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May 2, 2012

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RE: Suggested Clarifications and Changes to Revenue Procedure 97-13

Dear Mr. Cross and Mr. Polfer:

The National Association of Bond Lawyers (*"NABL"*) respectfully submits the attached suggested clarifications and changes to the management contract safe harbors against private business use in Revenue Procedure 97-13. Revenue Procedure 97-13 provides both the general framework to evaluate whether a management contract gives rise to private business use for the purposes of the tax-exempt bond rules and several safe harbors. Increasingly, the safe harbors contained in Revenue Procedure 97-13 do not account for current business practices and do not provide the ability to properly incentivize service providers, making compliance with the safe harbors unnecessarily complex and costly. NABL's suggested clarifications and changes would provide issuers and borrowers with additional flexibility in structuring their management contracts, while still preserving the policy goals of Revenue Procedure 97-13. These comments were prepared by an ad hoc subcommittee of NABL's Tax Committee comprised of those individuals listed on Exhibit A, and were approved by the NABL Board of Directors.

NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the laws affecting public finance. A professional association incorporated in 1979, NABL has approximately 2,700 members and is headquartered in Washington, D.C.

If you have any questions concerning the comments, please feel free to contact Bill Daly, NABL's Director of Governmental Affairs at 202-503-3303 (or via e-mail at bdaly@nabl.org).

Thank you in advance for your consideration of these comments.

Sincerely,

Kristin H.R. Franceschi

NATIONAL ASSOCIATION OF BOND LAWYERS
Recommended Changes to the Management Contract
Safe Harbors Against Private Business Use

EXECUTIVE SUMMARY

The National Association of Bond Lawyers ("NABL") hereby submits its suggested clarifications and changes to the Management Contract safe harbors against Private Business Use in Revenue Procedure 97-13, 1997-1 C.B. 632, as amended by Revenue Procedure 2001-39, 2001-2 C.B. 38 (collectively, "Rev. Proc. 97-13").[1] Since its release, Rev. Proc. 97-13 has provided the general framework by which Qualified Users, their counsel and bond counsel evaluate Management Contracts for purposes of determining whether a Management Contract gives rise to Private Business Use. Increasingly, Qualified Users find that the formulaic safe harbors contained in Rev. Proc. 97-13 do not account for current business practices and do not provide Qualified Users with the ability to properly incentivize Service Providers, making compliance with the safe harbors unnecessarily complex and costly. NABL's suggested clarifications and changes would provide Qualified Users additional flexibility in structuring Management Contracts, while still limiting the rights afforded to, and benefits derived by, Service Providers.

NABL has divided its recommendations by topic. In some instances, the recommendation is simply a request for clarification of a concept currently contained in Rev. Proc. 97-13. For example, NABL seeks clarification that the definition of a "per-unit fee" in a separate billing arrangement between a hospital and a physician group is not subject to the requirement that the fee must be specified in the contract or otherwise determined by either an independent third party or the Qualified User.

NABL makes several other recommendations that, if accepted, would modify the structure (and number) of the safe harbors to provide additional flexibility for Qualified Users. In particular, the short-term safe harbors in Rev. Proc. 97-13 could be simplified to permit any compensation method not based on net profits to be used as part of a single three-year safe harbor. For example, a five-year management contract with compensation based on a capitation fee and a periodic fixed fee fits within the five-year safe harbor, and one with compensation based on a per-unit fee and a periodic fixed fee does not.[2] In our view, having to look to two different safe harbors for those contracts is unnecessarily complex. Similarly, more than two forms of compensation should be permitted under all of the short-term safe harbors, not just those meeting the 50% periodic fixed fee safe harbor.

[1] Unless otherwise indicated, capitalized terms used and not defined herein have the meanings given such terms in Rev. Proc. 97-13.

[2] This assumes that the capitation fee (in the first contract) and the per-unit fee (in the second contract) each constitutes greater than 50% of the compensation payable in any annual period.

Addressing the issues described in these comments would eliminate many of the difficulties faced by Qualified Users in structuring Management Contracts to comply with the safe harbors, thereby facilitating post-issuance compliance.

RECOMMENDATIONS

1. **Expand the list of examples of "incidental services" that are not considered Management Contracts beyond those currently listed in Rev. Proc. 97-13 and the Regulations.**

Section 1.141-3(b)(4)(iii)(A) of the Regulations (as restated by Subsection 2.01(7)(a) of Rev. Proc. 97-13) provides that contracts for services "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)" are not treated as Management Contracts and generally do not give rise to Private Business Use. The three parenthetical examples of incidental services are fairly limited, resulting in ambiguity regarding the characterization of many ancillary services provided to Qualified Users. Although the existing language does provide that incidental services include "similar services," practitioners currently struggle with distilling guiding principles from the stated examples, and are therefore generally reluctant to apply the "incidental services" exception beyond the examples.

