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VIA EMAIL

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RE: Comments to Safe Harbor Conditions set forth in Revenue Procedure 2016-44

Dear Mr. Cross and Ms. Tsilas:

The National Association of Bond Lawyers ("NABL") respectfully submits the attached comments for revisions to the safe harbor conditions set forth in Revenue Procedure 2016-44.

NABL appreciates the efforts of the Treasury Department to provide a more flexible and less formulaic approach toward variable compensation for longer-term management and service contracts. NABL is concerned, however, that certain aspects of the safe harbors could cause confusion among issuers, borrowers, their counsel, and Internal Revenue Service examiners and would limit the usefulness of the safe harbors, particularly with respect to shorter-term contracts. NABL respectfully requests that Rev. Proc. 2016-44 be revised to address these concerns.

The safe harbors for management and service contracts are relied upon by a large number of issuers, including issuers financing critical projects for public infrastructure, utility services, healthcare delivery, and higher education, and involving many bond issues each year. For example, in the healthcare arena, according to *Statistics of Income* published by the Internal Revenue Service in 2014, the most recent year for which data are available, there were a total of 544 issues (both governmental and 501(c)(3)) identified on Forms 8038-G or 8038 for hospitals and other health facilities in the aggregate amount of $21.756 billion.

Of those, 336 were new money issues aggregating $7.905 billion. During the same year, according to *Statistics of Income,* 1,117 new money governmental issues were issued for transportation infrastructure projects, totaling $28.233 billion.

The enclosed comments were prepared by a working group comprising those individuals listed in the appendix hereto 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 law affecting public finance. We provide this submission in furtherance of that mission.

If NABL can provide further assistance, please do not hesitate to call Bill Daly in our Washington, D.C. office at (202) 503-3303.

Thank you for your consideration of these comments.

Sincerely,

Clifford M. Gerber

Enclosure

NATIONAL ASSOCIATION OF BOND LAWYERS
COMMENTS TO SAFE HARBOR CONDITIONS SET FORTH IN
REVENUE PROCEDURE 2016-44

The National Association of Bond Lawyers ("NABL") appreciates the efforts by the Treasury Department to provide safe harbor guidance in Rev. Proc. 2016-44[1] (the "Revenue Procedure") to update and replace the guidance contained in Rev. Proc. 97-13.[2] Rev. Proc. 97-13 provided safe harbors to determine whether a management or service contract results in private business use under Sections 141 or 145 of the Internal Revenue Code of 1986, as amended (the "Code"). Issuers, borrowers, and their counsel have applied the safe harbors to nearly every management and service contract that relates to the management by third parties of tax-exempt-bond-financed property. For that reason, the safe harbors annually affect many thousands of tax-exempt bond transactions, amounting to billions of dollars of debt. Rev. Proc. 97-13 particularly affects governmental and nonprofit healthcare providers and public transportation infrastructure projects.

We believe the flexible, principles-based approach of the Revenue Procedure will assist issuers and borrowers in structuring agreements that meet current business practices and needs and should accommodate public-private partnership financing structures that have become important tools to improving the nation's infrastructure. We are concerned, however, that there are certain interpretive gaps that could significantly compromise the usefulness of the Revenue Procedure and may lead to inconsistent application by Internal Revenue Service examiners of the private business use rules to management and service contracts. Clarification and guidance on the matters set forth below should assist with alleviating these concerns and will also assist in educating and training Internal Revenue Service examiners concerning the appropriate interpretation of the Revenue Procedure.

1. No Intent to Change Prior Law; Revenue Procedure is a Safe Harbor

The Revenue Procedure modifies and effectively supersedes Rev. Proc. 97-13 (other than provisions related to accountable care organizations). As stated in the first paragraph of the Revenue Procedure, it is intended as a safe harbor. If a management or service contract does not meet the specific safe harbor conditions in Section 5 of the Revenue Procedure, the contract is to be analyzed for private business use based on all the facts and circumstances. Although the Revenue Procedure is intended to function as a safe harbor within broader substantive law for determining private business use, we are concerned that Internal Revenue Service examiners will, as they have with Rev. Proc. 97-13, assert that a management contract creates private business use merely because the contract falls outside of the safe harbor conditions of the Revenue Procedure. This risk substantially impairs the intended flexibility and broad principles underlying the Revenue Procedure. For that reason, we believe an express statement by the

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[1] 2016-36 I.R.B. 316 (Sept. 1, 2016).

