

Chapman Client Alert

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Current Issues Relevant to Our Clients

IRS Releases New Management Contract Guidelines for Tax-Exempt Bonds

On August 22, 2016, the Internal Revenue Service released new safe harbor guidelines (the “*Management Contract Guidelines*”) for determining whether a management contract results in private business use of property for purposes of the federal income tax rules relating to tax-exempt bonds. This determination in turn affects whether the interest on bonds issued to finance facilities that are subject to such contracts will be (or will continue to be) tax exempt. This determination is important for governmental use bonds and qualified 501(c)(3) bonds, but is not relevant for private activity bonds (other than qualified 501(c)(3) bonds), such as exempt facility bonds issued for residential rental projects. The new guidelines replace Internal Revenue Service guidelines that provided multiple safe harbors for different types of contract arrangements with a single set of safe harbor requirements. The Management Contract Guidelines continue to broadly define management contracts to include a management, service, or incentive payment contract between a governmental entity or 501(c)(3) organization and a service provider under which the service provider provides services for a managed property.

The new Management Contract Guidelines provide that a management contract generally does not result in private business use if the contract meets each of the eight requirements outlined below.

First, the payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract.

Second, the contract must not provide to the service provider a share of net profits from the operation of the managed property. Compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property’s net profits or both the managed property’s revenues and expenses for any fiscal period.

Third, the contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property.

Fourth, the term of the contract (including renewal options) must be no greater than the lesser of 80 percent of the weighted average reasonably expected economic life of the managed property or 30 years.

Fifth, the governmental unit or 501(c)(3) 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 governmental unit or 501(c)(3)

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).

Sixth, the governmental unit or 501(c)(3) organization must bear the risk of loss upon damage or destruction of the managed property.

Seventh, 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 governmental unit or 501(c)(3) organization with respect to the managed property.

Eight, the service provider must not have any role or relationship with the governmental unit or 501(c)(3) organization that, in effect, substantially limits the ability of the governmental unit or 501(c)(3) organization to exercise its rights under the contract, based on all the facts and circumstances. The Management Contract Guidelines provide a safe harbor for meeting this requirement that provides limits on board membership and prohibits overlapping chief executive officers.

The new Management Contract Guidelines apply to any management contract that is entered into on or after August 22, 2016, and an issuer may apply these safe harbors to any management contract that was entered into before

August 22, 2016. However, an issuer may continue to apply the prior management contract guidelines to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended on or after August 18, 2017.

For More Information

If you would like further information concerning the matters discussed in this article, please contact a member of our Public Finance Group or visit us online at chapman.com.

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