Recommendation: Recognizing that defining incidental services in a meaningful way with objective criteria is difficult, particularly when what is incidental may vary based on the particular facility at issue; we recommend that additional specific examples of incidental services be added to the list of examples found in Rev. Proc. 97-13. These additional incidental services could include, but should not be limited to, building maintenance services, lawn and landscaping services, equipment and machinery repair services, billing services, security services, employee or patient laundry services, uniform services, patient or resident nutrition services, patient, student or resident transport services, valet parking services for patients and visitors, call center or help desk services, secretarial services, consulting services and purchasing services.[3]

2. **Combine the two-, three- and five-year Short-Term Safe Harbors into a single three-year safe harbor.**

Subsections 5.03(4), (5) and (6) of Rev. Proc. 97-13 provide safe harbors for Management Contracts with respective stated maximum terms of five, three and two years ("Short-Term Safe Harbors"), which allow for a variety of arrangements to provide compensation under the Management Contract depending on the length of the Management Contract. These arrangements, when read together, have the potential to be complicated and often confusing.

For example, in a five-year contract terminable after three years, compensation to the Service Provider based on a combination of a periodic fixed fee and capitation fee fits within a safe harbor, as does a contract with compensation payable to the Service Provider based on a periodic fixed fee and any other compensation method not based on a sharing of net profits so

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[3] *See, e.g.,* PLR 200501004.

long as the fixed component constitutes at least 50% of total compensation. In a three-year contract terminable after two years, a per-unit fee is permitted in combination with a periodic fixed fee. Capitation fees are not mentioned in this three-year safe harbor or in the two-year safe harbor but are permitted under the five-year safe harbor.

Qualified Users are negotiating an increasing number of Management Contracts pursuant to which more than one method of compensation is used, and these methods often cannot neatly be categorized under any of the existing compensation categories described in Rev. Proc. 97-13 (*i.e.,* each such compensation method is neither per-unit, percentage of revenue, percentage of expense, capitation nor fixed). For example, the methods may include incentives based on achievement of certain quality benchmarks or incentive payments based achievements on financial benchmarks that do not individually or in the aggregate give rise to a net profits interest, each of which is being encouraged by the Centers for Medicare & Medicaid Services in connection with federal healthcare reform. In some cases, multiple services are provided under a single contract, and the Qualified User is selecting the compensation method it deems most appropriate for each service. In other cases, the Qualified User is using a combination of compensation methods to achieve a lower overall cost or better quality of service. From the Qualified User's perspective, either of these more focused and sophisticated approaches aligns the amounts paid by the Qualified User more effectively with the services being provided. However, attempts by counsel and Qualified Users to force these complex business relationships into one of the current Short-Term Safe Harbors often results in fundamental changes to the business terms or the disaggregation of services from a single contract to multiple contracts in ways that make little economic sense. Not infrequently, the result of these efforts is increased service-related costs to the Qualified User with no resulting control by the Qualified User over the facility or higher performance levels by the vendor. In a very real sense, the changes required to bring the arrangement into compliance with Rev. Proc. 97-13 actually cut against the policy underpinnings of Rev. Proc. 97-13 by impairing the ability of Qualified Users to control their own assets and closely monitor and incentivize private vendors.

Incremental distinctions between the Short-Term Safe Harbors and a requirement that each component of compensation under a contract fit within one of the categories defined in Rev. Proc. 97-13 add levels of complexity to the Private Business Use analysis, inhibit the flexibility of the Qualified User to obtain a closer matching between the fee paid to the Service Provider and the service provided, and unnecessarily limit the ability of a Qualified User to achieve improvements in service. As described in Section 7 below, Qualified Users frequently include variable compensation payable based on the achievement of specified performance criteria as additional compensation in Management Contracts that are primarily per-unit-fee-based (*e.g.,* a contract between a university and a third party to manage the university's food service operations). Such arrangements do not satisfy any of the Short-Term Safe Harbors. Similarly, compensation arrangements using revenue- or expense-based fees that include a periodic fixed fee component technically fail the Short-Term Safe Harbor for start-up facilities; clearly the inclusion in an arrangement of a periodic fixed fee should not cause that.

<u>Recommendation</u>: Collapse the Short-Term Safe Harbors into a single safe harbor ("Modified Short-Term Safe Harbor") with a maximum term of three years utilizing any combination of compensation components that does not, individually or in the aggregate, give

rise to a net profits interest.[4] For the reasons described in Section 4, below, the Modified Short-Term Safe Harbor should not include a requirement that the Qualified User have the right to terminate the Management Contract without penalty or cause prior to the end of the permitted term.

3. **Clarify certain ambiguities in determining the term of a Management Contract.**

All of the safe harbors in Rev. Proc. 97-13 have stated limits on the term of the Management Contract. If a Management Contract does not have a stated term, or has a longer stated term than permitted under Rev. Proc. 97-13, but provides that the Qualified User may terminate the Management Contract without penalty or cause upon notice to the Service Provider of 180 days, the Management Contract arguably does not qualify for any of the Safe Harbors. We suggest that the term of a Management Contract be deemed to be the stated notice period (180 days in this example). This seems eminently justifiable since, under the terms of such a Management Contract, the Service Provider does not have any assurance that its services will be continued beyond the stated notice period.

