Student Housing:

Comparing Options for Tax Exempt Financing

Chas Cardall, John Wang and Roger L. Davis

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Contents

Introduction 1

Chapter 1: University Financing 2

Chapter 2: Auxiliary Bonds 4

Chapter 3: Third Party Nonprofit Corporation Financing 6

Chapter 4: Financing Trust Structure –
A Variation on Third Party Financing 8

Chapter 5: Ownership Structure (P3) 10

Chapter 6: Qualified Management Contracts:
Revenue Procedure 2016-44 17

Appendix: Copy of Revenue Procedure 2016-44 i

Introduction

This book grows out of a webinar on Comparing Financing Structures for Student Housing, hosted by The Bond Buyer and presented by Orrick on July 27, 2016. More than 350 registered and at least 250 participated. Obviously, something is going on that is significantly increasing interest in financing student housing. Across the country, colleges and universities are updating or expanding their student housing facilities. Some are using independent nonprofit corporations, P3 concessions, or other innovative financing structures that may not count against the college's or university's borrowing capacity.

During the webinar, the question was posed to the audience whether the incidence of private development of student housing was going to continue to increase? Over 92 percent answered affirmatively. This response correlates with what Orrick, as the nation's leading bond counsel, has been experiencing, which, among other things, led us to create the ownership structure described in Chapter 5. For the same reason, while this book covers traditional financing techniques, it focuses on off balance sheet, off credit structures.

This book is designed for use by colleges and universities, developers, underwriters, direct purchase lenders and others involved in the financing of student housing.

Nothing in this book should be construed or relied upon as legal advice. Instead, this book is intended to serve as an introduction to the general subject of financing student housing, from which better informed requests for advice, legal and financial, can be formulated.

CHAPTER 1

University Financing

The most traditional form of financing of student housing is by universities and colleges (for convenience herein collectively referred to as "universities"), backed either by general university revenues, including tuition, or by special enterprise revenues, like student housing, bookstore, sports, etc. The project is developed, owned, managed and financed by the university.

A public university can usually issue tax exempt bonds itself. Nonprofit universities must borrow proceeds of tax-exempt bonds issued by a conduit issuer, a state or local government entity.

A conduit issuer issues bonds, loans the proceeds to a third party borrower (the real obligor and true party in interest), which uses the proceeds to develop the project, and makes loan repayments to the conduit issuer which uses those revenues to pay debt service on the bonds.

Typical tax issues that may occur with this type of financing relate to (1) contracting out management or operational responsibilities to a private manager and (2) summertime or other non-student rentals. In both cases, the underlying tax concern is with "private use", generally capped at 10%, for public universities and 5% for private nonprofit universities.

In addition, bonds issued for 501(c)(3) nonprofits, referred to for tax purposes as "qualified 501(c)(3) bonds", are also subject to additional tax requirements, such as (i) a prohibition against using more than 2% of the bond proceeds to pay for costs of issuing the bonds, (ii) the TEFRA public hearing and approval requirement, and (iii) certain limitations relating to acquiring existing housing projects (as opposed to new construction).[1]

A private manager or operator can avoid being treated as a private user for tax purposes if the terms of the contract do fit within certain guidelines established by the Internal Revenue Service ("IRS"). Until recently, these

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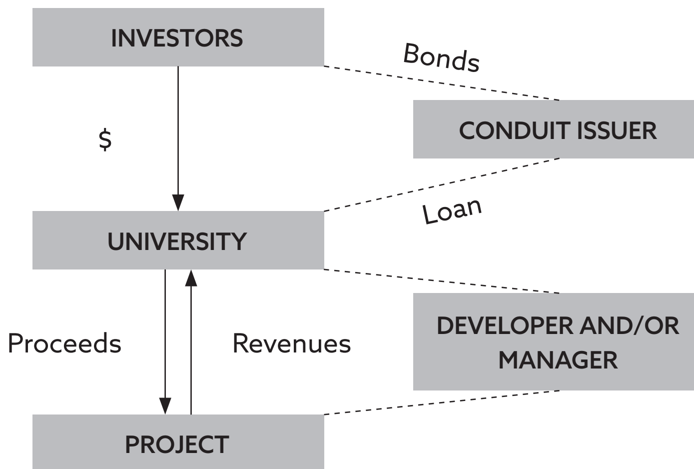
[1] In general, projects located near the university, that are rented by the bed (rather than by the unit) and that provide traditional student services will avoid the limitations related to acquiring existing housing projects.

guidelines were found in Revenue Procedure 97-13, as modified by Revenue Procedure 2007-47 and IRS Notice 2014-67. On August 22, 2016, the IRS published Revenue Procedure 2016-44, which substantially revised and expanded the guidelines. We expect the IRS to provide some additional clarification of the guidelines by early 2017. Until August of 2017, universities can choose which guidelines to apply. A summary of the new guidelines is set forth in Chapter 6. The full text of Rev. Proc. 2016-44 is set forth in the Appendix.

Student tenants contracting individually with the project owner or operator will not be considered to be private users of the project, but contracts with summer program or retreat organizers, sports camps, clubs, etc. can cause private use, and need to be reviewed case-by-case to evaluate whether and how much private use is involved.



This is the financing method which most directly involves the university and over which the university has maximum control. A potential problem with this financing method is that it is based on university credit, meaning it is on the university's balance sheet and is scored by rating agencies and investor analysts against the university's borrowing capacity.

