Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224


Dear Commissioner Shulman:

Enclosed are comments on management contract guidelines under Rev. Proc. 97-13. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William M. Paul
Chair, Section of Taxation

Enclosure

cc: Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
John J. Cross III, Associate Tax Legislative Counsel, Department of the Treasury
James A. Polfer, Chief, Branch 5, Financial Institutions and Products, Internal Revenue Service
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
COMMENTS ON MANAGEMENT CONTRACT GUIDELINES
UNDER REV. PROC. 97-13

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Christie Lombard Martin and Wendy Salinas of the Committee on Tax Exempt Financing of the Section of Taxation. Substantive contributions were made by Michael Bailey, Irving Finkel, John MacMaster, Carol Duane Olson, Robert Price, Susan Price, Valerie Roberts, and Peter Serreze. The Comments were reviewed by Jeremy Spector, Chair of the Committee on Tax Exempt Financing. The Comments were further reviewed by Kevin Jacobs of the Young Lawyers Forum, Carol Lew of the Section’s Committee on Government Submissions and by Andrew J. Dubroff, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 9, 2012
Executive Summary

Revenue Procedure 97-131 (“Rev. Proc. 97-13” or the “Guidelines”) sets forth safe harbor operating guidelines under which a management contract will not result in private business use under section 141(b).2 These Comments identify areas of uncertainty and recommend revisions to Rev. Proc. 97-13 for consideration by the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) regarding when a management contract will or will not give rise to private business use.

These Comments make several recommendations to permit a broader spectrum of agreements to fit within the operating guidelines when the agreement does not result in a transfer of any benefits and burdens of ownership of bond-financed property to private entities. The recommendations are summarized as follows:


2. Recognize that reasonable payment for the unamortized balance of equipment or fixtures contributed by the service provider under the contract is not a termination penalty if required to be paid by the qualified user upon early termination of the contract.

3. Recognize that (i) management contracts including both incidental and non-incidental services, and (ii) management contracts including multiple services, can be analyzed as separate contracts where the services, compensation arrangements, default and termination provisions are severable from a single contract.

4. Clarify that “incidental services” contracts that are not considered management contracts giving rise to private business use include a wide range of contracts for services that are solely incidental to the primary function of the facility. Examples include, but are not limited to, laundry services, security services, valet parking services for patients, information technology services, call center services, purchasing services, and similar types of services.

5. Collapse the two-year and three-year safe harbors into a single three-year safe harbor.

6. Recognize that there may be situations in which a combination of a gross revenue based incentive and a cost efficiency incentive does not result in a contract being based on net profits.


2References to a “section” herein are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated, and references to the “Regulations” are to the Treasury Regulations promulgated thereunder.
7. Clarify that reimbursement of expenses, including a reasonable allocation for benefits, can be excluded from the compensation analysis of a management contract.

8. Clarify the definition of a periodic fixed fee and the Guidelines for multiple incentive awards under a single contract, and include examples of circumstances substantially limiting the exercise of rights of a qualified user to terminate a contract.
ABA Tax Section Comments on Management Contract Guidelines

I. Background.

A. Private Business Use.

Governmentally issued bonds constitute private activity bonds, the interest on which may not be excludable from federal gross income pursuant to section 103, if they meet (i) the private business use test, and (ii) the private security or payment test. These limitations on section 103 originated in 1968 when Congress concluded that (subject to a series of well-defined exceptions) governmentally issued bonds do not merit federal tax exemption where the governmental issuer serves merely as a conduit for conferring tax exemption to another person if the beneficiary could not have accessed those same benefits directly. Of necessity, application of this limitation, which is driven by who bears the benefits and burdens of the bonds, depends on the use of proceeds of the bonds and, ultimately, the property financed thereby, as well as the source of and security for repayment of the bonds. To implement this legislative intent, Regulations amplify the meaning of the private business use test with respect to tax-exempt-bond-financed properties to stipulate that certain types of relationships between non-governmental persons and such properties rise to the level of “private business use.”