Recommendation: The length of a Management Contract should be determined by the first date on which the Qualified User may terminate the Management Contract without penalty or cause.

4. **Eliminate the requirement that the Qualified User must have the right to terminate a Management Contract within the Short-Term Safe Harbors without penalty or cause.**

The Short-Term Safe Harbors each require that the Qualified User have the right to terminate the Management Contract without penalty or cause at the end of one, two or three years during the respective two-, three- and five-year permitted terms. Requiring the Qualified User to have this unfettered right to terminate effectively limits the term of the Management Contract to a one-, two- or three-year term and, from a practical standpoint in negotiating a Management Contract with a Service Provider, limits the benefit of the permitted longer stated terms in the Short-Term Safe Harbors. In evaluating the financial and other business aspects of a Management Contract, the Service Provider will only consider the economic arrangement to cover the period through the date on which the Qualified User has a unilateral right to terminate the Management Contract (and not the nominal stated term) as the Service Provider has no assurance that the Management Contract will continue beyond that date.

Recommendation: Eliminate the required termination right of the Qualified User at the end of the applicable one-, two- or three-year period in the Short-Term Safe Harbors.[5]

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[4] As described in Section 3, below, the permitted three-year term of the Modified Short-Term Safe Harbor would be measured against the first date on which the Qualified User retains the right to terminate the Management Contract. In addition, we suggest retaining the definition of "renewal option" described in Rev. Proc. 97-13.

[5] We recognize the interplay of this recommendation and the recommendation in Section 3 above. If the recommendation in Section 3 above is adopted, then the requirement of a particular safe harbor to have a specified

5. **Requirements for documenting per-unit fees in separate billing arrangements between physicians and hospitals should be clarified.**

The definition of "per-unit" fee in Rev. Proc. 97-13 provides that separate billing arrangements between physicians and hospitals are generally treated as per-unit fees. Practitioners question whether such separate billing arrangements are subject to the additional requirement in the first sentence of the definition of per-unit fee that the fee must be specified in the contract or otherwise determined by either an independent third party or the Qualified User. It is common for a hospital to contract with a physician group to provide services for which the group will bill the patients directly for professional fees, *i.e.,* a separate billing arrangement. Although physician groups often have a standard schedule of charges that could be attached to the Management Contract, that is not always the case. Moreover, even there such a schedule exists, the amount actually required to be paid to the physician by patients for a procedure or service varies widely depending on the agreement that the physician group has with the patient's commercial insurer, health maintenance organization or other payor or the amount paid by Medicare or Medicaid. The fee structure in commercial insurance contracts may be negotiated by the Service Provider with the insurer rather than specifically determined by the insurer, but it is, nevertheless, a per-unit fee or discount that seems to fit logically into this category without raising any concern about abuse.

Recommendation: Clarify the definition of "per-unit fee" to eliminate the fee schedule requirement for these arrangements or to include negotiated third-party schedules .

6. **If the concept of termination of a Management Contract by the Qualified User without penalty or cause, is retained, it should be clarified**

Each of the Short-Term Safe Harbors requires that the Qualified User have the right to terminate the Management Contract "without penalty or cause" after one, two or three years. Many issues arise in the interpretation of "without penalty or cause," all of which should be clarified if the concept of requiring early termination is retained.[6]

A. Repayment of Amounts Advanced Under the Management Contract. Example: An exempt university enters into a Management Contract with a Service Provider for a five-year term to manage the university's food service operations. The Management Contract satisfies the five-year Short-Term Safe Harbor. The Service Provider agrees to purchase from its own funds certain kitchen equipment and will amortize the cost of the equipment over a five-year period based on a schedule described in the Management Contract. The university may own the purchased equipment from the outset, or may obtain title to the equipment at the end of the five-year amortization period, and is required to repay the unamortized cost of the equipment if

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term would encompass the ability of the Qualified User and the Service Provider to use a termination right in lieu of a stated term. In this regard, see our discussion in Section 6 below, which addresses the elements needed to have a qualified termination right.

[6] We discuss the concept of using a contract's early termination date, without penalty or cause, in Section 3 above. We thus recognize that the discussion in this Section 6 bears on the use of an early termination date to define the term of a Management Contract.

the contract is terminated prior to the end of the five-year amortization period. The university has the option to terminate the Management Contract at the end of third year without cause but is required to repay the Service Provider the unamortized cost of the equipment at the time of the termination.

In most instances, accelerated repayment of what is, in effect, a loan does not impose a burden on the Qualified User. Subsection 3.04 of Rev. Proc. 97-13 provides that if a Management Contract contains terms that are not customary and arm's-length that could operate to prevent the Qualified User from terminating the Management Contract, then such terms constitutes a termination penalty. A specific example cited in Section 3.04 includes termination of a loan upon termination of the Management Contract. The requirement that the Qualified User repay the loan on an accelerated basis (or refinance the loan) is only one factor for the Qualified User to consider in deciding whether to terminate the Management Contract. Typically, the amount of the accelerated payment is relatively small compared to the value of the Management Contract and the overall budgets of the Qualified User, or, in some cases, the amount owed on termination can be funded with a similar upfront payment from the replacement food service vendor. In either case, there is little or no impact on the Qualified User's decision to terminate (or not terminate) the Management Contract.