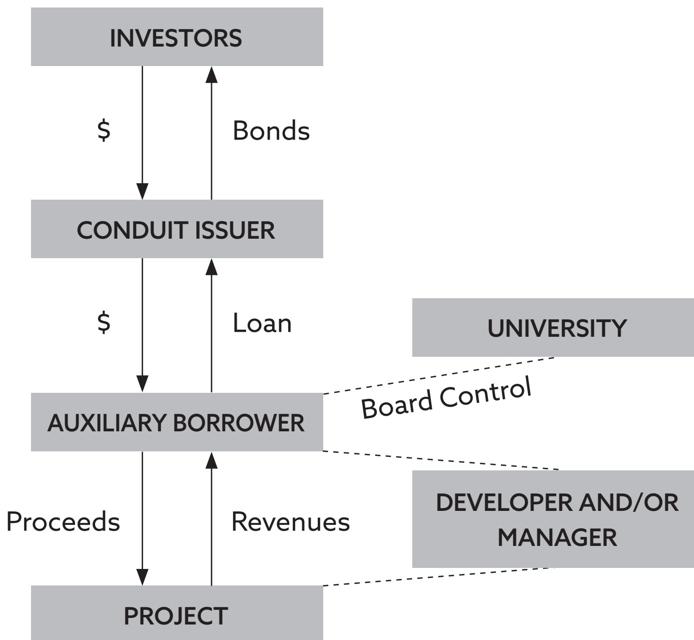
Many universities are rethinking their role in student housing and whether student housing is an appropriate use of the university's balance sheet or limited borrowing capacity. Many are concluding it's not. Perhaps the most dramatic example is the University of Georgia which is outsourcing a substantial part of its existing and to be developed student housing portfolio.

CHAPTER 2

Auxiliary Bonds

In a structure one step removed from the university itself, an auxiliary nonprofit corporation controlled by the university acts as borrower. A conduit issuer issues the bonds and loans the proceeds to the auxiliary, which develops, owns and finances the project instead of the university. However, the university can, as a practical matter, control the process if it chooses to do so.

The credit for the financing is usually limited to project revenues and maybe a mortgage on the project, although in some cases there is a lease to the university. This should get the financing off the university's balance sheet (although, if there is a lease, the lease may show up somewhere on the university's financial statements) and divorces the project and its revenues from any pledge of university assets or revenues made to other university bonds.



Even without a lease or other direct university obligation, the financing is likely to be considered by rating agencies and investors closely enough associated with the university to be on credit, meaning that it would be counted against the university's credit and borrowing capacity based on a concern that, although it is not legally obligated, the university may be motivated to cover any defaults anyway.[2]

In addition to tax issues referred to in Chapter 1, the tax issues associated with financing student housing through an auxiliary of the university relate to the federal tax status of the auxiliary entity. The auxiliary entity is usually a 501(c)(3) nonprofit corporation. Thus, private use for auxiliary financings generally is capped at 5% and a TEFRA hearing and approval is required. Further, it is important that the activity of supplying student housing is part of the core purposes of the auxiliary nonprofit in order to avoid problems relating to unrelated trade or business activities. On the other hand, if a 501(c)(3) nonprofit is directly controlled by a public university, it may be treated as an instrumentality of the university, effectively as part of the university, and, among other consequences, the 10% private use limit would apply.

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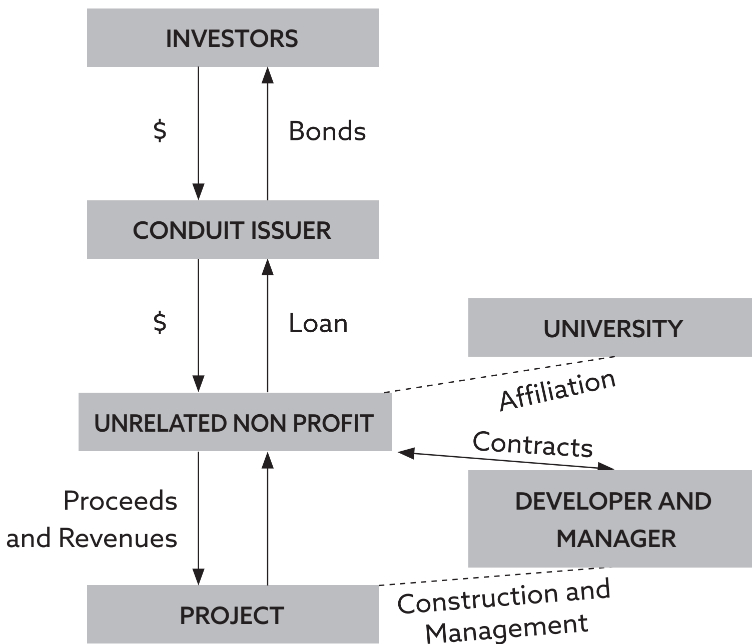
[2] A financing may be treated by rating agencies as affecting the university's credit, hence the term "on credit," even if the university doesn't have a direct or even indirect obligation with respect to the financing. A number of factors are taken into account in evaluating the likelihood that the university nonetheless would step in to avoid default on the financing or loss of the project as student housing. Such factors may include whether the project is owned by an entity that is in some manner affiliated or related to the university or in which the university has an interest, whether the project is located on campus, whether the university has a reversionary interest in the project pursuant to a ground lease or other similar interest, or how involved the university is in developing or managing the project or in publicly supporting the project (including how it is described in the university's housing literature for students). The degree to which the financing will be treated as "on credit" may be 100% or less depending on these same factors, on the particular circumstances of the university and, of course, on the criteria and judgment applied by the particular rating agency. If a financing is considered "on credit" it will also affect the university's future borrowing capacity.

