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ADVISORY COMMITTEE TO IRS RECOMMENDS CHANGES TO MANAGEMENT CONTRACT RULES

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The Tax Exempt Bonds Subcommittee of the Advisory Committee on Tax Exempt and Government Entities, a group of outside practitioners that advises the IRS on important issues, has issued a report (Report) that makes several recommendations regarding the private business use analysis of management contracts. The Report recommends that the IRS update the management contract safe harbors from private business use of tax-exempt bond-financed facilities as provided in IRS Revenue Procedure 97-13 (Rev. Proc. 97-13). The Report also recommends that the IRS publish generally applicable guidance for determining whether a management contract that does not satisfy such a safe harbor actually results in private business use based on all the facts and circumstances. Finally, the Report recommends that the IRS expand the training of its personnel in applying this facts and circumstances test.

The Report, issued June 11, is part of a recent trend of comments and suggestions from various industry groups asking the IRS to update Rev. Proc. 97-13 to address current realities faced by issuers and borrowers. The Report discusses the history and conceptual challenges of applying current Rev. Proc. 97-13 in today's business and legal environments, which are significantly different from those of 1997. The Appendix to the Report contains the most significant and detailed suggestions, where, for example, the Subcommittee has revised the educational materials used by the IRS to train its agents on management contract and private business use issues.

What is this "facts and circumstances" test, and why do we care about it?

Rev. Proc. 97-13 provides "safe harbors" against private business use from management contracts, which, if successfully navigated, allow an issuer or borrower to conclude that its management contract does not result in private business use. Too often forgotten, however, is that a contract not satisfying a safe harbor can still avoid private business use. In this case, Treasury Regulations provide that the facts and circumstances determine whether the contract results in private business use.

Many bond counsel treat any management contract falling outside the Rev. Proc. 97-13 safe harbors as creating private business use because the "facts and circumstances test" is so uncertain. Existing private letter rulings addressing the facts and circumstances test provide possible indications of how the IRS would treat a contract outside the safe harbors but these rulings cannot be relied on as precedent. Thus, bond counsel may not have sufficient legal support to render an unqualified opinion if forced to rely on this test. This uncertainty may force an issuer into an expensive choice of issuing taxable debt, obtaining a private letter ruling or entering into a less desirable contract.

Although not explicitly addressed in the body of the Report, in its proposed re-draft of the IRS educational materials, the Subcommittee appears to be asking the IRS to allow all taxpayers to use the rationales contained in the existing private letter rulings when applying the facts and circumstances test. The main thrust of these rationales is that the more a contract "looks like" a contract that fits within a Rev. Proc. 97-13 safe harbor, the more likely the contract will not result in private business use. In short, through these revisions to the educational materials the Subcommittee is asking the IRS to tell practitioners which facts might be relevant on a case-by-case basis—exactly the task that the IRS undertook in each of the private letter rulings.

The Subcommittee requests implementation of this guidance for all types of management contracts in all industries. The Subcommittee also specifically references two developments from the Affordable Care Act (ACA) that especially merit additional guidance from the IRS. The first ACA development is the encouraged use of an undertaking known as an "affordable care organization" (ACO) under the ACA. ACOs typically involve joint ventures between hospitals and private doctors' groups to share cost savings. The second ACA development is the use of "bundled payments," where the federal government makes a single collective payment to the parties that provide medical care to a patient during a single "episode of care," as opposed to individualized payments for each element of the medical care. Both ACOs and bundled payments commercially link a hospital with a private party, which could result in private business use. The re-drafted educational materials would provide several examples that illustrate when an ACO or bundled payment arrangement does or does not result in private business use.

Whether the IRS will adopt any of the Subcommittee's recommendations remains to be seen. According to an article by Naomi Jagoda in the Bond Buyer on June 11, Rebecca Harrigal, the director of the Tax-Exempt Bond office for the IRS, has stated that her department plans to rework the training manual to take into account the Subcommittee's recommendations. The article also notes, however, that the portions of the Subcommittee's report that "are more like guidance will be referred to the Chief Counsel's office." Which aspects of the Subcommittee's Report are, in the judgment of the IRS, "more like guidance" also remains to be seen. In any event, the Report certainly represents a positive step in encouraging the IRS to provide much-needed flexibility for issuers and conduit borrowers to use the facts and circumstances test to avoid private business use when business exigencies make it difficult for their contracts to fit within Rev. Proc. 97-13.