The Regulations provide guidance as to the types of uses that satisfy the private business use test. For example, “ownership by a nongovernmental person of financed property” and “lease of financed property to a nongovernmental person” are generally uses that satisfy the private business use test. Additionally, the Regulations provide that certain types of output contracts with respect to a specialized subset of financed properties (e.g., electric power generating facilities) are generally treated as satisfying the private business use test. The Regulations also identify other forms of actual or beneficial use that are more attenuated, but still might constitute private business use, in particular, research agreements (e.g., with respect to health care institutions or research facilities). Interestingly, the Regulations provide that so-called management contracts (which broadly includes management service contracts and management incentive payment contracts) may satisfy the private business use test “based on all the facts and circumstances;” but, the Regulations identify only one type of management contract that will constitute private business use—one that bases compensation, in whole or part, on a share of net profits of the facility. In other cases, the “facts and circumstances” test has

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3 See section 141(a).
5 Reg. §1.141-3(b).
6 Reg. §1.141-3(b)(2).
7 Reg. §1.141-3(b)(3). Leasehold rights would ordinarily imply the right to exclusive use of the leasehold subject to the terms of the lease.
8 Reg. §1.141-3(b)(5); Reg. §1.141-7.
9 Reg. §1.141-3(b)(6).
10 Reg. §1.141-3(b)(4)(i).
been interpreted by a series of revenue procedures culminating in the Guidelines (as well as by private letter rulings and whatever guidance might be inferred from public notice of Service enforcement actions in isolated situations).

B. Management Contracts.

The origins and purposes for the specialized treatment of management contracts as a private business use under the Regulations merit further consideration given that such contracts are pervasive and relate to virtually every area of governmental operations, and many functions of section 501(c)(3) organizations. There are a myriad of sound reasons for a governmental entity or a section 501(c)(3) organization to have services performed by independent contractors rather than its own employees. At a high level, these could relate to obtaining needed expertise, retaining operational flexibility, or avoiding labor issues associated with using public employees (e.g., pension costs). The purpose of these Comments is to provide specific suggestions that will allow governmental units and section 501(c)(3) organizations to appropriately arrange their operations while reasonably addressing Congressional concerns with private business use.

Management contracts and service agreements serve a wide variety of objectives: a contract can be entered into for the operation of a discrete building, to provide a discrete service, or to operate an entire system. Many existing facilities that are the subject of these agreements have historically been operated by the governmental entity, and reasons vary for contracting with a private manager or operator. In some cases, it is to reduce or fix the costs of operation. In other cases, the government entity or section 501(c)(3) organization (the “qualified user”) may be unwilling or unable to develop the expertise or staffing for operation of a facility. In all of these cases, a private manager or service provider serves a public need or exempt purpose.

C. Service Guidelines.

The Guidelines provide safe harbors for determining when a management contract does not enable the manager/service provider (the “service provider”) to exploit the benefits of tax-exempt bond financing of the managed or operated facility, thereby avoiding the taint of private business use. The Guidelines are the result of an evolutionary process that began with Rev. Proc. 82-14\(^{11}\) (“Rev. Proc. 82-14”) and Rev. Proc. 82-15\(^{12}\) (apparently tailored to health care facilities). This guidance was replaced by Rev. Proc. 93-19,\(^{13}\) which, in turn, was superseded by the Guidelines. Many of the rules now in the Guidelines originated in Rev. Proc. 82-14, but the purposes for the rules have never been articulated as would have been the case in a regulatory rulemaking process. We recommend that the Guidelines not be given precedential deference, and that the Treasury and Service freshly reexamine the need for many of the rules in light of

\(^{11}\) Rev. Proc. 82-14, 1982-1 C.B. 459.
the original purpose for limiting management contracts. While we acknowledge the importance of preventing governmental entities and section 501(c)(3) organizations from providing tax-exempt financing benefits to private entities, we believe that the recommendations set forth herein will provide flexibility to access expertise and capabilities that governmental entities and section 501(c)(3) organizations either do not possess or cannot provide efficiently, while not permitting or encouraging the shifting of tax benefits to nonqualified entities.

