October 2, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Safe Harbors Under Sections 141 and 145

Dear Commissioner Koskinen:

Enclosed please find comments suggesting safe harbors under section 141 and section 145 for public/private (“P3”) arrangements (“P3 Models”) relating to the provision of capital improvements to be owned by qualified users (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

cc: William J. Wilkins, Chief Counsel, Internal Revenue Service
    Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
    Victoria A. Judson, Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service
    Sunita Lough, Commissioner, Tax Exempt & Government Entities Division, Internal Revenue Service
    Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Carol L. Lew of the Section’s Committee on Tax Exempt Financing (the “Committee”). Substantive contributions were made by Sarah Breitmeyer, Charles Cardall, Michela Daliana, Stefano Taverna, and Michael Thomas. Citation and format review was provided by Man Huynh, of the Section’s Young Lawyers Forum. The Comments were reviewed by Todd Cooper, Vice Chair of the Committee, Stefano Taverna, Chair of the Committee, Clifford M. Gerber, of the Section’s Committee on Government Submissions, and by Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 2, 2015
Executive Summary

These Comments suggest safe harbors under section 141\(^1\) and section 145 for certain public/private partnership ("P3") arrangements ("P3 Models") relating to the provision of capital improvements to be owned by state and local governments or organizations described in section 501(c)(3) of the Code (both referred to herein as “Qualified Users”).\(^2\) In summary, we believe that new guidance should be provided to clarify the tax treatment for private business use purposes of P3 Models that are intended to facilitate Qualified Users providing to the public (or beneficiaries of the applicable 501(c)(3) organization) quality infrastructure and other capital improvements at the lowest long-term cost. We believe that Rev. Proc. 1997-13,\(^3\) as amended and amplified by Notice 2014-67\(^4\) (the “Guidelines”), should be revised to include a longer safe-harbor term (at least 30 years, but not longer than 80% of the useful life of the applicable facility) for arrangements that are not considered a lease for federal income tax purposes, with a flexible compensation structure that is not based on net profits. This revision would assist Qualified Users in providing potentially higher quality capital improvements at a lower cost without transferring the benefits of tax-exempt financing to an entity other than a Qualified User or otherwise creating private business use within the meaning of section 141 (or section 145) of the Code. Further, we believe that guidance should be issued creating a new safe-harbor similar to the safe-harbor of Notice 2014-67 for accountable care organizations (“ACOs”), for certain P3 Models involving operators with percentage residual interests in mixed use facilities with respect to which the benefits of tax-exempt financing have not been shifted to the private operator. As described herein, we suggest that the safe-harbor require a written agreement, fair market value terms, and the retention of key controls over the facilities by the Qualified User, and permit a return (as distinct from reasonable compensation for services) to the operator limited to an amount no greater than the ratable portion of the benefits or contributions the operator provides to the arrangement.

\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, amended (the “Code”), unless otherwise indicated.

\(^2\) The Tax Exempt Financing Committee of the Section of Taxation previously submitted comments, dated May 9, 2012 (the “2012 Comments”), which addressed the management contract guidelines of Rev. Proc. 1997-13, 1997-1 C.B. 632. These comments supplement those previously submitted comments to address evolving arrangements for the provision of public infrastructure and capital improvements for organizations described in section 501(c)(3) of the Code.


DISCUSSION

A. **Background Relating to Typical P3 Models.**

I. **In General.** Many years have passed since the Tax Reform Act of 1986, the imposition of the restrictions of the private activity bond test of section 141 of the Code, and the formulation of safe harbors relating to management and service contracts. Over this period of time, arrangements relating to the provision and operation of public infrastructure have fundamentally changed, encouraged by the Federal government and driven by the objective of providing cost effective, high quality public infrastructure improvements and services. In addition, the demand for public infrastructure improvements has outpaced the amount of public funding available to finance such improvements. For example, balances in the Federal Highway Trust Fund (historically used to fund hundreds of billions of dollars of road, bridge, and transit projects across the nation) have continued to decrease to the point where the ongoing viability of the Highway Trust Fund has become a concern.

In April 2015, the U.S. Department of the Treasury, Office of Economic Policy, released a paper entitled “Expanding the Market for Infrastructure Public—Private Partnerships” (the “Economic Policy Paper”), which identifies that the “[y]ears of underinvestment in our public infrastructure have imposed massive costs on our economy,” and that “[t]he need to reverse years of underinvestment in infrastructure, despite tighter budgets at every level of government, calls for us to rethink how we pay for and manage infrastructure . . . “\(^5\) State and local governments, in response to the need for infrastructure, have begun searching for alternative sources of funding for and means of procuring new or refurbished capital projects, as well as alternative ways of operating and maintaining new and existing assets.