CHAPTER 3

Third Party Nonprofit Corporation Financing

To further remove the financing from the university, an unrelated nonprofit corporation can be used as the borrower. Like the structure described in Chapter 2, the bonds need to be issued by a conduit issuer, with the credit based on project revenues and a mortgage. The project may be university driven or developer driven.

Each financing method discussed so far is further removed from direct university involvement. If the nonprofit corporation is truly unrelated to the university, this financing structure may be both off balance sheet and off credit so far as the university is concerned.



The IRS is of the view that 501(c)(3) nonprofit corporations generally may only act to further the charitable purpose of one other nonprofit or lessen the burden of one governmental entity and that being in the business of financing projects for multiple beneficiaries may not qualify as a charitable purpose. However, after some controversy, the IRS more or less blessed a few nonprofits like Provident and Collegiate Housing Foundation to finance projects that benefit any number of nonprofit corporations, subject to some conditions.

Therefore, to use this financing method, it will be necessary to either (a) create a nonprofit corporation and obtain a 501(c)(3) determination letter from the IRS (which is expensive and time consuming – taking maybe 6 months or more) or (b) use one of these existing nonprofit corporations. The latter adds another party and set of lawyers to the mix, and in order to satisfy the IRS, these existing nonprofits typically require an affiliation agreement or some other direct connection with the university, which may be inconsistent with the university's "off credit" objectives or not uncommon preference for having no involvement in the project or the financing.

Picking up on the discussion of the tax issues associated with the tax status of auxiliaries in Chapter 2, third party nonprofit corporation financings will almost always be subject to the lower, 5%, private use limit, even for a project associated with a public university, because the nonprofit owner will almost never be controlled by the university. The other requirements related to qualified 501(c)(3) bonds will also apply: principally the 2% limit on costs of issuance and the TEFRA hearing and approval requirements. The specific tax issues that arise in this context relate to the sometimes tricky tax qualification of the third party nonprofit, unrelated trade or business issues, and the need to retain a private operator for the project, discussed in Chapters 1 and 6.

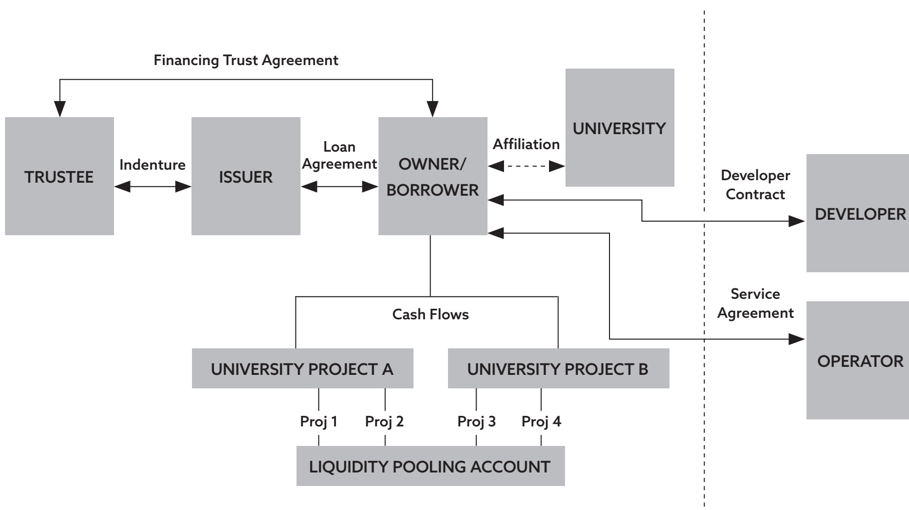
For additional general information on third party nonprofit corporation financing, see our green book entitled "Nonprofit Corporations: Borrowing with Tax-Exempt Bonds" which can be found at *https://www.orrick.com/Insights/2002/09/Nonprofit-Corporations-Borrowing-With-Tax-Exempt-Bonds*.

CHAPTER 4

Financing Trust Structure – A Variation on Third Party Financing

This is basically a pooling version of the structure described in Chapter 3. It enables program financing of multiple projects on multiple campuses, at one time or from time to time, as part of a student housing development and finance program, usually for a single university. The security is the combined revenues of all financed projects, supported by a rate covenant based on aggregate project revenues and maybe a mortgage or other real estate security and a liquidity account funded from each series of bonds issued.

This structure has been designed to give the university organizational influence over the financing and the projects included in the trust. It allows the university, if it chooses, to procure developers to design, build and operate the project, while maintaining control over the financing and related matters such as disclosure, marketing of bonds and investor relations, and potentially preserving enough distance to justify off balance sheet and/or off credit treatment (although off credit treatment is less likely). Other benefits



are efficiency, single unified credit, standardized documentation and lower cost of financing (due to scale, standardization and diversity of credit).

As noted on the previous page, this financing structure is similar to the third party qualified 501(c)(3) bond structure described in Chapter 3, but it allows for multiple projects to be pooled together. Therefore, the tax issues associated with this structure include all of the issues discussed in Chapter 3 as well as issues relating to the pooled nature of the financing. There are a number of structuring alternatives relating to the funding and application of debt service and operating reserves, the timing of bond issuance and project development, and the accumulation and use of project revenues and explicit or implicit university guarantees, if any, that require tax input. In general, these issues are similar to other pooled financing transactions and do not include elements special to student housing.

CHAPTER 5

Ownership Structure (P3)

Even with three or three and a half good ways to finance student housing, some universities or developers still needed an off balance sheet, off credit financing method that does not require a third party nonprofit corporation borrower or any material involvement of the university. The solution we came up with was simple. Use a conduit issuer, but instead of acting like a traditional conduit, and lending the proceeds of the bonds to the university, auxiliary or nonprofit corporation borrower, the conduit issuer uses the bond proceeds itself to build or acquire the project.