II. Recommendations Regarding Guidelines for Management Contracts.


The Guidelines govern management contracts in which “a service provider provides management or other services involving property financed with proceeds of an issue of state or local bonds subject to section 141 or section 145(a)(2)(B) . . . .”14 For management contracts to definitively not result in private business use, they must satisfy certain general compensation requirements,15 they must be in the form of one of the six permissible arrangements,16 and “the service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user’s ability to exercise its rights, including cancellation rights, under the contract, based on all the facts and circumstances.”17

The six permissible arrangements are: (1) 95 percent periodic fixed fee arrangements; (2) 80 percent periodic fixed fee arrangements; (3) contracts predominantly involving public utility property; (4) 50 percent periodic fixed fee arrangements; (5) certain 3-year per-unit fee arrangements; and (6) certain 2-year percentage of revenue or expense fee arrangements.18 For a management contract to be described as the fourth, fifth, or sixth permissible arrangement, the qualified user must have the right to terminate the contract on reasonable notice without penalty and cause at certain times before the specified end of the contract term.

We suggest that the Guidelines be amended to remove any need for a termination right. In our view, requiring a right to terminate a contract (without penalty and cause) for some contract terms, but not others, is too refined. It is also unclear how the termination requirements are applied to holdover service providers who continue to provide services after the formal contract term has expired (e.g., how the contract term is

14 Rev. Proc. 97-13, §4. Section 3.09 of the Guidelines defines a service provider as “any person other than a qualified user that provides services under a contract to, or for the benefit of, a qualified user.” Section 3.07 of the Guidelines defines a qualified user as

.07 Qualified user means any state or local governmental unit as defined in [Reg.] §1.103-1 or any instrumentality thereof. The term also includes a section 501(c)(3) organization if the financed property is not used in an unrelated trade or business under section 513(a) of the 1986 Code. The term does not include the United States or any agency or instrumentality thereof.

16 Rev. Proc. 97-13, §5.03.
17 Rev. Proc. 97-13, §5.04(1).
18 Rev. Proc. 97-13, §5.03(1) – (6).
then measured and what termination requirements apply). Even if a service recipient is more likely to actively reconsider contract terms and counterparties when the contract must be renewed, rather than when the contract can be terminated, we think any modest amount of inertia arguably working in the service provider’s favor is too slight to justify the distinction made in the Guidelines.

We further suggest that the Guidelines recognize that a management contract with a specified term that exceeds the length of terms set forth in the permissible contract arrangements, or which does not specify the length of the contract term, can nevertheless be considered to satisfy the Guidelines’ so long as the contract can be terminated without penalty and cause by the qualified user upon a reasonable notice period. A contract which can be terminated at any time upon a reasonable notice period should be deemed to be a contract with a term of such notice period. For example, a nominal five-year contract that can be terminated at any time by the qualified user without penalty and cause upon 90 days notice would be effectively a 90-day contract. In addition, a contract that can be terminated at any time after a certain date should be deemed to have a term that ends on the first optional termination date. Thus, a nominal five-year contract that can be terminated at the end of three years at the option of the qualified user is effectively a three-year contract, and a nominal two-year contract that can be terminated at the end of one year at the option of the qualified user is effectively a one-year contract. There should be no analytical difference between a three-year contract with an option to extend for two years and a five-year contract with an option to terminate at the end of three years.

To this end, we recommend adding a new definition to the Guidelines as follows:

“Contract term” means the period from the effective date of the contract to the stated end date of the contract; provided that the contract term for contracts that provide the qualified user with a right to terminate the contract without penalty and cause at a specific date prior to the stated end date shall be considered to end at the allowed termination date; and provided further that contracts of any stated length that may be terminated at any time by the qualified user without penalty and cause shall be considered to have a contract term equal to the required notice period for such termination. Contracts in which the qualified user does not exercise the optional termination right shall be treated as having a new contract term from the date such optional termination right is not exercised to the next optional termination date, if any, or the stated ending date of the contract.

In addition, sections 5.02(3), 5.03(1), 5.03(2), and 5.03(4) of the Guidelines refer to compensation during each “annual period.” In each instance, we recommend amending this phrase to read “each annual period or lesser term of the contract.”
2. Recognize that reasonable payment for the unamortized balance of equipment or fixtures contributed by the service provider is not a termination penalty if required to be paid by the qualified user upon early termination.

A service provider will often be required to purchase with its own funds the equipment it will be using to provide its management services. For example, a college may use tax-exempt financing to build a dormitory that includes a dining hall. To assure that it is operating the dining hall properly, the college may enter into a management contract with an experienced food-service operator. That management contract may require the service provider to purchase the food preparation equipment it will use in the dining hall, such as the refrigerators, stoves and serving tables. In some situations, the service provider may even be required to pay for the dining hall fixtures and improvements in addition to equipment.