Private companies have long been involved in the design, construction, and management of public infrastructure. A traditional source of capital for state and local governments is the tax-exempt bond market. The two basic categories of tax-exempt bonds issued for public infrastructure are generally (i) governmental bonds, and (ii) private activity bonds for airports, docks, wharves and solid waste disposal facilities, among others, and facilities that are owned or operated by organizations described in section 501(c)(3) of the Code (“501(c)(3) organizations”).

The types of facilities that need to be constructed include social infrastructure projects (e.g., public buildings, public schools, municipal office buildings, courthouses, and correctional facilities), as well as roads, water and wastewater facilities, and similar facilities for public services. Many of these projects are not revenue producing; the source of payment of construction costs, as well as operation and maintenance expenses, must be subsidized from other governmental revenue sources, such as tax revenue. Even in circumstances

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involving facilities that give rise to user fees, the overall costs of construction, operation, and maintenance are often subsidized by tax and other revenues of the Qualified User, as user fees are not sufficient to defray the costs of operation and maintenance.

Private companies engaged in these social infrastructure projects can be involved in the design, construction, operation and maintenance in a manner that achieves the best, and in the appropriate circumstance, most cost-effective result for the Qualified User by allowing such companies to be involved on a long-term basis with the project, thereby ensuring accountability for the appropriateness and quality of design and construction, as well as long-term viability, operation and maintenance. These objectives can be accomplished through a model known as a public-private partnership, or P3 Model, which has been successfully deployed in the United Kingdom, Australia, and Canada, and in the United States, albeit with limited access to capital derived from the issuance of tax-exempt bonds.

In order for the P3 Model to be implemented successfully when Qualified User projects are, at least partially, financed with tax-exempt governmental or qualified 501(c)(3) bonds (“tax-exempt (non-AMT) bonds”), the current rules governing contractual arrangements between the Qualified User as owners of capital projects and the for-profit contractors/service providers need to be clarified and amplified in order to allow longer-term arrangements to exist in the context of capital projects. See Private Activity Restrictions below. Although private activity bonds are potentially available for limited types of P3 transportation facilities (qualified highway facilities) under section 142(a)(15) of the Code, such financings typically are more costly (as the interest paid on such bonds is an item of tax preference for purposes of the alternative minimum tax), are more time-consuming and complicated, and are not available for many P3 facilities.  

Many facilities of Qualified Users are procured using the traditional design-bid-build (“DBB”) project delivery method. Under DBB, separate contracts are made sequentially for design and construction of the qualified project. Financing and operations are also each handled separately. Unlike the P3 Model, where a project is developed under a single contract on an integrated basis with a life-cycle focus, the DBB procurement infrastructure delivery model requires as many as four contracts. Because the Qualified User assumes budget and schedule accountability from the design stage to the operation stage, there is diminished incentive for the private contractor to provide for asset quality or timely delivery. The traditional DBB delivery model, therefore, involves a segmented process where each segment in the process is managed independently. Design-build (“DB”) project delivery is also occasionally used. DB involves a single design-build contract, but no private financing or long-term contractor operating responsibility.

The traditional DBB and DB models, while operationally more costly, less efficient and not readily adaptable to changes in technology than P3 Models (described below), do not typically present the significant questions or issues often associated with financing involving

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6 Some P3 Models involve arrangements that involve leasehold or ownership interests by a private contractor. See description of a lease of existing infrastructure coupled with a grant by a governmental owner in Joint Committee on Taxation, Overview of Selected Tax Provisions Relating to the Financing of Infrastructure (JCX-29-11), May 13, 2011.
the issuance of tax-exempt (non-AMT) bonds. Consequently, the DBB and DB Models allow Qualified Users to access capital at an initial lower cost than other models.

By contrast, the P3 Model follows a procurement method under which a Qualified User competitively awards a single contract to a private project company to design, build, finance, operate and maintain a Qualified User owned facility. Because under the P3 Model, there is only one person responsible for all the phases of the long-term project, including its design, construction, and future maintenance, the contractor/service provider takes into account various factors at each stage of the contract which, although they may appear uneconomical at the beginning of a project (e.g., the raw lowest initial cost to provide the facility) are intended to be economically more advantageous in terms of construction, maintenance and operation costs over the entire duration of the contract. For example, the private contractor might suggest that higher quality (longer lasting) fixtures be utilized for a project resulting in lower long-term operating costs (e.g., using LED lighting fixtures rather than fluorescent lights).