Results:

a. Conduit issuer isn't really a conduit, and, in effect, becomes both lender and borrower.

b. Conduit issuer owns the project.

c. Bonds become government purpose bonds, and private activity bond rules would not apply (2% cap on costs of issuance and TEFRA hearing and approval), unless project is gifted to a private nonprofit university (see discussion of "What Happens to the Project" on page 15), or a private nonprofit university has some other significant involvement. If there is too much involvement by a private nonprofit university, the bonds likely will need to be treated as qualified 501(c)(3) bonds to which these private activity bond rules would apply, but such qualified 501(c)(3) bond status will not be a serious obstacle.

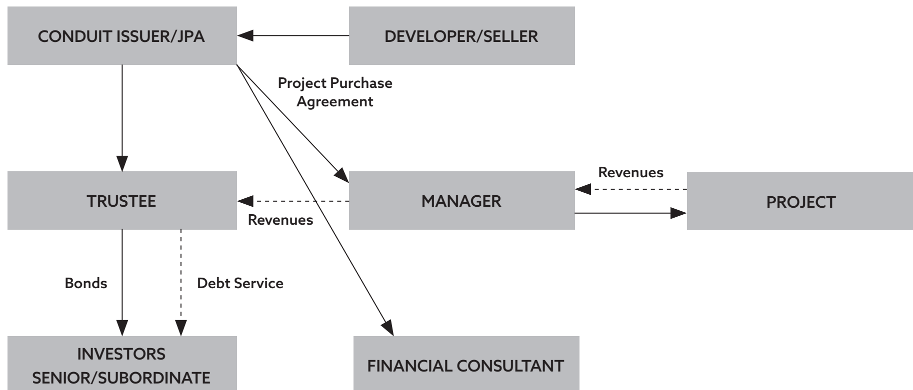
d. Off balance sheet, off credit.

e. Public private partnership (P3). Private party may be (i) developer selling to conduit issuer, (ii) developer constructing the project as agent for the conduit issuer, (iii) developer or other private party taking responsibility for the project under concession agreement with the university, or (iv) even conduit issuer acting as concessionaire (a public private partnership).

f. No affiliation with or involvement of university is required, except perhaps including the project on a list of housing options offered to students for their consideration.

g. Alternatively, university could be the operator of the project, but that could interfere with off credit treatment.

h. Depending on state and issuer/owner, such ownership by the public entity conduit issuer may convey property tax exemption for the project (which could be worth more than tax-exemption of bond interest to the developer in terms of maximum borrowing and purchase price, and can be combined with tax exemption of interest on bonds.)



Although simple in concept, this ownership structure was not considered or used until 2014, when it was invented by Orrick. The first transaction was a student housing project in California near a Cal State campus, financed and owned by the Public Finance Authority based in Wisconsin (but authorized by its governing law to finance projects anywhere in the United States and even abroad).

The Issuer's Perspective

Not every conduit issuer will likely feel comfortable stepping out of its traditional conduit role and becoming the real borrower of bond proceeds and real owner of projects, with the potential additional risks and liabilities associated with such role.[3] As of this writing, in addition to the Public Finance

[3] Most conduit issuers, such as joint powers authorities and state financing agencies, are not political subdivisions because they lack at least one of the three sovereign powers (taxing power, police power or power of eminent domain) required by the IRS for political subdivision status. Political subdivisions are simply exempt from federal income tax. In contrast, an authority or other governmental entity that issues bonds but is not a political subdivision is instead an instrumentality or constituted authority, which derives its exemption from federal income taxes on project revenues from a section of the Internal Revenue Code that covers only "essential governmental functions." There is no clear authority that owning a student housing project would be viewed by the IRS as an essential governmental function for this purpose. Conduit issuers would not want to expose themselves to income tax filing or liability. There is a way of structuring around this concern however for conduit issuers that are not political subdivisions.

Authority (PFA), three joint powers authorities in California have either used or agreed to use the ownership structure for student housing or some other asset.[4]

The following is a discussion of the additional risks and exposures associated with the ownership structure and how they have been addressed. The importance of careful document drafting by capable and experienced bond counsel (intensely focused on precise characterization of the conduit issuer's role and responsibility every time it is referred to) cannot be overemphasized.

The conduit issuer, of course, would not be liable on the bonds except from project revenues. It has no greater exposure to liability on the bonds or any related contracts than in a traditional conduit financing. Like a traditional conduit financing, the bond documents and the disclosure documents will make it perfectly clear (often in all caps and bold) that the issuer is not liable to pay the bonds except from project revenues and other amounts held by the trustee and available for that purpose under and in accordance with the bond indenture. An equivalent limitation on issuer liability will appear in every contract or agreement that the issuer may enter into in connection with the bonds.

So, the issuer should have no contractual liability that extends beyond moneys available under the bond indenture, and ownership of the project should not make it any more likely than would be the case in a traditional conduit structure that it would be liable for any contractual obligation, whether under the bonds or other related agreement, except to the extent moneys are available therefrom or under and in accordance with the bond indenture.

The conduit issuer's additional risk exposure related to owning the project is mostly related to tort liability. Tort refers to some wrongful act or condition other than breach of contract. Tort liability may be associated with the bonds or the project.

The tort liability associated with the bonds relates primarily to possible violation of the so-called anti-fraud provisions of the securities laws, principally Rule 10b-5, which prohibits misstatements or omissions of material fact, typically in the official statements, in connection with the sale of securities (including municipal bonds).