The service provider’s cost to purchase the equipment will normally be reimbursed by the qualified user (the college in the above example) through a series of annual payments to the service provider. That reimbursement requirement may be embodied either in the management contract as part of the management fee or in a separate agreement, but reimbursement payments will normally be made to enable the service provider to recover its outlay for the equipment in installment payments over a period of time. That period of time usually tracks the length of the management contract, often including expected management contract renewals. The installment payment amounts may be tailored to reflect the depreciation or amortization of the equipment, or even take into account its expected fair market value at the end of the reimbursement period, as the parties may agree.

The management contract or a separate agreement normally will also address the ownership of the equipment once the reimbursement period is complete. Some or all of the equipment may then belong to the service provider or to the qualified user, again as the parties may agree. The management contract or the separate agreement normally will further address what happens in the event that the qualified user terminates the management contract earlier than expected, or fails to renew it as initially expected. The documentation may treat the arrangement as a true lease of the equipment when the arrangement is terminated, in which event the service provider will remove the equipment. More often, the qualified user will have purchased and will retain the equipment, and there will be an agreed-upon formula for the recovery by the service provider of its remaining unrecovered costs. That agreed-upon formula may provide for: (1) continuation of the payments over the initially expected period of the management contract plus any expected renewals; (2) an agreed-upon shorter period; or (3) an agreed-upon lump sum payment upon termination.

The Service and Treasury should confirm that these types of arrangements, whether separate or included in the management contract, are not a penalty for terminating the management contract under the Guidelines. Indeed, such arrangements should be encouraged. First, they enable the qualified user to avoid the upfront cost of the equipment. Second, they generally reduce the size of the tax-exempt bond issue for
the facilities, thereby lessening the burden on the tax-exempt market. Third, they will have been negotiated at arm’s length by the parties and represent common commercial contract terms. Rather than a penalty for terminating the management contract, we believe that the payment of unrecovered costs should be considered a normal commercial provision of the qualified user’s equipment financing. This is particularly compelling when addressed by a separate agreement or a true lease.

Finally, although we believe this is implicit in the current Guidelines, we recommend that the Service and Treasury explicitly confirm that there is no management contract termination penalty if there is no acceleration of the equipment repayment schedule upon the termination of the management contract, and that there is no penalty when the parties have agreed that they have had a true lease of the equipment and that the departing service provider will merely remove the equipment at the end of the lease.

We recommend that the definition of penalties in section 3.04 of the Guidelines be amended as follows:

.04 **Penalties** for terminating a contract include a limitation on the qualified user’s right to compete with the service provider; a requirement that the qualified user purchase equipment, goods or services from the service provider; and a requirement that the qualified user pay liquidated damages for cancellation of the contract. In contrast, a requirement effective on cancellation that the qualified user reimburse the service provider for ordinary and necessary expenses, including equipment or fixture reimbursement that is not accelerated but remains on a set schedule, or removal of equipment or fixtures owned by the service provider, or a restriction on the qualified user against hiring key personnel of the service provider is generally not a contract termination penalty. If the service provider has purchased equipment or fixtures for use as the service provider or paid for improvements to the qualified user’s property, and the service provider is being reimbursed for those expenditures by the qualified user’s payments over a period of time either in the management contract or in a separate agreement, acceleration of those payments upon the termination of the contract will not be treated as a penalty if it represents a commercially reasonable cost for the equipment, fixtures or improvements. Another unrelated contract between the service provider and the qualified user, such as a loan or guarantee by the service provider, is treated as creating a contract termination penalty only if that contract contains terms that are not customary or arm’s-length that could operate to prevent the qualified user from terminating the contract (for example, provisions under which the contract terminates if the management contract is terminated or that place substantial restrictions on the selection of a substitute service provider.)