As a public works project delivery method, the P3 Models have been found to have the following advantages over DBB or DB models: expedited delivery, lower cost, innovation promotion, improved construction quality, qualifications-based contractor selection, full collaboration between designer, builder and operator, transfer of design and construction risks, transfer of operation and maintenance risks, predetermined asset “handback” conditions at the end of term, best value selection of contractor, single point of accountability, minimization of change orders and disputes, life-cycle focus, improved capital maintenance, at-risk equity, and/or at-risk private debt to further incentivize performance. The reduced cost and efficiency provided by the P3 Model will better enable local governments to deliver essential public services, and reduce their need for reliance on the Federal government for other forms of assistance.

One of the more widely used P3 Models provides for compensation to the private participant in the transaction based on “availability payments” (herein, referred to as the “Availability Payment Model”). Generally, under the Availability Payment Model, the Qualified User commits to make predetermined periodic payments to the private party contractor during a certain period of time. These payments are only due if the construction has been completed according to required specifications set forth in the contract entered into by the Qualified User and the contractor, and the infrastructure is properly operated and maintained, and is “available” for use at the quality/service levels agreed to in the contract. The payments, which are typically established at the outset, are frequently capped, with

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7 P3 is a primary project delivery method selected by local governments for large public work projects in Canada, the UK and Australia. In these countries, unlike in the U.S., private debt and government debt are both taxable. Accordingly, cost-of-capital differences do not need to be factored into the project delivery method decision, assuming similar financing structures.

8 See Letter from Samara Barend, Founder, Performance Based Building Coalition, to David Camp, Chairman, House Ways and Means Committee (April 15, 2013).

9 However, business considerations of various parties to a P3 arrangement may compel a different structure. See Buckberg, supra note 5.
variations only in the amount paid by the private contractor to reflect penalties or fines due to non-performance or failure to satisfy certain quality standards.

Availability payments typically commence when construction is complete and the Qualified User has beneficial use of the facility. These payments include a capital charge component and an operating and maintenance component. The capital charge is composed of a debt service component and an equity return component, which is based, in part, on the contractor’s debt service on its debt and the costs of construction to the contractor. Availability payments could be payable from any available source of funds, including the Qualified User’s general fund in the case of nonrevenue-producing assets (for example, a city hall), or facility revenues (for example, tolls from a toll road). The Availability Payment Model is not based on revenue collections or usage of the applicable facility.

The operating portion of the arrangement is generally over a relatively long period, frequently reaching 20 to 50 years, the length of which is not driven by a desire to transfer benefits to a private entity but rather to allow for a life-cycle approach to the procurement of the facility, which ultimately ensures high quality provision of infrastructure to the public over a significant period of time, while giving the Qualified User the ability to estimate with more certainty the operational costs of these projects. Despite the length of the typical P3 Availability Payment Model contract, the Qualified User generally retains actual and substantive ownership of the asset and fundamental control over the asset and the delivery of public services associated with the asset. The P3 contractor typically remains accountable to the Qualified User. For example, rate setting, terms of use, and occupancy remain in the hands of the Qualified User.

II. Project Financing. In many instances, the private contractor in the P3 Model is responsible for providing capital to the project, by securing at least a portion of the financing or participating in the financing package. Its investment typically takes the form of nonrecourse debt that is secured by the arrangement with the Qualified User to provide services in connection with the facility. A component of the availability payment made by the Qualified User is used to make debt service payments on this obligation.Were tax-exempt (non-AMT) bonds available for these projects, the Qualified User would provide the capital through the issuance of tax-exempt (non-AMT) bonds, potentially together with other sources of funding.

III. Private Activity Restrictions. Tax-exempt bonds for public infrastructure are typically issued as tax-exempt (non-AMT) bonds subject to the two-part private business tests of section 141 of the Code, which include a private business use test and a private security or payment test. Service or operating contracts may or may not satisfy the private business use test of section 141 of the Code “based on all the facts and circumstances,” and private business use includes arrangements that base compensation to the contractor on a share of net profits. Under the Guidelines, the term of the contract with the private operator is limited to the lesser of (a) 10 years or 80% of the economic life of the financed asset in connection with arrangements based on 80% fixed fees, or (b) 15 years or 80% of the economic life of the financed asset in connection with arrangements based on 90% fixed

10 Reg. § 1.141-3(b)(4).
fees. The term may be extended up to the lesser of 20 years or 80% of the economic life of the financed asset in respect of certain public utility property. The Guidelines are intended to provide needed safe harbors for determining private business use with respect to service contracts under the facts and circumstances test, while facilitating arrangements crucial for providing cost effective governmental facilities and services without transferring the benefits of tax-exempt financing to a private entity.

