

TAX HOT TOPICS

Chair:

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Panelists:

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This panel will discuss current federal tax issues, including any recently released notices, rulings, regulations and/or other guidance. In order to address any late-breaking topics, the specific topics are subject to change. However, the panel expects to address the recent hotel management private letter contract ruling with the insights of someone who worked on the ruling request. Final topics that will be addressed will be communicated to attendees via NABL Connect prior to The Workshop.

1. Legislative Updates

a. Inflation Reduction Act of 2022 updates

b. Advance refunding proposals

2. IRS and Treasury Updates

a. Recent PLRs

b. Priority Guidance Plan Relating to Tax-Exempt Bonds

- i. Final regulations relating to the definition of registered form under §§149(a) and 163(f). Proposed regulations were published on September 19, 2017.
- ii. Regulations under §1001 on the modification of debt instruments, including issues relating to disregarded entities.

3. Revenue Procedure 2017-13

- a. Section 5.02(2) of the revenue procedure provides that a management contract must not provide a share of the net profits from the operation of the managed property to the service provider. It then goes on to say “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 (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties) 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.” “Unrelated parties” are defined in Section 4.09 as “persons other than either (1) a related party (as defined in §1.150-1(b)) to the service provider or (2) a service provider’s employee.”
- b. There appears to be a significant disagreement in the bond counsel community regarding what the parenthetical in Section 5.02(2) means. Section 5.02(1) states that compensation includes payment to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider. In addition, Section 4.09 states that the employees of the Service Provider are now considered unrelated parties to the service provider. Accordingly, does the parenthetical in section 5.02(2) mean that a percentage of gross revenues contract may not provide for the reimbursements of employee salaries? If not, under what circumstances would a reimbursement avoid resulting in the overall compensation being treated as based on a share of net profits?
- c. Hypothetical: A hotel contracts with the management company to manage the hotel facilities. All employees are employees of the management company. The contract provides for the management company to be paid a percentage of gross revenues and to be reimbursed for the costs of employees working at the facility. Does this contract result

in compensation based on a share of net profits? Do we have enough information to answer that question? What additional information is needed?

- d. With respect to employee compensation that is reimbursed by an issuer, in PLR 202229002 the issuer reimburses the service provider for operating expenses with respect to the hotel operation including service provider's employee costs, such as employee salaries, fringe benefits, incentive compensation, bonuses, employee performance and service awards from the gross revenue of the hotel operation.

Incentive compensation and bonuses to senior management employees of service provider are evaluated based on formulas used to measure the performance of the hotel by factors such as the hotel's financial performance, guest experience, and individual goals. Incentive compensation and bonuses to a senior management employee are payable on a yearly basis as a percentage of the respective employee's salary subject to the service provider's discretion.

- e. The IRS states that because the compensation to the service provider includes the reimbursement of employee costs of the service provider, the terms of the agreement do not meet the safe harbor conditions set forth in Section 5.02(2) of Rev. Proc. 2017-13, such that a facts and circumstances test must be used to determine if the agreement will result in the service provider's private business use of the hotel.

The PLR then goes on to state that incentive compensation and performance bonuses to senior management employees of the service provider are determined based on formulas used to measure the performance of the hotel, using factors such as the financial performance of the hotel, guest experience, and individual goals, and are payable as a percentage of the employees' respective salaries, the timing and amount of which are not contingent upon the net profits from the hotel operation.

- f. Given that these employee salaries are based at least in part upon the financial performance of the hotel, is it possible to determine what factors led the IRS to getting comfortable that the reimbursement of these employee salaries does not result in private business use of the hotel by the service provider?