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19 For clarity, we have highlighted our proposed changes to each section by underlining our proposed additions and striking out our proposed deletions.
We recognize that the mere making of a large payment at the time of the termination for acceleration of the repayment schedule, in whole or in part, although commercially reasonable and according to conditions negotiated at arm’s length, might appear to be a penalty. However, we believe it should be considered to be a penalty only if it is large enough to possibly dissuade the qualified user from terminating or failing to renew the management contract or contracts. We believe that a qualified user with a large operating budget would not be dissuaded by a payment that is less than 3% of its budget. Similarly, a qualified user with a smaller budget, where the payment exceeds 3%, would not be dissuaded by an acceleration payment with a present value not appreciably larger than it would have had to pay had there been no termination. If the size of the acceleration payment is taken into account in the determination of what is a penalty, we suggest the following bright line test to determine whether the acceleration payment is so appreciably large as to dissuade a termination: compute the dollar difference between the present value of the stream of payments to be made under the payment schedule without acceleration and the present value of the payments to be made with acceleration, and if that dollar difference constitutes a more than 20% increase in the present value of the remaining payments to be made without the acceleration, that dollar difference may be deemed to be a penalty.

If the Service and Treasury decide that the size of the termination payment should be considered in determining whether a penalty is imposed, we recommend the following amendments to section 3.04 of the Guidelines:

.04 Penalties for terminating a contract include a limitation on the qualified user’s right to compete with the service provider; a requirement that the qualified user purchase equipment, goods or services from the service provider; and a requirement that the qualified user pay liquidated damages for cancellation of the contract. In contrast, a requirement effective on cancellation that the qualified user reimburse the service provider for ordinary and necessary expenses, including equipment or fixture reimbursement that is not accelerated but remains on a set schedule, or removal of equipment or fixtures owned by the service provider, or a restriction on the qualified user against hiring key personnel of the service provider is generally not a contract termination penalty. If the service provider has purchased equipment or fixtures for use as the service provider or paid for improvements to the qualified user’s property, and is being reimbursed for those expenditures by the qualified user’s payments over a period of time either in the management contract or in a separate agreement, acceleration of those payments upon the termination of the contract will not be treated as a penalty if it represents a commercially reasonable cost for the equipment, fixtures or improvements. For this purpose, payments from the acceleration of the reimbursements as a result of the termination of the contract or contracts will be a penalty if: the amount of the payments exceed 3% of the qualified user’s annual budget in the tax year prior to entering the contract and the present value of the payment or payments to be made as a result of
the acceleration is 20% or more than the present value of the payments to be made had there been no acceleration. Another unrelated contract between the service provider and the qualified user, such as a loan or guarantee by the service provider, is treated as creating a contract termination penalty only if that contract contains terms that are not customary or arm’s-length that could operate to prevent the qualified user from terminating the contract (for example, provisions under which the contract terminates if the management contract is terminated or that place substantial restrictions on the selection of a substitute service provider.)

3. Recognize that management contracts for both incidental and non-incidental services and multiple services can be analyzed as separate contracts where the services, compensation, default and termination arrangements are severable from the remainder of the contract.

Many service providers offer a wide range of services to qualified users. Some of these services are clearly incidental (e.g., janitorial), while others may not be incidental (e.g., food service in a cafeteria). In some cases, the organization prefers to negotiate a single contract that includes multiple service lines. In other cases, the organization prefers separate contracts. For example, a hospital may enter into a single contract with a service provider for environmental services (e.g., janitorial services), patient food services, and food services at its cafeteria. The Guidelines should be clarified as to whether the management contract rules apply separately to each line of service or on a combined basis.

Where the services provided, the payment terms for these services and the termination provisions for those services are clearly severable within one contract, the terms could have been captured in separate contracts but are combined generally for administrative ease. Because such services could have been captured in separate contracts, it is recommended that the Guidelines allow each line of service to be separately analyzed for compliance with the Guidelines as if each service component were a separate contract. To this end, the following definitional change is recommended to section 3.03 of the Guidelines:

.03 Management contract means a management, service, or incentive payment contract, or portion thereof, between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract, or portion thereof, for the provision of management services for an entire hospital, a contract, or portion thereof, for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract. A portion of a contract may be considered a separate Management Contract where the service component, the payment terms, the termination terms and the default terms for such service component, are clearly severable from the remainder of the contract. See §§1.141-3(b)(4)(ii) and 1.145-2.
4. Clarify that “incidental services” contracts include a wide range of contracts for services that are solely incidental to the primary function of the facility.

The Regulations\textsuperscript{20} and section 2.01(7)(a) of the Guidelines provide that contracts for services solely incidental to the primary governmental function or functions of a bond financed facility are not treated as management contracts that may give rise to private business use. The examples of incidental services include contracts for janitorial, office equipment repair, hospital billing or similar services.

