of property that is part of the facility, rates charged for the use of the facility, and the general nature and type of use of the facility.

5 *Owner bears risk of loss.* The exempt organization must bear the risk of loss resulting from damage to or destruction of the facility. This requirement is not affected by the exempt organization obtaining conventional insurance from a third-party insurer.

6 *No inconsistent tax positions by service provider.* The service provider must agree not to take any tax position inconsistent with its role as merely a service provider. For example, the service provider must agree not to claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the managed facility.

7 *Prohibited relationships.* Finally, the service provider must not have any role or relationship with the exempt organization that substantially limits that organization's ability to exercise its rights under the contract. This requirement limits any overlapping of officers and/or directors of the exempt organization with those of the service provider, as well as common control of the exempt organization and service provider, that would cause them to be treated as ‘related parties‘ under tax law rules.

Functionally related and subordinate facilities.

If a management contract satisfies the new guidelines such that the service provider's use of a facility is not considered private business use, then private business use also will not be considered to result with respect to any use of the facility that is 'functionally related and subordinate' to its performance of services under the contract. Thus, for example, if the contract for the provision of food service in a school cafeteria satisfies the new guidelines, the service provider's use of separate food storage facilities and administrative space required on site to implement performance of the contract should not be considered to be subject to private business use.

What if the guidelines are not satisfied?

The new guidelines provide a 'safe harbor' from private business use such that if a contract meets its requirements, the IRS generally will not challenge the contract as giving rise to private business use. But the failure of a management contract to satisfy the new guidelines does not necessarily mean that private business use results from it. To the contrary, many insignificant deviations will arise in practice that can cause a contract to fail to satisfy some condition of the new guidelines, but are not of such significance that private business use must be considered to result.

The IRS regulations implementing the private business use restrictions contain a higher level of authority than the safe harbors in defining when such use results. They provide the general rule that a management contract with respect to a tax-exempt bond-financed facility may result in private business use of the facility 'based on all the facts and circumstances.' This broader standard enables counsel to consider whether a particular management contract should not be considered to give rise to private business use, taking into account all the facts and circumstances, despite the contract's failure to satisfy each requirement of the new guidelines.

****5** Other approaches also are available to deal with management contracts that do not satisfy all requirements of the new guidelines. ***254** Comfort may be obtained from informal discussions with IRS personnel revealing that the particular facts are not ones that they would find offensive. And the IRS will issue private letter rulings pursuant to which it will provide a written statement of its position on which the organization may rely as to the private business use consequences resulting from the terms of a management contract. But because obtaining such rulings is both costly and time consuming, they are seldom obtained in practice to resolve the analysis of management contracts.

Comparison to existing guidelines

While a detailed comparison of the new guidelines to the existing guidelines is beyond the scope of this article, some overview comments are merited. As discussed, the new guidelines carry over certain safe harbor provisions of the existing guidelines as to the nature of acceptable compensation.

Some other requirements of the new guidelines are more limiting than those in the existing guidelines, however. For example, the restriction that a contract's term not exceed 80% of the remaining economic life of a managed facility limits the usefulness of the new guidelines for contracts that relate to facilities near the end of their economic lives or that involve only assets with very short economic lives. Although comments requested guidance or revisions on this issue, [4] the IRS has not altered the new guidelines to accommodate such situations. [5] Rather, assurance that such contracts do not give rise to private business use generally will have to be obtained under the 'all facts and circumstances' text of the regulations. [6]

The requirement in the new guidelines that the service provider must agree not to take any tax position inconsistent with its role as merely a service provider will require express language to that effect in the management contract. As this requirement was not present in the existing guidelines, all contracts entered into after the effective date of the new guidelines must include such text. Exempt organizations with management contracts that typically renew at that expiration without change to the contract terms will need to take note that such new text as to no inconsistent tax positions will need be added to the contract.

Effective dates

The new guidelines can be applied immediately. They apply to any contract entered into on or after 1/17/17 and may be applied to a management contract entered into before that date. Alternatively, the existing guidelines can be applied to contracts entered into up until 8/18/17 (the 'mandatory effective date'). Additionally, the existing guidelines can continue to apply to contracts entered into before the mandatory effective date that are not materially modified or extended thereafter.

****6** A further exception to the mandatory effective date is available if the extension occurs pursuant to a 'renewal option' contained in the contract. A renewal option is a provision under which either party has a legally enforceable right to renew the contract. Thus, a contract entered into before the mandatory effective date can continue indefinitely to make use of the existing guidelines if it includes a 'renewal option' and is extended only pursuant to that option without the occurrence of any other material modification to its terms.

Conclusion

Although their newness brings issues of interpretation, and some concerns remain as to benefits of the existing guidelines not carrying over in a few situations, the new guidelines offer significant flexibility to exempt organizations in structuring management contracts relating to their tax-exempt bond-financed facilities with the comfort that such contracts will not result in private business use. While no substantial refinements to the new guidelines are to be expected, an exempt organization that makes use of the new guidelines should stay alert for additional guidance issued via rulings or commentary by the IRS and applicable to its particular contracting situation. As with the existing guidelines, it must be expected that the new guidelines will be a topic of ongoing discussion. They surely will result in private letter rulings being issued as guidance when interpretation is sought regarding their application to the unique facts and circumstances that often arise in theimplementation of management contracts for tax-exempt bond-financed facilities.

Further revision or substantial additional guidance from the IRS on their application is not be expected in the near term.

The vast majority of the less significant contracts with third-party service providers are outside the scope of the private business use rules.

The failure of a management contract to satisfy the new guidelines does not necessarily mean that private business use results from it.

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1 1997-1 CB 632.

2 2017-6 IRB 787.

3 The new guidelines were initially issued in August 2016 as Rev. Proc. 2016-44, 2016-36 IRB 316, but were subsequently reissued as Rev. Proc. 2017-13 in response to questions and comments received by the IRS.

4 See comments submitted by the National Association of Bond Lawyers to the Treasury and IRS by letter dated 11/22/16.

5 However, the new guidelines do address the treatment of land and provide that if 25% or more of the net proceeds of any issue is to be used to finance the acquisition of land, such land must be taken into account and treated as having an economic life of 30 years.

6 Comments of Vicky Tsilas, attorney advisor in the IRS Office of Chief Counsel on 12/13/16 during an American Health Lawyers Association webinar, as reported in BNA Daily Tax Report, 240 DTR G-4.