[2] References herein to Rev. Proc. 97-13 mean Rev. Proc. 97-13, 1997-1 C.B. 632, as amended by Rev. Proc. 2001-39, 2001-2 C.B. 38, and as amplified by I.R.S. Notice 2014-67, 2014-46 I.R.B. 822 (Nov. 10, 2014).

Treasury Department is needed to communicate that the Revenue Procedure does not alter the interpretations, policies, and concepts that were addressed by Rev. Proc. 97-13 and other interpretations of substantive law and that failure to adhere to the safe harbor conditions of the Revenue Procedure should not be read to automatically constitute private business use.

2. Capitation Fees, Periodic Fixed Fees, Per-Unit Fees, and Percentages of Revenues or Expenses

Under Rev. Proc. 97-13, certain specified compensation arrangements with a service provider were not treated as compensation based, in whole or in part, on a share of net profits from the operation of a managed facility. The less formulaic approach to compensation under the Revenue Procedure creates uncertainty as to whether such compensation arrangements continue to benefit from a safe harbor against private business use. For that reason, we believe that three clarifying statements are needed, two general and one industry-specific.

First, we recommend that there be a statement that compensation in the form of (i) a periodic fixed fee, (ii) a capitation fee, (iii) a per-unit fee, (iv) a permitted productivity award, or (v) a percentage of gross revenues (or adjusted gross revenues) or expenses, or a combination of these five types of compensation, will not be considered to be based on a share of net profits regardless of whether the expenses incurred by the service provider in managing the managed property or otherwise providing its services, such as salaries or supplies, to the qualified user ("internal expenses") are reimbursed to the service provider.

Second, we recommend that there be a statement that compensation in the form of (i) a periodic fixed fee, (ii) a capitation fee, (iii) a per-unit fee, or (iv) a permitted productivity award, or a combination of these four types of compensation, will not be considered to be based on a share of net profits regardless of the scope of the operating expenses borne by the service provider. Such scope is not limited to internal expenses. Thus, for example, the qualified user and the service provider may agree that the service provider will bear a portion of the managed property's utility expenses, supply expenses, maintenance expenses, and insurance expenses without causing the arrangement to be considered to be based on a share of net profits so long as the compensation to the service provider is limited to the four types of compensation set forth in the preceding sentence.

Third, consistent with the notion of not altering current law with respect to physician and physician group contracts, we recommend that there be a statement that separate billing arrangements by physicians and physician groups be treated as per-unit arrangements irrespective of whether the physician's or physician group's professional fees are set or reviewed by the qualified user, set forth in the contract, or determined by an independent third party.

In addition to the above three clarifying statements, we recommend that the IRS modify the Revenue Procedure to include a statement that the treatment of a fee as a periodic fixed fee, a capitation fee, a per-unit fee, or a permitted productivity reward, or a combination of these four types of compensation, is unaffected where the service provider bears certain capital costs of the facility it manages or of equipment therein. Thus, for example, a requirement that the qualified user compensate the service provider for the undepreciated cost of an asset installed by the service provider at the managed property should the qualified user cancel the contract prior to its

stated term would not alter the characterization of the compensation to the service provider and, subject to satisfying one or both of our two non-industry specific recommendations above with respect to the bearing of expenses, would not be treated as giving rise to a share of net profits or losses.

3. Approval of Rates Charged

Section 5.04 of the Revenue Procedure sets forth elements of control that the qualified user must exercise over the use of the managed property. One element of control is the right of the qualified user to approve the rates charged for the use of the managed property by either (1) expressly approving such rates (or the methodology for setting such rates) or (2) 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. We understand the underlying reason for imposing a rate control test but believe that additional guidance is critical to avoid inconsistent application.

We believe that the approval or rates test should be met if (i) the arrangement requires that rates not exceed rates that are consistent with reasonable and customary market rates or are rates negotiated at arm's-length with unrelated parties, such as third-party insurers, and (ii) the qualified user has the right to review the rates set by the service provider. The qualified user's approval of reasonable and customary market rates ensures that the qualified user maintains sufficient oversight and control.