There is uncertainty among practitioners regarding what constitutes an incidental service for purposes of the Guidelines, in general, and in particular what constitutes “similar services” to those identified as examples. We believe that the examples should be expanded to include other incidental services that are clearly not the primary governmental function or functions of the facility and are not intended to be revenue producing. To clarify what constitutes an incidental service, we recommend the following changes to section 2.01(7)(a) of the Guidelines:

(a) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, including but not limited to contracts for janitorial, office equipment repair, hospital billing, laundry or housekeeping, security (other than at a prison or detention center), valet parking, information technology, call center, purchasing services, or other similar services) not part of the primary governmental function or functions of the financed facility;

5. Collapse the two-year and three-year safe harbors into a single three-year safe harbor.

Sections 5.03(5) and (6) of the Guidelines provide safe harbors for contracts with terms of three years and two years, respectively. The limitations on the availability of the two-year safe harbor have severely limited its usefulness. In addition, we believe that the distinction between the two-year and three-year safe harbors, while clearly stated, does not appear to have a basis in prior law and is unnecessary given the contract’s short duration. Interpretive questions also arise with respect to services that are permitted by one safe harbor but not the other, including application of the per-unit fee combined with any other compensation arrangement, and the limitations on application of the two-year safe harbor (e.g., whether a service provider must primarily provide services to third parties). Confusion has arisen among practitioners regarding the different requirements of these safe harbors. Each involves fee arrangements that include compensation arrangements other than periodic fixed fees. We recommend collapsing the two-year and three-year safe harbors into one three-year safe harbor that would be applicable in all cases where the longer safe harbor provisions are not applicable.

To that end, we recommend replacing sections 5.03(5) and (6) of the Guidelines in their entirety with the following:

\textsuperscript{20} Reg. §1.141-3(b)(4)(iii)(A).
(5) Fee arrangements in certain 3 year contracts. All of the compensation for services for each annual period (or such lesser term of the contract) during the term of the contract is based on a combination of a capitation fee, a periodic fixed fee, a per-unit fee, a percentage of fees charged, a percentage of revenue fee, or a percentage of expense fee. The term of the contract, including renewal options, must not exceed 3 years.

6. Recognize that there may be situations in which a combination of a gross revenue based incentive and a cost efficiency incentive does not result in compensation being based on net profits.

As previously noted, in order for a management contract to definitively not result in private business use, the contract cannot provide for compensation “based, in whole or in part, on a share of net profits from the operation of the facility.”21 In making that determination, the Guidelines provide that “compensation based on (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; (b) a capitation fee; or (c) a per-unit fee is generally not considered to be based on a share of net profits.”22 Additionally, section 5.02(3) of the Guidelines includes the following:

a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues) or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract, generally does not cause the contract to be based on a share of net profits.

We agree that a contract that provides the manager with a share of actual net profits should not be eligible for the safe harbor. However, we believe that sections 5.02(2) and (3) of the Guidelines are overbroad because not every contract that takes into account both revenues and expenses is net profit-based as section 5.02(2) of the Guidelines implies. For example, a hospital that has bond-financed its parking garage may contract for the garage’s operation by a for-profit manager based on a fixed management fee with a bonus. The parking rates at the garage may be set in an annual budget subject to hospital approval, at levels that may not cover operating costs let alone the debt service on the bonds that built the garage. Because the purpose of the garage is to provide needed parking, not to make a profit, the garage may generate an annual net loss funded by the hospital. The parties may structure a bonus that compensates the manager based on both an increase in revenue and a reduction in expenses that reduces the budgeted net loss. Such an arrangement, which takes into account both revenues and losses, appears to be treated as based on net profits under section 5.02(2) of the

21 Rev. Proc. 97-13, §5.02(1).
22 Rev. Proc. 97-13, §5.02(2).
Guidelines, even though the garage has no net profits.

As another example, a school district or college’s food service contract for its dining halls may compensate the manager based on a fixed base fee with a bonus that targets both gross revenue and expense. Other targets becoming more common include the percentage of food obtained locally or the percentage of “healthful” food -- bonus targets that were unknown in 1997 when the Guidance was issued. The combined targets may even be an increase in net income. Whatever the target, if the bonus is not a percentage of the net income of the dining halls (or a substantially similar amount), the management contract would not provide the manager with a “share of net profits.”