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[4] The ownership structure, like the 501(c)(3) structure, can be used for a variety of projects in addition to student housing. For example, it has been or is currently being used for government offices, proton therapy centers, hotels, health care facilities, etc.

The issuer, in theory, may be somewhat more exposed to misstatements or omissions in an official statement or other disclosure document in the ownership structure than in a typical conduit structure, principally for the reason that in the conduit structure it is easier to ascribe responsibility for some of the information in that disclosure document to the nonprofit corporation or other third party borrower, and in the ownership structure there is no third party borrower. However, the information ascribed to the borrower in such typical disclosure document is usually limited to the information about the borrower and the project. Information about the borrower, of course, is simply not applicable in the ownership structure, where the relevant equivalent information might be about the manager hired to manage the project, which information can be ascribed to that manager. Information about the project may be ascribed to the seller. In any case, the official statement or other disclosure document is considered the Issuer's document and additional means are deployed (whether in conduit structure or ownership structure) to limit the Issuer's scope of responsibilities and potential exposure – such as explicitly limiting the issuer's responsibility for information in the official statement to information under the captions "The Issuer" and "Litigation."

Many of the ownership structure transactions have been or are expected to be unrated or privately placed, whether to a single buyer or a small number of qualified institutional investors or accredited investors. Whether or not there is a limited offering memorandum with something like the above aimed at limiting the scope of the Issuer's responsibility for its content, in each case, the investor will be required, as a condition to purchasing the bonds, to execute a so-called "big boy investor letter" which, among other things, represents that the investor has done its own due diligence and has either been supplied with or been given access to information which a reasonable investor would consider material in making its investment decision.

Another potential source of bond related liability might be actions taken or omitted by the Issuer that result in taxability of the bonds. In the typical conduit structure, the borrower would be responsible for most actions that could affect taxability, primarily private use of the project or arbitrage investment of bond proceeds. Ownership structure issuers have usually addressed this concern by hiring a post-issuance tax compliance consultant (like BLX Group, an Orrick subsidiary), to provide rebate and other post-issuance review and compliance monitoring. In general, it is very rare

(albeit not unprecedented) for issuers of bonds to be charged with bond related tort liability.

The project related tort liability relates to harm to persons or property from the operation or condition of the project. Examples with respect to a student housing project might include slip and fall injuries of residents, guests or staff, food poisoning from the cafeteria, water or fire damage to students' personal effects, environmental liabilities and the like. For this category, the conduit issuer's exposure clearly would be greater and more direct in the ownership structure than in the typical conduit financing structure.

This exposure has been addressed to the satisfaction of the ownership structure issuers and the law firms representing them, largely through the use of insurance (based on advice of an independent insurance consultant hired by the issuer to design and periodically review the insurance package for protection of the issuer). In addition there may be limited indemnities from the seller of the project and from the manager[5], and an unexpected expense reserve account in the revenue waterfall, which also covers any other unexpected expenses that might arise that are not covered by indemnification.[6]

In addition to exposure to liability, more operational responsibilities might be expected of a conduit issuer in the ownership structure, where it owns the project, than in the traditional conduit structure, where a borrower owns the project and is expected to be responsible for its operation.

The issuers that have used the ownership structure so far have no real staff or ability to undertake responsibility for any operational activities. Even if they did, they would be unlikely to have the experience or bandwidth, or desire, to handle these responsibilities itself. As a result, all of those responsibilities are delegated to one or more of the bond trustee under the bond indenture, the manager under the facilities management agreement, and the financial consultant (essentially the issuer's stand in for matters not covered by the

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[5] Note that often there is no party to provide the kind of broad indemnity that conduit issuers usually expect from the borrower. Of course, such indemnities are only worth the credit of the indemnitor, which is frequently a special purpose entity with no assets other than the project.

[6] A typical flow of funds might be the following: Revenues are deposited first (before debt service on the bonds) into an Operating Expense Fund to cover budgeted operating expenses, which includes fees and expenses of the issuer, including legal expenses, and insurance costs. Budgets are prepared annually and therefore include only anticipated expenses, which, however, may include expenses that arise from unexpected events that occurred in the preceding year the costs of which remain unpaid or continue into the current budget year. There is also an Operating Reserve Fund which comes behind debt service on the senior bonds, but ahead of debt service on the subordinate bonds (if any). The Operating Reserve Fund covers any extraordinary costs and expenses, including indemnification, not covered by the Operating Expense Fund. Further, any subordinate bonds would absorb the first and substantial part of the risk of any shortfall in revenues, acting in effect as a buffer of protection for the Operating Expense Fund and Operating Reserve Fund.

trustee or manager and to monitor their performance) under a financial consultant services agreement.

The Developer's Perspective

Developer gives up ownership of the project, but can derive profit in a variety of ways:

a. Selling the completed project to the JPA, for a price based on the lesser of appraised value or the amount of bonds that can be serviced (usually plus a coverage factor) with project revenues – this is 100% debt financing, no equity required

b. If the project is to be built, selling development rights or ground lease to conduit issuer

c. Development fees

d. Operator/management fees (management contract must satisfy the conditions for a qualified management contract set out in IRS Revenue Procedure 2016-44 – see Chapter 6)

e. Asset management fee

f. Possible fees for pre-opening services or centralized services

g. Subordinate bonds with relatively high tax exempt interest (equivalent to seller financing, used to leverage and enhance credit of and reduce the interest rate on senior bonds and to increase the purchase price of the project and overall return to the developer, which subordinate bonds may be held by the development or sold)

What happens to the project?