Notice 2014-67 takes an important step forward in amplifying and simplifying the Guidelines and facilitating important private arrangements in circumstances where there is no improper transfer of the benefits of tax-exempt financing constituting private business use under section 141 (or section 145) of the Code. Notice 2014-67 consolidates several of the compensation arrangements of Rev. Proc. 97-13, including fixed fees, capitation fees, per-unit fees and revenue-based compensation (the “Permitted Fees”) into a single safe-harbor with a maximum five-year term, while retaining longer (and shorter) safe harbors with certain specified different compensation structures—generally requiring more fixed and narrow permissible compensation as the permitted term is lengthened.

While alternative P3 Models are likely to develop or evolve over time, these Comments discuss two basic P3 Models currently in use. It is important that any guidance in this area remains broad and sufficiently flexible to address such a changing environment. The Economic Policy Paper notes important business reasons that are leading to the continual evolution of business models for P3 transactions. State and local governments and 501(c)(3) organizations want to ensure the provision of both high quality facilities (designed to serve the public (or charitable class) over long periods of time), while also benefitting from the cost savings associated with tax-exempt (non-AMT) financing.

B. Examples.

The City Hall Example below is an example of an Availability Payment Model. We note that the Availability Payment Model described in the City Hall Example is not representative of all potential structures used in P3 transactions.

City Hall Example

City X intends to provide the lowest cost/highest quality city hall for its community. City X takes bids from various contractors with respect to an arrangement for provision of the city hall, including designing, building, operating, maintaining and financing. Under the selected arrangement with the P3 contractor, City X will own the city hall, and the contractor will, post-construction, be responsible for maintaining the facility at an agreed upon level for the next 30 years. As service provider, the contractor is responsible for assuring that the city hall is well maintained and functional pursuant to specifications detailed in the contract, including making necessary repairs and performing customary maintenance, and replacing capital components such as air conditioners. Rather than paying the contractor for the design/build costs upfront, City X agrees to pay for the construction costs, the design/build services, and the cost of maintaining/operating city hall, over a 30-year period pursuant to an

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11 Notice 2014-67 created a “5-year” safe harbor with a flexible compensation structure; however, such safe harbor is impractical for the typical P3 Model.
availability payment arrangement that is not based on net profits. The availability payments will only be payable if the city hall is available for use at an agreed upon level (e.g., a certain number of days a year open to the general public). These payments take into account the construction and operation costs (together with the financing costs) of the contractor. City X retains ownership and operational control over the use of the city hall.

Proceeds of tax-exempt (non-AMT) bonds would be used to finance the construction costs incurred to design and build the city hall. Any revenues that may be expected in connection with the use of city hall are negligible. In this example, the contractor does not control the use of the facility, nor does it share in facility revenues (there are none); yet it bears risks associated with the long-term maintenance of the asset at the designed level.

**Toll Road Example**

Authority Y plans to build a high quality toll roadway and solicits bids for an arrangement that will include designing, building, operating, maintaining and financing the roadway. Authority Y desires to issue tax-exempt (non-AMT) bonds to finance a portion of the toll road costs. The selected contractor will contribute a portion of the capital costs of the project with its own equity, for which it is expected to receive an on-market return that will be paid from project revenues, on a subordinated basis. At no point will either Authority Y and/or the contractor be responsible for the payment of debt service on the borrowing of the other party.

Similar versions to the Toll Road Example might be structured with a subordinated note payable to the contractor. For Federal income tax purposes, that note may be considered a debt obligation or an equity residual interest, depending on the particular facts and circumstances.

C. **Many P3 Models Neither Involve Private Ownership Nor Constitute Leases for Federal Income Tax Purposes.**

I. **Ownership Issues.** There are numerous authorities that address whether an asset is owned, leased or is otherwise subject to a service contract. These authorities generally examine the benefits and burdens of ownership, including the length of the agreement, the useful life of the asset, the degree of control over the asset, and the risks and potential gain. Consistent with these authorities, section 142(b)(1)(B) of the Code provides for a specific safe harbor for leases and service contracts that will not be considered to result in private ownership, provided that, among other requirements, the length of the contract is not more than 80% of the reasonably expected useful life of the property and the lessee/service provider does not claim depreciation or certain other tax benefits with respect to the property.