We believe that contracts should be treated by the Guidelines as net profit-based only where they provide the manager with a percentage of the excess of revenues over expenses of the operation, or a substantially similar amount. Under such a standard, a contract that provides a reward for reducing net losses (such as the parking garage management contract discussed above) would not be treated as net profit-based. Nor should a contract that provides incentives for both increasing revenues and reducing expenses be treated as net profit-based, so long as those incentives are not substantially similar to a percentage of the excess of revenues over losses.

To ensure that a more flexible standard would be used only to incentivize the service provider, and not to shift the benefits and burdens of the bond-financed property to the service provider, we suggest an additional restriction. To the extent that the service provider’s compensation takes into account both revenues and expenses, both the revenue and expense-based incentives should be limited relative to the total compensation paid under the contract. For example, the revenue and expense-based incentive could each be limited to 20% of the total compensation paid to the service provider in each annual (or lesser) period of the contract.

We recommend that the definition of net profits arrangements under section 5.02(2)(a) of the Guidelines be amended as follows:

(a) A percentage of gross revenues (or adjusted gross revenues) of a facility and/or a percentage of expenses from a facility, but not both, provided that such percentage is not based on the excess of aggregate revenues over aggregate expenses of the operation, or an amount substantially similar thereto, and provided further that to the extent any such percentage takes into account both revenues and expenses, the revenue and expense-based amounts in a given annual period each do not exceed 20% of the total compensation under the contract in that period;

We also recommend making the following changes to section 5.02(3) of the Guidelines:

(3) Productivity reward. For purposes of §1.141-3(b)(4)(i) and this revenue procedure, a productivity reward equal to a stated dollar amount,
up to 20% of the total compensation under the contract, based on
increases or decreases in gross revenues (or adjusted gross revenues),
and/or reductions in total expenses in any annual period (or lesser period
of the contract) during the term of the contract, generally does not cause
the compensation to be based on a share of net profits provided that the
productivity reward is not based on the excess of aggregate revenues over
aggregate expenses of the operation, or a substantially similar amount.

7. Clarify that reimbursement of expenses, including a reasonable allocation
for benefits, can be excluded from the compensation analysis of a management
contract.

Reimbursement of expenses is considered in two different contexts by the
Regulations and the Guidelines. First, the Regulations provide that a contract will not
be treated as a management contract if the only compensation is reimbursement of the
actual and direct expenses paid by the service provider to unrelated persons. Second,
section 5.02(1) of the Guidelines provides that reimbursement of actual and direct
expenses paid by the service provider is not by itself treated as compensation. We
believe that the scope of “actual and direct expenses” and “unrelated persons” should be
clarified for purposes of these exceptions.

In many cases, the service provider will provide staff, in addition to management
expertise, to the qualified user. This is particularly true where the functions performed
by the service provider are ancillary to the base function of the organization (e.g., food
services for a university). But are non-owner employees of a service provider, such as
kitchen workers, unrelated persons, or may only independent, non-employee, contractors
be unrelated persons for this purpose? We believe that the Guidelines should be clarified
to provide that employees are considered unrelated persons for this purpose.

There is also some uncertainty as to whether the wages paid to the employees of
either the service provider or a third party contractor may include a reasonable amount or
percentage for expected employment ancillary costs (e.g., taxes, unemployment
compensation, and insurance) even where the costs paid are based on reasonable
estimates rather than actual expenses. For example, it is not uncommon for a percentage
of salary to be given as a proxy for expected employment ancillary costs. We believe
that a reasonable proxy for employment costs should not be treated as a form of variable
compensation.

We recommend the following changes to section 5.02(1) of the Guidelines to
clarify the foregoing two ambiguities:

(1) In general. The contract must provide for reasonable compensation
for services rendered with no compensation based, in whole or in part, on
a share of net profits from the operation of the facility. Reimbursement of

23 Reg. §1.141-3(b)(4)(iii).
the service provider for actual and direct expenses (including a reasonable estimate of expected employment costs including taxes, unemployment compensation, insurance and other benefits) paid by the service provider to unrelated parties, including non-owner employees of the service provider, is not by itself treated as compensation.