Recommendation: Modify the language in Subsection 3.04 of Rev. Proc. 97-13 to provide that whether the accelerated repayment of a loan constitutes a contract termination penalty shall generally be based on the facts and circumstances, including the financial ability of the Qualified User to effect such accelerated repayment with minimal impact on its finances. In the case of an advance that converts to a loan upon early termination, we recommend modifying the language in Subsection 3.04 of Rev. Proc. 97-13 to provide that such conversion does not constitute a penalty if the interest rate on the loan is commercially reasonable as of the date the Management Contract was entered into.

B. Termination of Management Contract for Convenience of the Qualified User. State and local government units frequently have state law requirements or policies that result in the inclusion in a Management Contact of a provision that the Qualified User may terminate for the "convenience" of the Qualified User. These provisions are generally enacted or promulgated to assist Qualified Users in the event that, as a result of policy changes or budgetary issues, it elects to terminate services at a facility. In many respects these provisions are the contract equivalent of a subject-to-appropriation provision of a lease agreement or other contract. Determination of what constitutes "convenience" is determined under applicable state law principles rather than the terms of the Management Contract and is often within the sole discretion of the Qualified User and not subject to challenge by the Service Provider. Depending on applicable state law, however, upon a termination for convenience, the Qualified User may owe the Service Provider for accrued and unpaid fees and demobilization or other similar costs, and, in certain circumstances, be obligated to repay debt of the Service Provider incurred solely to perform its obligations under the Management Contract. It is our view that the obligation of the Qualified User to pay such costs if it elects a termination for convenience should not be viewed as a penalty as they arise under applicable state law principles designed to be protective of the Qualified User rather than under the terms of the Management Contract.

Recommendation: If the requirement that a Qualified User must be able to terminate a Management Contract without penalty or cause is retained in the Short-Term Safe Harbors,

clarify that a termination for "convenience" is a termination by the Qualified User without cause or penalty, notwithstanding any resulting payment required to be made by the Qualified User under applicable state law.

7. **Permit incentive compensation based on criteria other than financial performance in the Safe Harbors.**

Under Rev. Proc. 97-13, incentive compensation is expressly permitted only in extremely limited circumstances. To the extent that incentive compensation is specifically addressed in Rev. Proc. 97-13, it is permitted only in the context of the Service Provider's meeting revenue or expense targets (except to the extent included as part of the permitted variable component of compensation as described below). Qualified Users, however, increasingly attempt to include incentive compensation awards in Management Contracts in order to improve the level of service provided.

Example A: A city enters into a ten-year Management Contract with a Service Provider to manage the city's water utility system. The Service Provider is paid a periodic fixed fee and incentive payments based on meeting customer service and other performance measures (*e.g.*, response times to customer calls and service requests, customer satisfaction, timely meter reading, improved water quality, MBE/WBE hiring, workers' safety, system reliability and improved system maintenance), which performance measures and the respective incentive payment amounts are set forth in the Management Contract. For example, if 80% of customer calls during the measurement period are answered within one minute, 50% of the stated dollar amount of incentive compensation will be awarded, and if 90% of customer calls during the period are answered within one minute, 75% of the stated dollar amount will be awarded.

The 10-, 15- and 20-year period safe-harbors in Subsections 5.03(1), (2) and (3) of Rev. Proc. 97-13 (the "Long-Term Safe Harbors") only provide for a single fixed incentive payment during the term of the Management Contract. A single incentive payment over a long-term contract is not as effective in producing the desired behaviors by the Service Provider as the multiple performance criteria established by the city in Example A, above. Currently, multiple incentives in a long-term Management Contract must fit within the permitted variable component of the applicable Long-Term Safe Harbor (5% in the case of the 95% periodic fixed fee safe harbor and 20% in the case of the 80% periodic fixed fee safe harbor). Analyzing performance-based incentive compensation in a multiple-service contract to test compliance with the variable fee component is costly and should be unnecessary because these incentive payments are designed to improve the service provided to the Qualified User rather than pass through the benefits of tax-exempt financing to the Service Provider.

