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## P3s and Tax-Exempt Bonds: Butler Snow

In the past, states and local governments have relied in large part on low-cost tax-exempt financing to meet their infrastructure needs. While there is a growing consensus that our present infrastructure needs are great, many states and local governments are finding it more difficult to continue to borrow to address such needs due to a number of factors, including constitutional and statutory debt limitations, mounting pension liabilities and flat and/or declining revenues. As a result, a number of states and local governments have turned to public-private partnerships ("P3s") to address infrastructure needs. P3s have been successfully used in Western Europe and Canada for many years but have only recently taken root in the United States. A P3 is an arrangement between a governmental entity and a private entity that allows for greater private sector investment and participation in public projects. Sectors where P3s have been used include transportation, energy (including municipal electric and gas generation and distribution facilities, as well as renewable energy projects), telecommunications, water and wastewater, governmental buildings, healthcare, education, housing (affordable, senior, student and military) and hospitality. While Federal tax law requirements often force governmental entities to choose between low-cost tax-exempt financing and P3s, there are a number of proposals pending that would expand the ability of governmental entities to use both together.

Under Federal tax law, governmental entities may only issue tax-exempt governmental bonds to finance projects where there is little to no private business use. Private business use can arise from any number of arrangements with private entities, including leases and management contracts. Until recently, management contracts generally had to fit within one of the safe harbors set forth in IRS Rev. Proc. 97-13, which essentially only allows for compensation to the private party to be a fixed amount or a fixed amount per unit of service. However, the IRS has recently provided more flexibility with the respect to the terms of such arrangements. Notice 2014-67 added to the list of allowable agreements an agreement where the compensation paid to a private party may include a percentage of gross revenues or expenses of a facility (but not both) so long as the term of the contract is not more than 5 years. In addition, the Notice clarified that a productivity reward generally does not cause the compensation to be based on a share of net profits, which would result in private use, if the eligibility for such award is based on the quality of the services rather than increases in revenues or decreases in expenses and the amount is a stated dollar amount. Even more recently, the IRS released Private Letter Ruling1 201622003, which approved a management contract where a portion of the compensation is an incentive fee that is partly triggered by a variant of net profits. The IRS found that the incentive fee was not structured in such a way that its amount rose in proportion to increases in net profits or fell in proportion to decreases in net profits, and therefore ultimately was not based on a share of net profits. The IRS has indicated that it intends to publish further guidance on management contracts sometime this year, and it is our hope that such guidance will allow for even more flexibility with respect to the terms of such agreements.

In addition to guidance on management contracts, in 2015, the IRS released final <u>allocation and accounting regulations</u> that will also help to facilitate P3s. These regulations allow for "mixed-use" projects where the governmental portion is financed with tax-exempt bonds and the private portion is financed with equity. In addition, with respect to partnerships, the new regulations look through

to the partners so that the amount of private business use is only the private partner's use of the property.

In addition to tax-exempt governmental bonds, Federal tax law currently allows tax-exempt private activity bonds to be issued to finance a variety of specified projects, including airports, water and sewer infrastructure, solid waste facilities, public education facilities and highway infrastructure. In fact, a number of large P3 projects in the transportation sector have paired credit assistance under the Transportation Infrastructure Finance and Innovation Act ("TIFIA") with tax-exempt qualified highway facility private activity bonds. There are also several administration and congressional proposals to enhance existing private activity bonds and to add new categories of private activity bonds. As part of his 2016 proposed budget, President Obama presented the concept of qualified private infrastructure bonds and there is proposed legislation in Congress that would create Move America Bonds, both of which would help encourage private investment in infrastructure through P3s by allowing for tax-exempt financing of certain types of public facilities where there is private use. Another <u>legislative proposal</u> would add to the list of tax-exempt private activity bonds certain types of governmental buildings and thus allow for state and local governments to utilize tax-exempt financing for P3 projects involving public libraries, public universities and colleges, courthouses, public hospitals and health care, research and laboratory facilities, government offices, and public safety facilities. Under current law, the amount of many private activity bonds that may be issued annually is limited, but water and wastewater infrastructure P3 projects, which municipalities all over the country have increasingly looked to in order to fulfill the massive need for capital improvements in that sector, could be bolstered by proposed legislation that would remove this volume cap limitation for private activity water and wastewater bonds. In a related development, Congress also recently amended the Water Infrastructure Finance and Innovation Act ("WIFIA," and modeled after TIFIA) to allow the use of tax-exempt bonds with WIFIA credit assistance.

All in all, leaders in Washington seem to have recognized the growing use of P3s by state and local governments, have taken positive steps to facilitate the combination of P3s and low-cost tax-exempt financing, and are poised to take further action in this area.

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## **Butler Snow LLP**

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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