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Federal Tax Limitations on Private Business Use

This memorandum discusses certain federal income tax considerations relating to the financing of facilities by The University of Texas System with the proceeds of tax-exempt bonds. The rules relating to the use of the facilities and the source of payment of the bond issue are reviewed to determine whether the bonds are classified "private activity bonds".

Private Use Test. In general, interest on state or local bonds is exempt from federal income taxation only if the proceeds are used by governmental units. Limited exceptions to this rule apply to "private activity bonds." However, numerous additional federal income tax requirements come into play if bonds are classified as "private activity bonds". Whether a bond is a "private activity bond" depends upon the use of the proceeds of the bonds and the source of payment for debt service on the bonds. The private business test manifests itself in various forms. Any special contractual right to use a facility which grants rights to a private person which are superior to those of members of the general public constitutes private use. Thus, for example, the use of a facility by a lessee is private use. In particular, certain non-possessory, contractual rights can also cause private business use.

The general rule is that no more than ten percent (10%) of the proceeds may be used in a disqualified manner. A bond is tested both (1) on the date of issue, and (2) over the term. The tests are applied to analyze the character of the bond on the date of issue, based on how the issuer expects to use the proceeds and the bond-financed property. This is known as the "reasonable expectations" standard. The reasonable expectations standard will be the basis of the statement of expectations incorporated into the Federal Tax Certificate.

The tests also continuously are applied during the term of the bonds to determine whether there has been a deviation from those expectations. This is known as the "change of use" standard. The regulations contemplate the possible change by providing certain remedial actions to preserve the tax-exempt status of the bonds. If a change of use, i.e., a disposition or other disqualified use, occurs in connection with bond-financed property, then the issuer is required to undertake certain remedial action. In effect, the issuer is required either (1) to provide alternate property which qualifies for bond financing, or (2) to retire a portion of the bonds. Depending on the nature of the change of use, the amount of bonds subject to the remedial action is equal to either the disposition proceeds or, if the disqualified use is not caused by a sale of the bond-financed property, the fair market value of the disqualified use.

Space Utilization. The sale of a bond-financed facility to a non-governmental person would cause a private business use problem if that facility involved the use of more than ten percent (10%) of the bond proceeds. Since state law often prohibits a governmental issuer from lending credit, this circumstance generally does not occur. Leases, however, also can be a problem because such

arrangements grant a possessory interest in the facility which results in the lessee receiving a right to use the facility which is superior to members of the general public. The question is whether the benefits and burdens of ownership have transferred to the private user, as in the case of a sale or lease, or, as will be discussed later in the memo, whether such benefits and burdens have been limited in such a way as to permit the use to be disregarded, as in the case of certain management agreements, cooperative research agreements or other beneficial use agreements. If these benefits and burdens have not transferred, such use may be disregarded for purposes of measuring private business use.

Private business use is measured on a bond issue or facility basis. For this purpose, the ten percent (10%) limitation on bond-financed property is measured based on any reasonable and consistently applied method. On a bond issue basis, the proceeds of the bond issue are allocated to private and governmental (or public) use of the facility to determine the amount of private business use over the term of the bond issue. On a facility basis, such use is generally measured by relative square footage, fair market rental value, percentage of cost allocable to the private use or by relative time of usage. As an example of one such method, the ratio of rentable square footage (not including common areas) or, in some cases, the relative fair market values of the differing public and private interests in the property are compared. In the case of time, on the other hand, the relative number of days or hours of public or private use are measured (noting that any periods during which the facility is not used by any such party are disregarded). Thus, if a stadium or arena is used by a school team for 180 days a year and by a professional team for 30 days a year, then the professionals' team use exceeds 10 percent (i.e., 30 days / 210 days = 14%).

Special Agreements. Under some circumstances, agreements which otherwise might be treated as transferring benefits and burdens by virtue of granting superior interests in the property, e.g. management contracts and cooperative research contracts, can be disregarded. This is because the IRS has established safe-harbor limitations that, if met, will be deemed such use to be incidental to the use by the governmental issuer. Notably, where there is such a qualifying agreement then no private use results and the income derived from such enterprise is not treated as disqualified for purposes of measuring the use of proceeds. Therefore, without regard to the amount of income received by the issuer from these agreements, no adverse federal tax consequences to the bonds results. To the extent an agreement does not meet the Private Use and/or Space Utilization tests described above, it may still not result in private business use if other agreement-related IRS safe harbors are met, as further described below.

Management Contracts.

Management Contracts entered into before February 18, 2017. The following types of agreements are specifically described by the tax regulations as *not* resulting in private business use:

- Contracts for services incidental to the facility's primary functions (e.g., janitorial services);
- The granting of hospital admitting privileges to a doctor, in certain cases;
- Contracts for operation of public utility property (e.g., water and wastewater systems, electric systems), if compensation is limited to reimbursement for direct expenses and reasonable overhead of the service provider; or
- Contracts for services, if compensation is limited to reimbursement for direct expenses paid to unrelated third parties.