Example B: A hospital contracts with a physician group to provide services to patients under a separate billing arrangement, which is a per-unit fee arrangement. In addition, the Qualified User agrees to make additional incentive payments to the Service Provider for meeting set goals for clinical quality standards, patient service and patient access using measures set forth in the Management Contract. These measures include patient satisfaction survey responses, timely completion of charts, prevention of infection, timely administration of preventive measures and providing indigent care. A schedule of the stated dollar amounts awarded upon achieving the delineated benchmarks for each standard is set forth in the Management Contract. Another example that is likely to become increasingly prevalent in view of recent health care

reforms is the payment to the Service Provider of incentive compensation tied to the reduction in hospital readmissions. In this scenario, the Management Contract would not fit within either the Long-Term Safe Harbors or the Short-Term Safe Harbors, as the Qualified User is not permitted to pay even a limited amount of incentive compensation in a per-unit fee arrangement. Such contracts have become increasingly common.[7]

Recommendation: The language in Rev. Proc. 97-13 limiting incentive compensation should be modified to allow incentive compensation that is a stated dollar amount (including a sliding scale for progressive benchmarks) awarded for achieving quality or performance standards as an additional compensation method, without any need to limit the amount or frequency of such compensation. This modification is in line with policy considerations if the incentive payments are not based on revenue or expense measures but instead are crafted to enable Qualified Users to encourage Service Providers to provide more reliable and efficient service (*e.g.,* service to utility customers, improved patient care, a safer workplace, etc.).

8. **Clarify that certain types of compensation that include both revenue and expense measures are not considered as based on net profits.**

Rev. Proc. 97-13 and Section 1.141-3(b)(4)(i) of the Regulations both provide that compensation based in whole or in part on net profits results in Private Business Use. One of the key factors in determining whether Private Business Use occurs is whether the benefits and burdens of ownership of the bond-financed facility, and thus the benefits of the tax-exempt financing, have shifted from the Qualified User to the Service Provider. While it is reasonable to consider compensation based on net profits (or the excess of revenues over expenses) of the bond-financed facility as shifting the benefits of the tax-exempt financing to the Service Provider, not every contract that has compensation containing both revenue and expense measures should be treated as being based on net profits.

Example: A city enters into a ten-year Management Contract with a Service Provider to manage the city's water utility system. The Service Provider is paid the following: (i) a periodic fixed fee, (ii) a stated dollar amount for achieving an increase of more than a stated percentage in adjusted gross revenues over the prior year, and (iii) a stated dollar amount for reducing the cost of electricity and other utilities over the prior year. The incentive payment described in clause (ii) relates to revenues, and the incentive payment described in clause (iii) relates to expenses, raising the question of whether the compensation paid to the Service Provider would be treated as being based on net profits. The costs in (iii) do not represent all of the operating costs of the system; thus, the Service Provider is not bearing the burdens of the bond-financed facility.

Recommendation: Modify the language in Subsection 5.02(2) of Rev. Proc. 97-13 to provide that (1) a Management Contract may contain separate elements of incentive compensation for meeting separate performance targets, some of which are targets for increasing gross revenues (or adjusted gross revenues) of a facility or system, and others of which are targets for reducing gross expenses (or adjusted gross expenses) of a facility or system, without being treated as including a compensation arrangement that is a net profit arrangement, as long

[7] *See, e.g.,* PLR 200926005.

as each element of incentive compensation is a stated dollar amount or a sliding scale of stated amounts; and (2) a Management Contract containing incentive compensation methods, some of which provide for incentive compensation in the form of paying the Service Provider a portion of the increased gross revenues or adjusted gross revenues above a revenue target, and others of which provide for incentive compensation by paying the Service Provider a portion of reduced gross expenses (or adjusted gross expenses) of a facility or system, will not be treated as a net profits arrangement as long as the total compensation derived from such incentives over a period is not greater than a stated percentage of the net revenue derived from the facility over such period (with the use of perhaps a 10 percent threshold for this purpose).

9. **Assuming the Modified Short-Term Safe Harbor is not adopted, the percentage of revenue or expense Short-Term Safe Harbor should be available for a broader range of Management Contracts.**

Subsection 5.03(6) of Rev. Proc. 97-13 expressly limits the use of the percentage of revenue or expense safe harbor to Management Contracts during an initial start-up period and Management Contracts in which the Service Provider renders services to third parties. The flexibility under this Short-Term Safe Harbor afforded a Qualified User during "an initial start-up period during which there have been insufficient operations to establish reasonable estimates of the amount of gross revenues and expenses" would be extremely useful in a variety of situations beyond the start-up period. Qualified Users often find it difficult to establish "reasonable estimates of the amount of gross revenues and expenses" of a bond-financed facility not only during the start-up period but also during other times of uncertainty. Moreover, many practitioners have been unclear on the policy underlying the limited application of the Short-Term Safe Harbor to start-up and third-party situations.

Example: A city undergoing significant population growth enters into a Management Contract with a one-year term for the management of its electric utility, with compensation based on a percentage of revenue. The city chooses this option because of the uncertain volume of service to be provided in the near future. Under Rev. Proc. 97-13, the Short-Term Safe Harbor based on percentage of revenue is not available to the city because the utility is not in a start-up period.

Recommendation: Modify the language in Section 5.06 of Rev. Proc. to eliminate the language limiting the application of this safe harbor to an initial start-up period.