Despite the terminology “public/private partnerships,” many P3 Models, particularly those utilizing the Availability Payment Model, do not result in the creation of a new entity (for example, a partnership) for Federal income tax purposes. Treasury Regulation section

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301.7701-1(a)(2) provides that a joint undertaking results in the creation of a separate entity when two or more participants carry on a trade or business or venture and divide the profits from it.\(^{13}\) The courts similarly have examined the facts and circumstances of joint undertakings (including whether they are formed to conduct a business and share in profits) to determine whether a separate entity (or partnership) exists.\(^{14}\)

The Availability Payment Model, typically utilized for nonrevenue-producing facilities, does not generally involve profit splitting or joint control; nor is the intent of the parties to jointly conduct a business, which is necessary for partnership status for Federal income tax purposes. Treasury Regulation section 301.7701-1(a)(2) distinguishes between arrangements that give rise to a separate entity for Federal tax purposes, versus those that involve mere co-ownership or a joint undertaking solely to share expenses. Depending upon the facts and circumstances, even in circumstances where there is revenue splitting, in most Availability Payment Models, a Qualified User’s typical control over the operation of public infrastructure (for example, rate setting, and road improvements/alterations), might not give rise to a separate entity (for example, partnership) for Federal income tax purposes.

II. **Lease Issues.** Section 7701(e) of the Code addresses the difference between leases and service contracts by providing that a service contract shall be treated as a lease if it is in substance a lease taking into account all relevant factors, including physical possession and control, among others. Court decisions reviewing the differences between service contracts and leases have examined who determines the amount and bears the cost of expenses, and whether the compensation paid to the operator is dependent upon the profits of the business.\(^{15}\) Similarly, Treasury Regulation section 1.141-3(b)(3) provides that to determine whether a service contract is a lease, it is necessary to consider “the facts and circumstances, including . . . [t]he degree of control over the property . . . and [w]hether a nongovernmental person bears risk of loss of the financed property.” In substance, this means that a contract should be treated as a lease (as contrasted with a mere service contract), based upon (1) the contractor’s controls over the functioning of the “business” utilizing the asset (such as control over rate setting and budget relating to the running of the applicable

\(^{13}\) Section 761(a) of the Code defines a partnership to include “a . . . joint venture . . . through or by means of which any business . . . or venture is carried on . . . which is not . . . a corporation or trust or estate.”

\(^{14}\) See *Commissioner v. Tower*, 327 U.S. 280, 286-287 (1946) (where the United States Supreme Court stated that a “partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and where there is community of interest in the profits and losses”); *Luna v. Commissioner*, 42 T.C. 1067 (1964) (for purposes of making a determination of whether an arrangement is a partnership, courts examine the intent of the parties, control over income and capital, and a mutual shared interest in profits as opposed to one party being the agent or service provider to the other); *Commissioner v. Culbertson*, 337 U.S. 733 (1949) (finding that the determination of partnership status is based upon the facts and circumstances and whether the “partners joined together in good faith to conduct a business . . .”).

\(^{15}\) See, e.g., *State Nat. Bank of El Paso v. United States*, 509 F.2d 832 (5th Cir. 1975) (focusing on control over and payment of expenses, and risk of loss of compensation); *Meagher v. Commissioner*, 36 T.C.M. 1091 (1977) (finding that a management contract is not a lease where the owner maintained control and risk of loss); *McNabb v. Commissioner*, 81-1 U.S.T.C. 9143 (W.D. Wash. 1980) (finding that a management contract constituted a lease because owner transferred control and risk of loss to the “manager”).
enterprise), and (2) the operator’s ability to share in both the combined revenues and expenses of the applicable enterprise, both over the limited term of the lease.