The conduit issuer owns the project. It can keep it or give it away. If it gives it away while the bonds are still outstanding, the gift will be subject to the bonds and the mortgage on the project securing the bonds. The conduit issuers who have engaged in the ownership structure so far have not been interested in the upside of being a property owner. Their only interest is the same as in traditional conduit financings, to facilitate the financing of worthy projects and to earn a fee for undertaking the financing.

On the other hand, they have been interested in giving the project away, usually to the university or its auxiliary. The gift could occur when the bonds are issued and the project acquired by the issuer (subject to the bonds or

mortgage) or the issuer can contractually agree to donate the property when the bonds have been paid, and can even give the university an option to purchase the project at a price sufficient to defease the bonds (even if less than the then appraised value). If the university doesn't want the gift, which may reflect an objective to distance itself from the project or the financing, the issuer has held on to the project, in case the university changes its mind or another suitable recipient
is identified.

Alternatively, developer can arrange to get the project back, pursuant to either:

a. An option to purchase (at the greater of amount needed to defease bonds or then fair market value), or

b. A ground lease (for a term long enough to convey tax ownership to conduit issuer – e.g., over 50 years), with reversion to developer at end of the term.

Federal Tax Issues

The federal tax issues associated with the ownership structure more or less include all of the issues described in earlier chapters. In addition, the starting point for the ownership structure is finding an issuer that is able to own the project without incurring any income tax liability (either a political subdivision or an instrumentality for which student housing would be considered an essential government function). If the issuer does not commit, directly or indirectly, to transfer ownership of the project to a nonprofit, then the bonds should be governmental purpose bonds subject to the 10% private use limit, and the other private activity bond requirements would not apply. Also, as noted, the issuer/owner will likely need a private operator of the project and the terms of that contractual arrangement must satisfy the IRS guidelines in Revenue Procedure 2016-44 (see Chapter 6).

CHAPTER 6

Qualified Management Contracts; Revenue Procedure 2016-44

Until recently, the IRS guidelines for determining whether contracting out the operation or management of a bond-financed project would result in impermissible private use by the operator or manager were found in Revenue Procedure 97-13, as modified by Revenue Procedure 2007-47 and IRS Notice 2014-67. On August 22, 2016, the IRS published Revenue Procedure 2016-44, which substantially revised and expanded the guidance. We expect the IRS to provide some additional clarification of the guidelines by early 2017. Until August of 2017, universities can choose which guidelines (97-13 or 2016-44) to apply. Below is a short summary of Revenue Procedure 2016-44. Contracts that fit within these guidelines are referred to as "qualified management contracts."

Revenue Procedure 97-13 set forth highly formulaic safe harbor requirements for contracts for services performed in bond-financed facilities. Revenue Procedure 2016-44 significantly relaxes this approach. However, the lack of technical specifics in the new guidance means that universities, auxiliaries, third party owners and issuers (together, "qualified users") must now navigate principle-based concepts to ensure that service contracts do not result in private business use. While there are some interpretive questions to be resolved, contracts that qualified under the earlier (Rev Proc 97-13) rules will very likely qualify under these new rules, perhaps with minor changes.

Revenue Procedure 2016-44 (the "Revenue Procedure") eliminates the detailed safe harbors involving length of term, termination rights, and limits on non-fixed variable compensation that have guided qualified users in drafting contracts for almost 20 years. The Revenue Procedure provides for significantly longer term service contracts than permitted under prior IRS safe harbor rules. For example, the Revenue Procedure permits contract terms up to the lesser of (a) 30 years or (b) 80% of the weighted average reasonable expected economic life of the bond-financed managed property. By comparison, the longest contract term allowed under Revenue Procedure 97-13 was 15 years.

The Revenue Procedure imposes the following principle-based requirements for safe-harbor-compliant contracts, many of which are new:

- The overall compensation paid to the service provider must be "reasonable."
- While Revenue Procedure 97-13 required largely fixed compensation for contracts longer than 5 years, Revenue Procedure 2016-44 allows variable compensation without regard to term. The contract must not provide the service provider with a share of "net profits" from the managed property. The Revenue Procedure clarifies that compensation will not be treated as providing a share of net profits if none of the eligibility for, timing of, or amount of compensation takes into account or is contingent upon the net profits of the managed property or both the revenues and expenses of the managed property. Incentive compensation will not be treated as providing a share of net profits if it is awarded based on standards of quality of service, performance or productivity, so long as the amount of the incentive payment is not expressed as a percentage of net profits. Further, for purposes of testing for a net-profits arrangements, reimbursements of the service provider's actual and direct expenses paid to unrelated parties are disregarded, although the Revenue Procedure states that employees of the service provider are related parties with respect to the service provider.
- The service provider may not share in the burden of bearing net losses from the operation of the managed property or the risk of loss if the property is damaged or destroyed. As with the net profits limitation, the Revenue Procedure clarifies that net losses may arise under a contract through direct reference or by taking into account both the managed property's revenues and expenses. However, dollar-amount reductions in compensation based on failures to keep expenses below one or more specified targets will not be treated as sharing net losses with the service provider.
- The qualified user (i.e. the university, auxiliary, third party 501 (c)(3) nonprofit corporation or the issuer, depending on which of the foregoing structures is used) must exercise a significant degree of control over the use of the managed property. The required control includes approval of the annual operating budget for the property, capital expenditures with respect to the property, each disposition of the property, rates charged for the use of the property and general nature and type of use of the property.
- The service provider must agree that it is not entitled to, and will not take, a tax position with respect to the financed property inconsistent with being a service provider (e.g., take depreciation with respect to the property or characterize payments to the qualified user as deductible rent).