10. **Clarify that the payment of certain costs constitute reimbursement of actual and direct expenses paid by the Service Provider to unrelated parties.**

A. Reimbursement of Employee Costs. Section 1.141-3(b)(4)(iii)(D) of the Regulations and Subsection 2.01(7)(d) of Rev. Proc. 97-13 state that a service contract the sole compensation for which includes the reimbursement of actual and direct expenses of the Service Provider paid to unrelated parties will not constitute a Management Contract. Subsection 5.02(1) of Rev Proc. 97-13 also provides that reimbursement of actual and direct expenses paid by the Service Provider to unrelated parties is not compensation. In both the governmental and 501(c)(3) sectors, it is commonplace for the Service Provider to be reimbursed for the cost of its employees rendering services to the Qualified User, because such variable staffing is generally less expensive for the Qualified User. Although employees generally are not considered related

persons with respect to their employer under Section 1.150-1(b) of the Regulations, uncertainty exists regarding application of Rev. Proc. 97-13 in this context.[8] If reimbursement of payments to employees is treated as compensation, certain contracts would be difficult to structure within any of the safe harbors, resulting in Qualified Users potentially paying higher compensation to the Service Providers due to a forced restructuring of the financial arrangements to provide for fixed staffing levels.

Recommendation: Modify the language in Subsection 5.02(1) of Rev. Proc. 97-13 to provide that the reimbursement of actual and direct expenses for the Service Provider's employees shall not constitute compensation to the Service Provider if the relevant employees are providing services to the Qualified User.

B. Estimate of Employee Benefit Costs. In many Management Contracts, the Service Provider is reimbursed for both the salaries and the benefits of the employees working under the Management Contract. Although the cost of employee benefits (health insurance, retirement benefits, taxes, unemployment benefits, paid time off, etc.) for each employee varies depending on the employee's individual circumstances, such costs are actual and direct costs of providing the employee under the contract and not administrative overhead. It is often impractical to track each employee, and direct costs in this context often are not immediately determinable. Accordingly, we suggest that a pass-through charge, expressed as either a percentage or a stated dollar amount, of a reasonable estimate of the actual and direct cost of providing the employee benefits be treated as actual and direct costs paid by the Service Provider to unrelated parties.

Recommendation: Amend the language in Section 5.02(1) of Rev. Proc. 97-13 to provide that a benefits charge, expressed as either a percentage or a stated dollar amount, that is a reasonable estimate of the actual and direct cost of providing employee benefits for employees rendering services to the Qualified User under a Management Contract will be treated as actual and direct costs paid by the Service Provider to unrelated parties.

C. Mark-Up Charge for Reimbursable Expenses. Section 1.141-3(b)(4)(iii)(D) of the Regulations and Subsection 2.01(7)(c) of Rev. Proc. 97-13 provide that a contract relating to public utility property that provides for the reimbursement of actual and direct expenses of the Service Provider and reasonable administrative overhead expenses will not be a Management Contract. In a typical arrangement for an electric generation facility, a governmental electric utility has a tenancy in common ownership interest in the facility with other electric utilities, which may be public power providers and investor-owned utilities. One of the participating utilities, often the investor owned utility, typically operates the entire facility under a long-term operating agreement among the owners. The operating utility passes through the actual cost of fuel and other supplies needed to operate the facility to each of the owners, and adds a de minimis percentage mark-up to such cost estimated to recover the cost of processing purchases. In this example, the bond-financed facility is public utility property so that the mark up can be analyzed as administrative overhead of the Service Provider, which is a permitted reimbursement item under the existing rules. In comparison, in a non-utility context, contractual

[8] *See, e.g.,* PLR 200222006 and PLR 201145005.

provisions for a reasonable mark-up to process purchases of supplies is common in Management Contracts with respect to health care facilities and other bond-financed facilities that are not public utilities. Reimbursement of administrative overhead is not permitted for these types of bond-financed property.

Recommendation: Add language to the provision found in Subsection 5.02(1) of Rev. Proc. 97-13 providing that, if the amount of a mark-up charge from a Service Provider is a reasonable estimate of its costs to process a reimbursable purchase, such mark-up will be treated as an actual and direct expense that also may be reimbursed.

11. **Eliminate the useful life test for Long-Term Safe Harbors.**

The Long-Term Safe Harbors limit the permitted term of a Management Contract to 80% of the reasonably expected useful life of the bond-financed property, if the otherwise permissible term would exceed this limit. While reasonable on its face, this requirement can be difficult to apply.