Otherwise, having a private manager or service provider (the "Provider") will give rise to private business use unless there exist certain terms of the management contract which demonstrate that beneficial use has not been passed to the manager. The primary focus of these management contract rules is on the manager=s compensation and the length of the contract=s term. In general, the Provider=s compensation must be reasonable and not be based, in whole or in part, on a share of net profits. The management contract will avoid private business use treatment if it falls within one of the five safe harbors, as follows:

i. *95% Periodic Fixed Fee Arrangement* B 95 percent of annual compensation for services is a fixed amount, and term is not more than the lesser of 15 years or 80 percent of expected useful life;

ii. *80% Periodic Fixed Fee Arrangement* B 80 percent of annual compensation for services is a fixed amount, and term is not more than the lesser of 10 years or 80 percent of expected useful life;

iii. *50% Periodic Fixed Fee Arrangement* B 50 percent of annual compensation for services is fixed or based on a capitation fee or both, and term is not more than 5 years and is terminable by user in 3 years;

iv. *Per-Unit Fee Arrangement* B 100 percent of compensation for services is based on a per-unit fee or a fixed fee or both, and term is not more than 3 years, terminable by user in 2 years; and

v. *Percentage of Revenue or Expense Fee Arrangements* B 100 percent of compensation for services is based on a percentages of fees charged or on a combination of a per-unit fee and a percentage of revenues or expenses, and term is not more than 2 years and is terminable by user in 1 years (only allowed for contracts where services are provided primarily to third parties, or contracts during an initial start-up period where reasonable estimates of revenues and expenses are unavailable).

In general, the reimbursement of the Provider for direct out-of-pocket expenses is not considered as compensation. Therefore, these costs can be excluded from consideration of the compensation structure.

Finally, the Provider may not have any role or relationship with the governmental unit that would limit the ability of the governmental unit to exercise its rights under the contract. Any voting power of either party which is vested in the other party, including its officers, directors, shareholders and employees, may not exceed twenty percent (20%). Further, the chief executive officer of either party may not serve on the governing board of the other party. Similarly, the two parties must not be members of the same controlled group or be related persons, as defined in certain provisions of federal tax law.

Furthermore, the IRS takes the position that the participation of state or local governmental unit in the Medicare Shared Savings Program (“SSP”) through an accountable care organization (“ACO”)

could raise a private business use issue. An ACO is a legal entity independent of the governmental unit, and can be comprised of groups of service providers and suppliers intending to take advantage of the Center for Medicare and Medicaid Services' program called Share Savings Program (SSP). Information about the SSP can be found here: https://www.cms.gov. The program is intended to provide benefit to organizations that "lower their growth in health care costs while meeting performance standards on quality of care and putting patients first". The Notice introduces a safe-harbor against the creation private business use for ACOs that meet the following 6 requirements:

i. the governmental unit's participation in an ACO is stated upfront in a written agreement negotiated at arm's length;
ii. the ACO is part of the SSP;
iii. the governmental unit's share of economic benefits derived from the ACO is proportional to the benefits or contributions the governmental unit provided to the ACO.
iv. the governmental unit's share of the ACO's losses does not exceed the governmental unit's share of ACO economic benefits;
v. all contracts and transactions entered into by the governmental unit with the ACO and the ACO's participants, and by the ACO with the ACO's participants and any other parties, are at fair market value; and
vi. the governmental unit does not transfer the bond financed property to the ACO unless the ACO is an entity that is a governmental person, or in the case of qualified 501(c)(3) bonds, either a governmental person or a 501(c)(3) organization.

Management Contracts entered into on or after February 17, 2017. After February 17, 2017, the following rules will apply in lieu of those discussed above. A contract that meets the safe-harbor guidelines of Rev. Proc. 2016-44 as summarized below between a state or local governmental unit and a Provider for the management of, or services rendered at, or incentive payment in respect of, a tax-exempt bond-financed facility that does not otherwise give the Provider an ownership or leasehold interest in bond-financed property for federal income tax purposes does not give raise to private business use within the meaning of the Internal Revenue Code of 1986 (the "Code").

General Requirements.

1. *Reasonable Compensation and No Net Profits.* The compensation must be reasonable and no portion of the compensation paid to the Provider may in any event be based on net profits derived from the bond-financed facility. However, a compensation that is based on a percentage either of gross revenues or of expenses (but not both) is permitted. Reimbursement for actual and direct expenses paid by the Provider to unrelated persons is not by itself treated as compensation and, therefore, an agreement that would provide only for such reimbursements would be treated as a qualified management agreement.