Many P3 Models do not have the attributes of a lease for Federal income tax purposes. While certain P3 Models involve the contractor absorbing certain risks of loss (see below), those arrangements that maintain Qualified User control over the applicable facility and do not involve compensation based on the residual profits of the facility should not be considered a lease. For example, despite the payment of availability payments over a relatively long period and the contractor’s loss of such payments in the event the facility is not “available” at the intended level, the economic substance of Availability Payment Models is fundamentally different from that of a lease. Although the operator may make recommendations to the Qualified User, the operator typically lacks control over rate setting, changes in operations, and infrastructure improvement changes/modifications – all of which are key elements in running a business as a lessee or proprietor. Rather than receiving revenue from a facility, paying expenses, and being enriched from the excess, the Availability Payment Structure contractor’s “upside” typically is limited to pre-determined availability payments, which are not substantially different from the existing Permitted Fees. This arrangement merely provides to Qualified Users a management tool to enhance their ability to sustain the project in the long term. Consequently, it does not appear warranted to treat Availability Payment Models as leases for purposes of the private activity restrictions of section 141 (and section 145) of the Code. We note that this type of structure is often useful (as in the City Hall Example) to provide infrastructure that is not revenue producing. We believe that, at least with respect to those instances where P3 Models do not give rise to a partnership or a lease, it would be useful to have service contract guidance providing a private business use safe harbor.

D. Service Contracts Issues

I. Length of Arrangement. Long-term operational agreements, such as those of P3 Models, raise concerns under the Guidelines. We note, however, that the Guidelines already permit longer term arrangements for certain public utility property, in recognition of the special nature of that asset type. This accommodation was compelled by the changing

16 Note that in the City Hall Example a portion of the availability payments are in substance payments repaying a loan for capital facilities. The existence of such “debt component” should not alter the fact that there should be no private business use in this instance as the operator, in the City Hall Example, has no proprietary usage of, true ownership interest in, or control over the City Hall.

17 It has been recognized that the Guidelines are not well suited to address certain types of management or service arrangements, particularly in the output facility context. When Treasury Regulations addressing output facilities were adopted, an “exception” to the Guidelines was included in Treasury Regulations for the use of electric output facilities by a regional transmission organization (RTO), independent system operator (ISO) or other independent transmission operator pursuant to a management or service agreement. As set forth in the Preamble to the Final Regulations:

Commentators stated that the management contract guidelines in Revenue Procedure 97-13 are not well-tailored to address the use of electric facilities by an RTO or an ISO. They requested additional guidance concerning the circumstances in which an RTO or an ISO will not be treated as a private business user. The final regulations provide that a contract for the operation of an electric transmission facility by an independent entity, such as an RTO or an
operational structure and regulation of these large scale projects.\textsuperscript{18} Similar large scale projects are involved with P3 Models such that, in many instances, the longer five-year temporary period is necessary to comply with the arbitrage limitations.\textsuperscript{19}

Longer-term arrangements providing compensation to the contractor based on either the existing Permitted Fees or a similar availability formula or other methodology that is not net profits-based should be permitted without a finding of private business use given the economic substance of some P3 Models (particularly those that do not constitute leases) with governmental (or 501(c)(3) organization) ownership and control over the applicable facilities. In those instances, the contractor is not operating as a lessee, nor is it a proprietor of any portion of the applicable facility. Rather, the contractor, typically lacking significant control over the operation of the provision of the infrastructure services, serves as an agent of the Qualified User, even if the contract’s term is longer than 15 years. The length of the arrangement, provided it does not exceed a term that would trigger a transfer of tax ownership,\textsuperscript{20} does not alter the nature of the arrangement for federal income tax purposes (nor the status of the operator as a mere service provider). Consequently, for purposes of section 141 (and section 145) of the Code, the contract should not be treated differently simply because of the duration of the service contract.

Treasury might consider adopting a rule comparable to that in section 142(b)(1)(B) of the Code, providing a limit to the term of the contract to not more than 80\% of the reasonably expected useful life of the applicable property. We believe that such a revision to the Guidelines, in those instances that do not involve the transfer of Qualified User ownership or a lease, would accommodate many P3 Models. We also note that it would be helpful in this area to provide guidance recognizing that the useful life of property takes into account routine and customary maintenance, which would be consistent with some of the capitalization rules for certain betterments under Treasury Regulation section 1.263(a)-3. Any safe harbor with respect to service contracts should also clarify that the operator, not being the owner of the asset, or the portion thereof, that is financed by tax-exempt (non-AMT) bonds, is not entitled to depreciation for its capital contribution.

\textit{ISO (independent transmission operator),} does not result in private business use of the facility if: (1) The facility is owned by a governmental person; (2) the operation of the facility by the independent transmission operator is approved by the Federal Energy Regulatory Commission (FERC) under provisions of the Federal Power Act (16 U.S.C. 791a through 825r) (or by a state authority under comparable provisions of state law); (3) the independent transmission operator’s compensation is not based on a share of net profits from the facility; and (4) the independent transmission operator does not bear risk of loss of the facility.

