

IRS Continues Trend of Flexibility for Qualified Management Agreements (QMA's) for Hotels Financed With Tax Exempt Bonds

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The US Internal Revenue Service (IRS) recently continued a trend of pronouncements further extending flexibility in structuring a Qualified Management Agreement (QMA) for a hotel financed with tax exempt bonds without jeopardizing the bonds' tax exempt status.

By way of background, many political subdivisions have facilitated the development or expansion of convention hotels and related facilities by use of tax exempt bonds. In structuring a QMA for the operation of such hotels, care must be taken to avoid the IRS reaching the conclusion that the hotel is being used for private business use rather than for public benefit. A determination of private business use will run the substantial risk that the tax exempt status of the bonds, the main incentive for many purchasers, will be disallowed.

The primary concern is that a hotel management agreement (HMA) not be the functional equivalent of a master lease of the property v. simply a management arrangement. If the former, then the hotel is being operating for private business use. If the latter, the project is being operated for public benefit. The IRS has set out a key test: Is the manager under the HMA receiving any portion of its compensation based on the net profits of the hotel operations? If the answer is yes, then the hotel fails to qualify and the financing bonds would lose their tax exemption. The resulting problem is that denying management fees based on net profits would exclude many hotel management agreement structures designed to align the interests of hotel owners and operators, especially in regards to the payment of management fees. If the hotel management agreement qualifies as a QMA, then all is good.

Safe harbors for what will qualify as a QMA have historically been based on criteria set out in [Revenue Procedure 97-13](#), with a key element being that none of the management company's compensation would be based, in whole or in part, on a share of the hotel's net profits. The IRS gave further guidance on QMA provisions two years ago in [Notice 2014-67](#), extending the safe harbor to circumstances in which the hotel management company's compensation is based on (a) a percentage of the hotel's gross revenue, or (b) a percentage of the hotel's operating expenses, but not both. In addition, to qualify for the safe harbor, the term of the management agreement could not exceed five years (including extensions).

While the 2014 expansion of the safe harbor confirmed that management fees could be safely structured to reflect the more typical "base fee" arrangement that most hotel management companies are familiar with, guidance was not given at the time with respect to "incentive fee" arrangements. Moreover, the short permissible term varied from usual industry practice.

In a recent private letter ruling ([PLR 201622003](#), dated March 2, 2016)¹, the IRS ruled that a hotel management agreement is a QMA when there is a base fee set at a fixed percentage of the gross revenue of the hotel, and an incentive fee set at an additional fixed percentage of the gross revenue of the hotel if the hotel achieved a certain level of profitability. For example, a permissible arrangement could set the management fee as a base fee of 3% of gross revenue of the hotel, and an incentive fee of an additional 2% of gross revenue of the hotel provided that the hotel achieved an agreed-to profit margin.

On August 22, 2016, the IRS issued new guidance in the [Revenue Procedure 2016-44](#). The goal of the new Revenue Procedure is to expand the applicable safe harbor by “taking a more flexible and less formulaic approach toward variable compensation for longer-term management contracts of up to 30 years.” While the safe harbor continues to include constraints on “net profits” compensation, the IRS otherwise generally permits any type of fixed or variable compensation that is reasonable for the services rendered.

The Revenue Procedure sets out specific conditions to qualify for the safe harbor (all of which must be satisfied to obtain the benefit of the safe harbor). Briefly:

1. Payments to the management company must be reasonable compensation for the services rendered;
2. Compensation to the management company may not include a share of net profits (which requirement will be deemed met if no element of the compensation takes into account or is contingent upon net profits). The Revenue Procedure for the first time specifically addresses incentive compensation as well, providing that such compensation will not be treated as providing a share of net profits if the eligibility for the incentive compensation is determined by the service provider’s performance in meeting “one or more standards that measure quality of services, performance, or productivity . . .”;
3. The term of the contract, including all renewal options, is no greater than the lesser of (a) 30 years, or (b) 80% of the weighted average reasonably expected economic life of the managed property;
4. The owner must exercise a significant degree of control over the managed property. This control requirement is typically satisfied so long as the owner retains approval rights over annual budgets, capital expenditures, dispositions of part of the managed property and rates charged for use of the managed property;
5. The owner and not the management company must bear the risk of loss with respect to the managed property; and
6. The management company must not take any position with the IRS contrary to its being a service provider with respect to the managed property (i.e., the management company must agree to not take any depreciation or amortization, investment tax credit or deduction with respect to the managed property).

While the most recent guidance still does not allow the management fees paid under a QMA to equate to the fee structure that one would typically expect to see in a hotel management agreement, it is clear that parties may now move closer to the typical fee model and remain in the band of what the IRS would likely find acceptable for purposes of the protection of the safe harbor.

Members of Kelley Drye's [Hospitality/Leisure Practice](#) have significant experience in structuring, drafting and negotiating hotel management agreements, including QMAs.

[1] While a private letter ruling may only be relied upon by the taxpayer to which it is issued, it is indicative of how the IRS will likely treat similarly-situated taxpayers.