2. *Provider Cannot Share Net Losses.* The Provider cannot share in the net losses resulting from the operation of the facilities. For this purpose, a safe-harbor is met if:

i. the compensation paid to the Provider does not take into account the property's net losses or both revenues and expenses within a fiscal period;

ii. the expenses paid by (and not reimbursed to) the Provider are not based on the property's net losses or both revenues and expenses within a fiscal period; and

iii. the timing of payment of compensation to the Provider is not dependent upon the property's net losses (e.g., if property does not cash flow, the Provider cannot be delayed payment of compensation) – however, a Provider's compensation can be reduced for failure to keep expenses below specified targets, so long as such compensation reduction is based on a stated dollar amount (or multiples thereof).

3. *Term*. The term of a qualified management agreement cannot exceed 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property, if less. For this purpose, all renewal options, whether exercisable by the state or local governmental unit or the Provider are taken into account.

4. *Governmental Control*. The state or local governmental unit must exercise a significant degree of control over the actual use of the managed property. For this purpose, a safe-harbor is met if:

i. the state or local governmental unit approves the annual budget of the property;

ii. the state or local governmental unit approves the capital expenditures of the property (as shown, for example, in an annual budget to be approved by the state or local governmental unit describing a functional purpose and maximum amounts of capital expenditures);

iii. the state or local governmental unit controls the disposition of the property (as shown, for example, in the annual budget);

iv. the state or local governmental unit approves rates charged for the use of the property --for this purpose, approval of rates can be satisfied by having

a. the state or local governmental unit retain express approval of rates,
b. the state or local governmental unit retain approval of methodology for setting the rates, or
c. a contractual limitation requiring rates that are reasonable and customary, as specifically determined by an independent third party; and,

v. the state or local governmental unit approves the general nature and type of use of the property (for example, the services rendered by the property).

5. *Risk of Loss with State or Local Governmental Unit and No Inconsistent Tax Position.* The state or local governmental unit must retain the risk of loss (for example, in cases of catastrophic events) and the Service Provider cannot take an inconsistent tax position from the position taken by the state or local governmental unit in a qualified management agreement (for example, by claiming depreciation deductions for the financed property).

6. *No Role or Relationship between State or Local Governmental Unit and Provider.* There must not be any role or relationship between the state or local governmental unit and the Provider that would substantially limit the state or local governmental unit's ability to exercise its rights under the qualified management agreement, based on all facts and circumstances. This requirement is considered satisfied if (i) not more than 20% of the voting power of the governing body of the state or local governmental unit (the "Board") is vested in the Provider or its directors, officers, shareholders, partners or employees, (ii) the Board does not include the chief executive officers (CEO), chairperson, or equivalent of the Provider, and (iii) the CEO of the Provider is not the CEO of the state or local governmental unit or any such User's "related party".

Certain Exceptions. Certain arrangements generally are not treated as management contracts that are subject to the above rules. These include:

- Contracts for services that are solely incidental to the primary governmental function or functions of a bond-financed facility (*e.g.,* contracts for janitorial, office equipment repair, hospital billing or similar services);
- 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 its facilities;
- A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property (as defined in section 168(i)(10) of the 1986 Code), 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
- 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.

<u>Cooperative Research Agreements</u>. A cooperative research agreement with a private sponsor whereby the private party uses bond-financed facilities may cause a private business use problem. Nevertheless, such use of a bond-financed facility by a non-governmental person is to be disregarded for purposes of private business use if the arrangement is in one of the following forms. First, the arrangement may be disregarded if the sponsoring party is required to pay a competitive price for any license or other use of resulting technology, and such price must be determined at the time the technology is available. Second, an arrangement may also qualify if a four-part requirement is met: (1) multiple, unrelated industry sponsors must agree to fund university-

performed basic research; (2) the university must determine the research to be performed and the manner in which it is to be performed; (3) the university must have exclusive title to any patent or other product incidentally resulting from the basic research; and (4) sponsors must be limited to no more than a nonexclusive, royalty-free license to use the product of any such research.

How Much "Bad Use" is Too Much? In general, there is too much private business use if an amount in excess of 10 percent of the proceeds of the bond issue are used, directly or indirectly, in a trade or business carried on by persons other than governmental units, and other than as members of the general public. All trade or business use by persons on a basis different than that of the general public is aggregated for the 10 percent limit. In addition, if the private use is considered "unrelated or disproportionate" to the governmental purpose for issuance of the bonds, the private business use test is met if the level of the prohibited private use rises to five percent (5%) . The "unrelated" question turns on the operational relationship between the private use and use for the governmental purpose. In most cases, a related use facility must be located within or adjacent to the related governmental facility, e.g., a privately-operated school cafeteria would be related to the school in which it is located. Whereas, the use of a bond-financed facility as an administrative office building for a catering company that operates cafeterias for a school system would not be a related use of bond proceeds. Nonetheless, even if a use is related, it is disproportionate to the extent that bond proceeds used for the private use will exceed proceeds used for the related governmental use.

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