IRS Expands Safe Harbors for Private Management Contracts

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With the recent release of Revenue Procedure 2016-44, the IRS has expanded the safe harbors under which 501(c)(3) institutions can permissively enter into management contracts with private service providers for the use and operation of the institutions' facilities financed with tax-exempt bonds. Generally, the use or operation of a bond financed facility by a private service provider under a management contract (such as a contract for the management of a campus bookstore or the school's dining facilities) can give rise to private business use potentially jeopardizing the tax-exempt status of the bonds. In an effort to provide for more flexible public-private arrangements, the new safe harbor rules move away from some of the more restrictive contract formulas contained in the prior rules. The new rules do, however, add some additional requirements for institutions to consider.

Under the prior tax rules, a management contract would not result in private business use only if the contract complied with very specific combinations of prescribed terms dictating allowable compensation (fixed fee, per unit fee, etc…), contract length and termination rights. In contrast, under the new rules permissible contracts can now contain any reasonable type of fixed or variable compensation with a term that is no greater than (including all renewal options) the lesser of 30 years or 80% of the weighted economic life of the managed property. Similar to the prior rules; however, the new safe harbors still provide that such management contracts may not include any compensation based on net profits. Additionally, the new rules provide that the 501(c)(3) institution, not the service provider, must still control the use of the managed property (approve the annual budget, capital expenditures, dispositions of property, rates charged, and the types of services provided) and bear the risk of net losses from operations and losses resulting from damage or destruction of the managed property. The new rules also require that the service provider must agree that will not take any tax position that is inconsistent with being a service provider (e.g. that it won't take any depreciation or amortization with respect to the managed property).

The new safe harbor rules apply to any management contract entered into on or after August 22, 2016 and may be permissively applied to any contract entered into prior to such date. For transition purposes, if a 501(c)(3) institution still wishes to use the prior rules (perhaps in connection with a contract recently negotiated under the prior safe harbor

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guidance), it may apply the prior rules to any management contract entered into before August 18, 2017.

Client Tip: *The new management rules provide for a more flexible approach to public-private management arrangements in connection with tax-exempt bond financed facilities, but also raises questions on the application of the new prescribed safe harbors. 501(c)(3) institutions should review their management contracts and service provider relationships, and consult counsel on the possible implications of the new rules.*

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