T.D. 9016, 2002-40 I.R.B. 628. A similar standard should be applied to all operation or management situations, including P3 structures where there is no transfer of tax ownership, as there are typically stringent approval requirements (legislative or otherwise) for entering into the P3 to ensure public benefit and arm’s length arrangements.\textsuperscript{18} See Rev. Proc. 97-13, Section 5.03(3).\textsuperscript{19} Reg. §1.148-2(e)(2)(ii).\textsuperscript{20} E.g., If the contract term exceeded the reasonably expected useful life of the applicable facilities, the ownership of the facilities (or an ownership type interest) might be considered to have transferred to the contractor. \textit{See, e.g.,} Rev. Rul. 55-540, 1955-2 C.B. 39.
II. Compensation Structure and Special Legal Entitlements. While the Treasury Regulations provide for a determination of private business use based on all the facts and circumstances, compensation based on a share of “net profits” from the operation of the facility is never permitted. The Guidelines have typically focused on the compensation to the service provider in addition to the term of the arrangement in providing safe harbors under the “facts and circumstances” test of section 1.141-3(b)(4) of the Treasury Regulations. The Permitted Fees under the Guidelines have been crafted to avoid a determination of “net profits,” permitting compensation based on stated amounts, periodic fixed fees, capitation fees, per-unit fees, and a percentage of gross revenues (or expenses, but not both).

Regardless of the compensation methodology, where the contractor is being paid a fee for services provided rather than sharing in the profits and losses of the financed property, the arrangements described in the P3 Model Examples above do not provide the contractor with special legal entitlements to the bond financed property.21

The Guidelines appropriately require the compensation paid to a service provider to be “reasonable compensation.” However, the Permitted Fees of the Guidelines may not reflect the current market payment methodologies of certain P3 Models. Provided the compensation methodology is reasonable, reflects current market practices for P3 Models, and does not result in a net profits arrangement, P3 arrangements should not result in private business use. The key for determining whether an operational arrangement constitutes private business use should be whether the operator has the benefits and burdens of ownership of the tax-exempt bond financed portion of the facility, including bearing the cost of capital and serving as a proprietor over such business – as opposed to merely being paid a fee for services provided to the Qualified User.

With respect to the operational portion of a P3 arrangement, a key distinction should be made between those contracts where the service provider is merely absorbing the risk of maintaining the applicable tax-exempt bond portion of a facility from those where the operator takes on the risks of the overall enterprise and is compensated as a “partner.” In many P3 Models, the operator does, much like a provider of a warranty, absorb the risk that the assets function and remain available at the designed level, such as in the City Hall Example above. Although this arrangement might typically involve the shifting of liability from the Qualified User to the service provider, we believe in this instance that such risk shifting is more akin to a warranty or maintenance contract with no “upside” appreciation benefit accruing to the operator. In the event of sale of the financed assets (such as in bankruptcy or dissolution), none of the profit that may result from a sale of the asset is allocable to the operator, other than as a secured creditor. The entire risk of loss is borne by the Qualified User. Such ancillary function should not create private business use.

We note that the Treasury Regulations exclude service contracts that provide services solely incidental to the primary governmental function of the financed facility (Regulation sections 1.141-3(b)(4)(iii)(A) and 1.141-3(d)(2)), and we believe that the

21 Although not considered legal precedent, in the context of a private letter ruling, the Service has recognized that in a combined contract for both design/build and operations for a utility facility with a 20-year term, payments for capital modifications and adjustments for extraordinary charges to the contractor did not result in profit-splitting and private business use. See PLR 200330010 (April 17, 2003).
warranty/maintenance-type function of the service provider in the City Hall Example is incidental to the primary governmental function and should not create private business use for purposes of section 141 and 145 of the Code. This model is fundamentally different from those where the P3 operator also absorbs the risks of a revenue-producing enterprise and is compensated based on residual receipts of the enterprise that involve the tax-exempt bond financed portion of a facility.\textsuperscript{22} For purposes of a service contract safe harbor under the Guidelines, it is substantively different for a P3 contractor to merely ensure that a building is available for use as opposed to absorbing the expenses of the enterprise, such as tenant improvements, marketing, energy usage, and waste collection. With respect to a road or bridge, there should be a substantive difference between an arrangement in which a contractor simply absorbs the risk that the road or bridge is available for usage and an arrangement in which the contractor is required to pay expenses of the enterprise, such as toll collection and marketing expenses while being compensated based on residual receipts. If the P3 operator is generally absorbing the risks that are comparable to a warranty/maintenance contract, and its compensation is reasonable and reflects market practices, the arrangement should not result in private business use.