Example: A state builds a new prison facility with an economic life of 30 years and enters into a Management Contract under the Long-Term Safe Harbor with a 15-year term. In this case, the 80% of reasonably expected useful life limit is easily satisfied at the outset. Twenty years later, a new Management Contract under the Long-Term Safe Harbor would be limited to eight years if the rule requires that the original useful life expectation be used for this measurement. If the reasonable expectation of useful life is not permitted to be adjusted at the time of the subsequent contracts, then the term of the Long-Term Safe Harbor contracts would be considerably shortened even if, as in many cases, the reasonably expected remaining useful life of the bond-financed facility at the later time is longer than reasonably expected on the date of issuance. Another issue in applying this requirement is whether the reasonably expected useful life of the bond-financed property is measured by reference to the bond-financed property as initially constructed or acquired. If subsequent additions and improvements to the bond-financed property extend the useful life of the bond-financed property, it is unclear whether the reasonably expected useful life of the bond-financed property would be extended for purpose of this limitation. Many Management Contracts are for management of an entire facility or system (*e.g.,* an urban wastewater system) that may have been constructed and improved over a long period of time and funded from a variety of sources. If the bond-financed property consists of shorter-lived assets (such as equipment or technology) being used to equip a building funded from other sources, the term of the Long-Term Safe Harbor would be limited by the short life of the bond-financed property. Further, it is unclear, if a series of bond issues has been used to finance portions of the facility over time, whether the limitation must be applied to each bond-financed asset separately, with the term for this purpose governed by the shortest useful life for any bond-financed asset, or whether a weighted average useful life of all bond-financed property may be used.

Recommendation: The foregoing examples illustrate the difficulty of analyzing the reasonably expected useful life limitation. Although some of this lack of clarity could be eliminated by specifying, for example, that adjustment to the expectations of useful life of a bond-financed facility are permitted and that weighted average useful life calculations could be utilized, we recommend eliminating the useful life limitations from the Long-Term Safe Harbors.

12. **Clarify that services provided prior to commencement of operations do not constitute a Management Contract.**

Although it is clear that a contract for services provided exclusively during the construction of a bond-financed facility should not be required to be analyzed under the safe harbors as a Management Contract, it is not as clear how to analyze the relatively common situation in which the Service Provider during the construction phase also will provide management services after the facility is in operation. In most cases, the contract or contracts for both aspects of such services is or are entered into at the outset of the development of the project.

Example A: A city engages a private contractor under a design, build and operate agreement for a city jail. The agreement is entered into prior to commencement of construction and separately states the compensation for the design/build component and for the operational component that follows completion of the facility. The compensation for the management and operational component following completion of the facility is a combination of a periodic fixed fee and a variable fee based on performance measures, with the variable portion capped at 20% of the annual compensation. The operational component has a ten-year term that begins on the date of commencement of operations. If the operational component of the contract were analyzed on a stand-alone basis, the Management Contract would satisfy a Long-Term Safe Harbor. If the term were required to be measured from the date the agreement was entered into, the term would be too long to satisfy a Long-Term Safe Harbor.

Example B: A tax-exempt organization that owns and operates a number of continuing care retirement communities decides to build a new continuing care retirement community in a neighboring state. This Qualified User enters into two contracts with a for-profit company to provide both development and management services, respectively, for the proposed facility. Both contracts are executed at the beginning of the development period. Under the development agreement during the development phase, the company will provide consulting services related to construction, financing, marketing, operational issues, programming of services and hiring and training staff. If the development agreement were required to be analyzed as a Management Contract (which it should not be, since the development phase of the Management Contract occurs prior to the placed-in-service date of the bond-financed facility[9]), the term of the development agreement causes a problem in satisfying any of the Safe Harbors because the contract term for the development agreement ends when the project is ready for occupancy and not on a specified date. Under the contract for management following the opening of the bond-financed facility, the Service Provider receives a periodic fixed fee and a variable fee, which is based on occupancy and is limited to fifty percent of annual compensation over the term of the Management Contract. The term of agreement begins on the date the bond-financed facility is placed in service and runs for three years after that date. If the term is required to be measured from the date of the development agreement, the term would be too long to satisfy the Safe Harbor.

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[9] *See* Treas. Reg. § 1.141-3(g)(2)(1) (measurement period for private business use purposes begins on the later of the issue date of the issue financing the project or the placed-in-service date of the financed project). See also Section 14, below, suggesting that Management Contracts with multiple service lines should be analyzed as separate agreements.

Recommendation: To the extent a contract addresses services provided in connection with the acquisition, construction, and development of a bond-financed facility, such portion of a contract should not be treated as a Management Contract. Further; the term of any Management Contract for services upon the commencement of operations should be measured from the commencement of operations regardless of whether the Service Provider provides development services under a single contract that includes an operational component or under a separate contract for development.[10]

13. **Clarify that a Management Contract covering multiple service lines and multiple Management Contracts with the same Service Provider covering multiple service lines may be analyzed separately.**

Ambiguities arise under Rev. Proc. 97-13 when (1) a Service Provider provides multiple service lines to a Qualified User under a single Management Contract for the same bond-financed facility, and (2) a Service Provider operates different service lines under multiple Management Contracts.

Example A: A university contracts with a Service Provider for both cafeteria management services and campus-wide janitorial services. Under Rev. Proc. 97-13, janitorial services alone would qualify as incidental, whereas cafeteria management services may not. It is unclear whether the incidental service may be disregarded for purposes of analyzing compliance with one of the Safe Harbors. As long as the compensation for each of the service lines is separately determined and the termination with respect to one of the service lines does not impact the other or result in termination of, or other changes to, the other contract, we suggest that the incidental service should be disregarded and only the non-incidental services be required to meet a Safe Harbor.