4. Bond Counsel Opinions for Qualified 501(c)(3) Bonds When the Charitable Purpose is Lessening the Burdens of Government

- a. IRC 501(c)(3) does not include lessening the burdens of government in its list of charitable purposes, which is as follows:
 - i. religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals

- b. Rather Treas. Reg. 1.503(c)(3)-1(d)(2) defines the term “charitable” as used in IRC 501(c)(3) to include lessening the burdens of government but provides no further guidance on what activities qualify as lessening the burdens of government.
- c. The test for lessening the burdens of government is generally provided in Rev. Ruls. 85-1 and 85-2, which establish a two-part test to determine whether an organization lessens a burden of the government.
- d. The organization must demonstrate that its activities are actually burdens of the government. The Service has long held that the government is in the best position to determine whether the activity is its burden. Thus, the government must make an objective manifestation that, in effect, declares the activity to be its burden. The following are examples of factors that have been used to establish that the government considers the activity to be its burden:
 - i. Legislative creation of the organization intended to carry out the activity and a legislative definition of its structure and purposes.
 - ii. Legislative authorization for the creation of the type of organization intended to carry out the activity.
 - iii. Direct government involvement in and oversight of the organization.
 - iv. Government funding of the organization's activities.
 - v. The organization participates with the government in conducting an activity that has actually been performed in the past by the government, acts jointly with the government in conducting an activity, conducts an activity that is an integral part of a larger government program, or takes over an existing government activity.
 - vi. The activity performed by the organization is required by statute to be performed by the government or is acknowledged by legislation to be a government responsibility.
 - vii. The organization pays the government's obligations.
- e. These factors can be difficult to apply to various fact scenarios and arguably require a practitioner with significant 501(c)(3) experience to evaluate
- f. Many developers are forming 501(c)(3) entities with a charitable purpose of lessening the burdens of government. The intent is that the 501(c)(3) will build and possibly operate facilities for multiple as-yet-unidentified governmental entities throughout the country. Some of these entities specialize in one type of facility, such as housing, while other entities plan to build any type of entity needed in a community, such as arenas, water facilities and housing all being developed by the same 501(c)(3).
- g. In the past, the IRS has viewed such entities with skepticism. Lately, there are reports that the applications for such entities are being approved by the IRS with what appears to be

little formal review. What factors should bond counsel look for before providing or agreeing to rely on a 501(c)(3) opinion for bonds being issued to benefit these entities?

- h. NABL's report on The 501(c)(3) Opinion in Qualified 501(c)(3) Bond Transactions (2014) discusses a bond opinion's reliance on the 501(c)(3) opinion of another law firm and notes that "[u]nder general legal opinion principles, by stating reliance upon the opinion of borrower's counsel as to the borrower's 501(c)(3) status in the bond opinion, bond counsel must make a professional judgment that such reliance is reasonable based on the reputation of borrower's counsel for competence in such matters and determine that the opinion of borrower's counsel is responsive to bond counsel's needs.
- i. Likewise, Circular 230 section 10.37(b) states

A practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is not reasonable when—

- i. The practitioner knows or reasonably should know that the opinion of the other person should not be relied on;
- ii. The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or
- iii. The practitioner knows or reasonably should know that the other person has a conflict of interest in violation of the rules described in this part.

5. Recent Refunding Proposal

Hypothetical: Financial advisor is proposing to issuer that it refund on a tax-exempt basis outstanding taxable advance refunding bonds issued in 2020. The 2023 refunding would be a portion of a multipurpose new money/refunding issue. The original tax-exempt new money bonds are no longer outstanding. The final maturity of the new money portion of the issue is 2043 and the final maturity of the refunding portion is 2043. The coupons on the 2020 taxable bonds are lower than the coupons on the 2023 tax-exempt bonds, and the yield on the entire multipurpose 2023 issue is between the two. The financial advisor is proposing to refund all maturities of the 2020 taxable bonds, including all noncallable maturities, and to defease to maturity rather than the earliest call date.

If savings are calculated using the yield on the entire multipurpose 2023 issue, savings are generated and the savings are increased the longer the escrow is in place. This is true if the escrow goes to the first call date or to maturity.

If savings are calculated using the yield on the refunding portion of the bond issue only, there are no savings.

How do you advise the issuer? See Treas. Reg. 1.148-10(a)(3).