- Finally, the ability of the qualified user to exercise its rights under the contract must not be limited by its relationship with the service provider. The Revenue Procedure offers an independent safe harbor based on a lack of overlapping governance and shared officers.

As this description indicates, qualified users must now focus more on concepts of control, risk, and who derives the benefits and burdens of managed property, rather than the application of a formulaic set of safe harbors that limited long-term arrangements and variable forms of compensation.

A copy of Revenue Procedure 2016-44 is contained in the Appendix.

APPENDIX

Rev. Proc. 2016-44

1. PURPOSE

This revenue procedure provides safe harbor conditions under which a management contract does not result in private business use of property financed with governmental tax-exempt bonds under § 141(b) of the Internal Revenue Code or cause the modified private business use test for property financed with qualified 501(c)(3) bonds under § 145(a)(2)(B) to be met.

2. BACKGROUND

1. Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any State or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of section 141). Section 141(a) provides that the term " private activity bond" means any bond issued as part of an issue (1) that meets the private business use test and private security or payment test, or (2) that meets the private loan financing test.

2. Section 141(b)(1) provides generally that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(6) defines " private business use" as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person must be treated as a trade or business use.

3. Section 1.141-3(a)(1) of the Income Tax Regulations provides, in part, that the 10 percent private business use test of § 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Section 1.141-3(a)(2) provides that, in determining whether an issue meets the private business use test, it is necessary to look at both indirect and direct use of proceeds. Proceeds are

treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

4. Section 1.141-3(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user as a result of ownership; actual or beneficial use of property pursuant to a lease, a management contract, or an incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

5. Section 1.141-3(b)(3) provides generally that the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. Section 1.141-3(b)(3) further provides that, in determining whether a management contract is properly characterized as a lease, it is necessary to consider all the facts and circumstances, including the following factors: (1) the degree of control over the property that is exercised by the nongovernmental person; and (2) whether a nongovernmental person bears the risk of loss of the financed property.

6. Section 1.141-3(b)(4)(i) provides generally that a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operations of the facility. Section 1.141-3(b)(4)(iv) provides generally that a management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes.

7. Section 1.141-3(b)(4)(ii) defines " management contract" as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion, or any function, of a facility. For example, a contract

for the provision of management services for an entire hospital, a contract 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.

8. Section 1.141-3(b)(4)(iii) provides that the following arrangements generally are not treated as management contracts that give rise to private business use: (A) contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services); (B) the mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services if those privileges are available to all qualified physicians in the area, consistent with the size and nature of the hospital's facilities; (C) a contract to provide for the operation of a facility or system of facilities that consists primarily of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; and (D) a contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

9. Section 141(e) provides, in part, that the term " qualified bond" includes a qualified 501(c)(3) bond if certain requirements stated therein are met. Section 145(a) provides generally that " qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if (1) all property that is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and (2) such bond would not be a private activity bond if (A) 501(c)(3) organizations were treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses, determined by applying § 513(a), and (B) § 141(b)(1) and (2) were applied by substituting " 5 percent" for " 10 percent" each place it appears and by substituting " net proceeds" for "proceeds" each place it appears. Section 1.145-2 provides that, with certain exceptions and modifications, §§ 1.141-0 through 1.141-15 apply to § 145(a).

10. Rev. Proc. 97-13, 1997-1 C.B. 632, modified by Rev. Proc. 2001-39, 2001-2 C.B. 38, and amplified by Notice 2014-67, 2014-46 I.R.B. 822, sets forth conditions under which a management contract does not result in private

business use under § 141 or cause the modified private business use test under § 145(a)(2)(B) to be met. These conditions include constraints on net profits arrangements, the permitted term of the management contract, the types of compensation, and the relationship between the parties.

11. Rev. Proc. 97-13 as originally issued (the original safe harbors) specifies various permitted terms of contracts that depend on the extent to which the compensation is a fixed amount (that is, the greater the percentage of fixed compensation, the longer the permitted term of the management contract). For example, the original safe harbors permit (i) contracts of up to 15 years if at least 95 percent of the compensation consists of a periodic fixed fee, and (ii) contracts of two to five years if greater percentages of the compensation consist of variable fees, depending on the particular type of variable fee. Subsequently, in Notice 2014-67, the Treasury Department and the Internal Revenue Service expanded these safe harbors to address certain developments involving accountable care organizations after the enactment of the Patient Protection and Affordable Care Act, Pub. L. 111-148 , 124 Stat. 119 (Affordable Care Act), and also to allow a broader range of variable compensation arrangements for shorter-term management contracts of up to five years. This revenue procedure builds upon the amplifications in Notice 2014-67 by taking a more flexible and less formulaic approach toward variable compensation for longer-term management contracts of up to 30 years. The safe harbor under this revenue procedure generally permits any type of fixed or variable compensation that is reasonable compensation for services rendered under the contract. This revenue procedure includes constraints on net profits arrangements and the relationship between the parties (as under the original safe harbors), but applies a more principles-based approach focusing on governmental control over projects, governmental bearing of risk of loss, economic lives of managed projects, and consistency of tax positions taken by the service provider.

3. SCOPE

This revenue procedure applies to a management contract (as defined in section 4.02 of this revenue procedure) involving managed property (as defined in section 4.03 of this revenue procedure) financed with the proceeds of an issue of governmental bonds (as defined in § 1.141-1(b)) or qualified 501(c)(3) bonds under § 145.

4. DEFINITIONS

For purposes of this revenue procedure, the following definitions apply:

1. Eligible expense reimbursement arrangement means a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider.

2. Management contract means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services for a managed property. A management contract does not include a contract or portion of a contract for the provision of services before a managed property is placed in service (for example, pre-operating services for construction design or construction management).