Example B: A governmental or 501(c)(3) hospital contracts with a physician group for the provision of administrative and management services, with compensation based upon a period fixed fee and a variable incentive based upon achieving certain quality measures. The physician group also has a separate contract with a third-party insurer under which the group provides patient care pursuant to a separate billing arrangement. Analyzed separately, each of these contracts could satisfy a Short-Term Safe Harbor. However, if the contracts are required to be analyzed as a single contract, the combined contract would not satisfy a Short-Term Safe Harbor, as a per-unit fee cannot be combined with a variable component under the Short-Term Safe Harbors.

Recommendation: Modify the language in Rev. Proc. 97-13 to provide that, if multiple-service lines are addressed in one or more Management Contracts, (1) each incidental service line will not be treated as a Management Contract and need not be evaluated so long as compensation for each service is separately determined and the Qualified User may separately terminate each such service pursuant to the terms of the Management Contract(s), and (2) each non-incidental service line may be analyzed separately so long as the compensation for each

[10] *See, e.g.,* PLR 200222006.

service is separately determined and the Qualified User may separately terminate each such service pursuant to the applicable Management Contract(s).

14. **Clarify that "circumstances substantially limiting the exercise of rights" do not include controlled subsidiaries of the Qualified User.**

Subsection 5.04(2) of Rev. Proc. 97-13 provides a safe harbor for applying the limitation that the Service Provider must not have a role or relationship with the Qualified User that substantially limits its ability to exercise its rights under the Management Contract under all the facts and circumstances. While generally helpful, this safe harbor creates an issue for exempt entities that contract with nonexempt wholly-owned or controlled entities. For example, assume an exempt hospital contracts with a taxable corporation to provide anesthesia services under a contract that meets a Short-Term Safe Harbor. The hospital is the sole corporate member, and appoints a majority of the board of directors, of the taxable corporation. Even if the boards are structured such that the 20% of voting power and overlapping executive officer limitations of the safe harbor are satisfied, the hospital and the taxable corporation are related parties under Section 1.150-1(b) of the Regulations. Thus, the relationship between the hospital and the taxable corporation may be an impermissible relationship under the Safe Harbors. The fact that the entities in this case are related parties should not result in a conclusion that the Qualified User is not in a position to exercise its rights under the contract.

Recommendation: Clarify in Subsection 5.04(2) of Rev. Proc. 97-13 that when the Service Provider is controlled by the Qualified User, the fact that they are related parties should not be interpreted as a circumstance substantially limiting the exercise of the rights of the Qualified User.[11]

15. **Permit adjustments to the periodic fixed fee based on measurable factors not within control of the Service Provider or the Qualified User**

The definition of "periodic fixed fee" under Rev. Proc. 97-13 provides that the fee may automatically increase by a specified objective external standard that is not linked to the output or efficiency of the bond-financed facility. Objective external indices that track fluctuations in prices, revenues or cost in an area or an industry, such as the Consumer Price Index, are often used in Management Contracts to automatically increase or decrease a periodic fixed fee over the term of the contract. The following examples illustrate why adjustments to a periodic fixed fee based on measurable factors relating to the bond-financed facility that are not within the control of the Qualified User or the Service Provider should be expressly permitted.

Example A: A city contracts with a Service Provider to operate the city's solid waste collection and disposal operations under a ten-year agreement. The city pays the Service Provider a periodic fixed fee and a per-unit fee for amounts over a stated minimum tonnage of solid waste processed. The per-unit fee is limited to 20% of the annual compensation in order to meet a Long-Term Safe Harbor. The periodic fixed fee, however, is adjusted annually based on the percentage by which the tonnage processed increased or decreased in the prior year. Neither

[11] *See, e.g.,* PLR 200123057 and PLR 200651012.

the Service Provider nor the Qualified User can control the tonnage, because the city is required to dispose of all solid waste in the district.

Example B: In a separate Management Contract for its water utility, the city provides a similar adjustment to the periodic fixed fee based on the increases or decreases in the customer base within the service area. Neither the city nor the Service Provider has control over how many customers the water utility will serve from year to year, because the utility is required to serve all customers in its service area.

In these examples, the annual adjustment is based on changes in the demand for the required services, which changes are not within the control of the Service Provider or the city. As such, the adjustment factor cannot practically be manipulated by either party. In addition, the adjustment may be viewed as not linked to the "output" or efficiency of the bond-financed property or based on the net profits of the bond-financed property.

Recommendation: Modify Subsection 3.05 of Rev. Proc. 97-13 to permit the adjustment of a periodic fixed fee by a stated formula based on measurable factors that are not within the control of the Service Provider or Qualified User so long as they are not based on the net profits or the output or efficiency of the bond-financed facility.[12]

[12] *See, e.g.,* PLR 200813016.

EXHIBIT A

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