4. Economic Life Determinations for Setting Maximum Contract Term

Section 5.03 of the Revenue Procedure permits a maximum contract term of the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. Economic life for this purpose is to be determined as of the beginning of the term of the contract or, for a contract that is materially modified, as of the date of the material modification. Land is not to be included in the calculation of economic life.

To avoid uncertainty, we ask that a clarifying statement be added to Section 5.03 to confirm that the determination of economic life may be made based on facts and circumstances existing at the time of determination. We believe this is the intent of the safe harbor. For example, a determination that the economic life of the managed property is longer than previously anticipated or that renovations and other improvements have extended the life of the managed property should be acceptable for purposes of the safe harbor if supported by facts and circumstances at the time of determination.

Importantly, we also request that Section 5.03 be clarified to state that the economic life of the managed property is to be determined on a weighted average basis irrespective of the source of financing. We believe that such approach more appropriately reflects the scope of the assets and facilities managed by the service provider under the contract. The contract has a direct relationship to the property being managed but usually makes no distinction among the sources of financing for the managed property. Limiting the managed property to bond-financed property for economic life determination for purposes of determining the maximum term of management contract could impair the ability of a qualified user to enter into certain longer-term

arrangements, even when the managed property has an average economic life that would support a longer contractual term. A classic example would be a situation in which the term of the contract complies with Section 5.03 for one issue of bonds (*e.g.,* because the issue finances building renovations that are part of the managed property) but not for another issue of bonds (*e.g.,* because such other issue finances equipment that is part of the managed property).

With respect to the treatment of land under the Revenue Procedure, we are seriously concerned that Section 5.03 excludes land from the calculation of economic life. Management contracts frequently relate to the management of land, meaning that the scope of the managed property will often include land (as well as the improvements thereon), irrespective of the source of financing (per our discussion above). If Section 5.03 were to remain unchanged, such management contracts could fail the maximum terms for the safe harbor condition of the Revenue Procedure. We believe there is no policy reason for this result, considering the principles-based approach of the Revenue Procedure. For that reason, we recommend that, for purposes of Section 5.03, land be treated in all instances as property having an economic life of 30 years.

5. Economic Life Determinations for Short-Term Contracts

We are concerned that the 80 percent economic life test in Section 5.03 of the Revenue Procedure in certain cases may impose a significant burden when the proposed management contract is a short-term contract. Rev. Proc. 97-13 permits contracts with terms of up to five years without regard to the economic life of the managed property that do not provide for the sharing of profits. By contrast, under the Revenue Procedure, no safe harbor management contract would effectively be permitted for the last year without requiring the qualified user and the service provider to enter into multiple management contracts during the last year, each one limited to 80 percent of remaining economic life at the time of the contract (*e.g.*, 9.6 months (80 percent of one year), then 80 percent of the remaining 2.4 months, then an even shorter period). This result poses significant practical and administrative difficulties that are unwarranted given the principles underlying the Revenue Procedure. The longstanding principle that any possible proprietary interest of a service provider in bond-financed property is sufficiently balanced by the short-term nature of the contract, which principle we believe was taken into account in Rev. Proc. 97-13 and previous authority, should continue to apply. For that reason, and consistent with the notion of not altering prior law with respect to short-term contracts, we request that Section 5.03 be revised to exclude contracts with terms of five years or less from the requirement that the contract term not exceed 80 percent of the expected economic life of the managed property.

6. Timing of Compensation

Section 5.02(2) of the Revenue Procedure states, among other things, that the timing of compensation may not take into account or be contingent upon either the managed property's net profits or both the managed property's revenues and expenses for any fiscal period. Section 5.02(3)(a)(ii) suggests that a contract imposes upon the service provider the burden of bearing a share of net losses from the operation of the managed property where the timing of the payment of compensation is contingent on the managed property's net losses. These two references to the timing of compensation cast uncertainty over the use of certain deferred compensation provisions

that we believe do not violate the tenets of the Revenue Procedure. We request that both sections be clarified to provide that a deferral of compensation will not itself cause an arrangement to constitute a net profits arrangement or cause a service provider to bear net losses if, at the time the contract is made, (i) the contract provides that any deferral is subject to an interest charge or other penalty and (ii) all compensation, including any accrued interest, is projected to be paid prior to the end of the contract term.

EXHIBIT A

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