8. Other miscellaneous recommendations.

*Clarify the definition of a periodic fixed fee.* Under section 3.05 of the Guidelines, the term periodic fixed fee is defined as a stated dollar amount for services rendered for a specified period of time. Some practitioners have questioned whether an hourly fee should be treated as a periodic fixed fee under the Guidelines. We believe that an hourly fee should be treated as a periodic fixed fee, and we recommend the following change to section 3.05 of the Guidelines to clarify this ambiguity:

> .05 Periodic fixed fee means a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per hour, per week or per month is a periodic fixed fee. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective external standards. Capitation fees and per-unit fees are not periodic fixed fees.

*Clarify the Guidelines for multiple incentive awards under a single contract.* Under section 5.03 of the Guidelines, a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount. Section 5.02(3) of the Guidelines currently includes the following:

>> a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract, generally does not cause the compensation to be based on a share of net profits.

In *GCM 37641*, the Service noted that a growing practice had developed whereby nonprofit hospitals hire profit-making management companies to provide necessary management expertise and significant cost reduction practices. The Service also recognized that management companies provide a range of services including purchasing, budgeting and billing and other administrative functions on a daily basis and pass on the benefits of volume purchasing to the nonprofit hospitals.

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In PLR 200330010, the Service ruled that a management contract which provided that any of three alternative compensation schedules could be applied under the contract at the discretion of the qualified user did not result in private business use. For each annual period, the service provider was to be paid the amount set forth in one of the three fixed-fee schedules. Each of those fee schedules represented a stated dollar amount for management services required to meet the reasonably expected demand by the qualified user under the contract for the upcoming year.

We believe, based in part on the reasoning of PLR 200330010, that so long as compensation of the service provider is not based in whole or in part on net profits, an incentive fee should not be limited to a single such incentive payment during the term of the contract. The concept of an alternative fixed fee schedule which becomes applicable when certain milestones are satisfied should not violate the definition of a periodic fixed fee. As a result, we recommend that a schedule of “periodic fixed fees” should continue to be treated as a periodic fixed fee where it is supplemented by an incentive fee schedule (comprised of alternative periodic fixed fees) so long as application of the amounts on that incentive fee schedule are dependent upon satisfaction of specified predetermined criteria such as various gross revenue targets or expense targets. In other words, where the incentive payments are predetermined on the basis of objective amounts based on satisfying objective performance criteria and are not based upon net profits, such incentive payments should be treated as permitted as part of a periodic fixed fee, even though a service provider may qualify for more than one incentive payment during the course of the management contract.

Clarify the Guidelines to include examples of circumstances substantially limiting the exercise of rights of a qualified user to terminate a contract. As previously noted, for a management contract to not result in private business use, “the service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user’s ability to exercise its rights, including cancellation rights, under the contract, based on all the facts and circumstances.” Section 5.04(2) of the Guidelines provides a safe harbor, where less than a specified percentage of cross ownership, or less than a specified percentage of overlap on the boards of the qualified user and service provider, will be treated as not substantially limiting the qualified user’s termination rights.

In PLR 200123057, the Service concluded based on all the facts and circumstances that even where two entities were related parties due to overlapping boards, the qualified user (a tax-exempt hospital) being the sole member of the taxable service provider and the qualified user having certain powers with respect to the service provider, the service provider did not have any relationship with the qualified user (its sole member) that substantially limited the qualified user’s ability to exercise its cancellation rights under the management contract. Because the qualified user had

25 PLR 200330010 (April 17, 2003).
26 Rev. Proc. 97-13, §5.04(1).
27 PLR 200123057 (March 13, 2001).
substantial control over the service provider (rather than vice versa), the Service held that there were no circumstances substantially limiting the qualified user’s exercise of its cancellation rights even though the two entities were related parties.

In many cases, a qualified user may be related to, be under common control with, may own directly or indirectly, or may otherwise have a relationship with, a for-profit service provider. As long as the qualified user (or one or more related governmental or tax-exempt entities) has control over the service provider and has the right to terminate any management contract between the qualified user and the service provider, the qualified user’s termination rights are not substantially limited.

We recommend that the Service and Treasury provide, either by example or by description, greater detail as to the conditions under which overlapping boards, related entities and other relationships will not be treated as substantially limiting the rights of the qualified user, so long as the service provider has no rights that could prevent the qualified user from terminating the contract.