3. Managed property means the portion of a project (as defined in § 1.141-6(a)(3)) with respect to which a service provider provides services.

4. Qualified user means, for projects (as defined in § 1.141-6(a)(3)) financed with governmental bonds, any governmental person (as defined in § 1.141-1(b)) or, for projects financed with qualified 501(c)(3) bonds, any governmental person or 501(c)(3) organization with respect to its activities which do not constitute an unrelated trade or business, determined by applying § 513(a).

5. Service provider means any person other than a qualified user that provides services to, or for the benefit of, a qualified user under a management contract.

6. Unrelated parties means persons other than a related party (as defined in § 1.150-1(b)) or a service provider's employee.

5. SAFE HARBOR CONDITIONS UNDER WHICH MANAGEMENT CONTRACTS DO NOT RESULT IN PRIVATE BUSINESS USE

1. In general. If a management contract meets all of the applicable conditions of sections 5.02 through section 5.07 of this revenue procedure, or is an eligible expense reimbursement arrangement, the management contract does not result in private business use under § 141(b) or 145(a)(2)(B).

Further, under section 5.08 of this revenue procedure, use functionally related and subordinate to a management contract that meets these conditions does not result in private business use.

2. General financial requirements.

   (1) In general. The payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract. Compensation includes payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider.

   (2) No net profits arrangements. The contract must not provide to the service provider a share of net profits from the operation of the managed property. Compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses for any fiscal period. For this purpose, the elements of the compensation are the eligibility for, the amount of, and the timing of the payment of the compensation. Further, solely for purposes of determining whether the amount of the compensation meets the requirements of this section 5.02(2), any reimbursements of actual and direct expenses paid by the service provider to unrelated parties are disregarded as compensation. Incentive 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, and the amount and the timing of the payment of the compensation meet the requirements of this section 5.02(2).

   (3) No bearing of net losses of the managed property.

      (a) The contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property. An arrangement will not be treated as requiring the service provider to bear a share of net losses if:

         (i) The determination of the amount of the service provider's compensation and the amount of any expenses to be paid by the service provider (and not reimbursed), separately and

collectively, do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and

(ii) The timing of the payment of compensation is not contingent upon the managed property's net losses.

(b) For example, a service provider whose compensation is reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) will not be treated as bearing a share of net losses as a result of this reduction.

3. Term of the contract and revisions. The term of the contract, including all renewal options (as defined in § 1.141-1(b)), is no greater than the lesser of -30- years or 80 percent of the weighted average reasonably expected economic life of the managed property. For this purpose, economic life is determined in the same manner as under § 147(b), but without regard to § 147(b)(3)(B)(ii), as of the beginning of the term of the contract. A contract that is materially modified with respect to any matters relevant to this section 5 is retested under this section 5 as a new contract as of the date of the material modification.

4. Control over use of the managed property. The qualified user must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property, and the general nature and type of use of the managed property (for example, the type of services). For this purpose, for example, a qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts; and a qualified user may show approval of dispositions of property that is part of the managed property in a similar manner. Further, a qualified user may show approval of rates charged for use of the managed property by either expressly approving such rates (or the methodology for setting such rates) or by including in the contract a requirement that the service provider charge rates that are reasonable and

customary as specifically determined by an independent third party.

5. <u>Risk of loss of the managed property</u>. The qualified user must bear the risk of loss upon damage or destruction of the managed property (for example, upon force majeure). A qualified user does not fail to meet this risk of loss requirement as a result of insuring against risk of loss through a third party or imposing upon the service provider a penalty for failure to operate the managed property in accordance with the standards set forth in the management contract.

6. <u>No inconsistent tax position</u>. The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property. For example, the service provider must agree not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property.

7. <u>No circumstances substantially limiting exercise of rights</u>.

   (1) In general. 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 under the contract, based on all the facts and circumstances.

   (2) Safe harbor. As a safe harbor, a service provider will not be treated as having a role or relationship prohibited under section 5.07(1) of this revenue procedure if:

      (a) No more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the directors, officers, shareholders, partners, members, and employees of the service provider;

      (b) The governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and

      (c) The chief executive officer of the service provider is not the chief executive officer of the qualified user or any of the qualified user's related parties (as defined in § 1.150-1(b)).

   (3) For purposes of section 5.07(2) of this revenue procedure, the phrase " service provider" includes related parties (as defined in

§ 1.150-1(b)) and the phrase " chief executive officer" includes a person with equivalent management responsibilities.

8. Functionally related and subordinate use. A service provider's use of a project (as defined in § 1.141-6(a)(3)) that is functionally related and subordinate to performance of its services under a management contract for managed property that consists of all or a portion of that project and that meets the requirements of this section 5 does not result in private business use (for example, use of storage areas to store equipment used to perform activities required under a management contract that meets the requirements of this section 5 does not result in private business use).

6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 97-13 and Rev. Proc. 2001-39 are modified and superseded. Section 3.02 of Notice 2014-67 is modified and superseded. All other sections of Notice 2014-67 remain in effect.

7. DATE OF APPLICABILITY

The safe harbors in this revenue procedure apply to any management contract that is entered into on or after August 22, 2016, and an issuer may apply these safe harbors to any management contract that was entered into before August 22, 2016. In addition, an issuer may apply the safe harbors in Rev. Proc. 97-13, as modified by Rev. Proc. 2001-39 and amplified by Notice 2014-67, to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended on or after August 18, 2017 (other than pursuant to a renewal option as defined in § 1.141-1(b)).

8. DRAFTING INFORMATION

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