We believe it is significant that the economics of Availability Payment Models do not involve the shifting of tax benefits of tax-exempt financing to the private operator. In this instance, the Qualified User is ultimately responsible for the payment of its own borrowing costs, while the operator is never responsible, directly or indirectly, for the payment of the debt service of the tax-exempt (non-AMT) bonds. Furthermore, the P3 contractor is typically selected pursuant to an arm’s length bidding procedure, involving unrelated third parties. Such competitive process and arm’s length relationship, together with the Qualified User’s incentive to provide the best quality facilities at the lowest cost, assure that the cost of the provision of the applicable facilities is not improperly inflated nor are the benefits of tax-exempt financing otherwise transferred to the operator.

E. \textbf{An Alternative Approach.}

I. \textbf{Mixed-Use Projects.} Because of the variety of P3 Models presently contemplated and encouraged by the Federal government,\textsuperscript{23} we believe that changing the safe harbors for service contracts, without more, will likely not address many arrangements that nonetheless should not be viewed as giving rise to private business use. For example, some P3 Models provide for the operator, who agrees to build and operate a facility, to also provide private financing for a portion of the construction costs. For such capital contributions, the operator intends to receive a rate on return on its investment, which is often payable from a percentage share of residual receipts.

The Service has shown willingness to provide clarifying guidance to address situations where private involvement is a necessary or important factor in fulfilling a

\textsuperscript{22} We believe that private business use should not exist by reason of the arrangement, even if the contractor provides subordinated financing that does not constitute debt for federal income tax purposes. In this instance, despite the character of the financing, the contractor has no revenue sharing or other proprietary interest in the facility. The contractor’s “equity” in such instance is typically its upfront costs in being an effective provider/operator of the facilities.

\textsuperscript{23} See Buckberg, supra note 5.
governmental entity’s purposes and where the private participant is not otherwise receiving the benefits of tax-exempt financing. For example, with respect to output facilities, in order to address issues of economies of scale, the Service has adopted helpful rules permitting the financing, with governmental (non-AMT) bonds, of a proportionate share of a jointly owned output facility. For example, with respect to output facilities, in order to address issues of economies of scale, the Service has adopted helpful rules permitting the financing, with governmental (non-AMT) bonds, of a proportionate share of a jointly owned output facility. To address technical issues in a situation where a partnership furthered the objectives of Qualified Users (rather than private interests), the Service released Proposed Treasury Regulation section 1.141-1(e), which provides a special rule for disregarding partnerships in which each of the partners is a governmental person. The Service has also issued private letter rulings addressing situations where 501(c)(3) organizations enter into joint ventures and private business use does not exist. Similarly, for purposes of determining whether an organization continues to qualify for exemption under section 501(c)(3) of the Code after entering into a joint venture, the Service has “looked through” a deemed partnership at the partner level and considered whether the venture was required to further the nonprofit’s charitable interest, and found that the arrangement only incidentally benefited private interests. We also note that the Service has made efforts to address, in other situations, facilities that involve a mixture of both governmental and private business use. While we suggest that any rules in this area be prospective and initially proposed (or re-proposed), the reserved portions of the allocation and accounting provisions of Treasury Regulation section 1.141-6 (or a new notice) may be an appropriate vehicle for providing guidance with respect to those P3 Models that do not raise true partnership issues.

II. Joint Venture Issues and ACOs. The most recent Service guidance addressing technical questions relating to private business use in situations where the usage and structure is being required or actively encouraged by the Federal government is Notice 2014-67. In Notice 2014-67, the Service addressed the application of section 141 (and section 145) of the Code with respect to arrangements entered into by hospitals or other health care organizations participating in the Medicare Shared Savings Program through an “accountable care organization” (an “ACO”). An ACO is intended to manage and coordinate high-quality healthcare for assigned Medicare patients. Although health care providers and suppliers participating in an ACO continue to receive Medicare payments in the same customary manner based on the provision of health care services to covered patients, an ACO that meets certain performance standards and demonstrates that it has achieved certain savings will be eligible to receive payments for Medicare shared savings under Section 1899(d)(2) of the Social Security Act. In Notice 2014-67, the Service crafted a safe harbor with respect to ACOs, which are required by statute to be separate legal entities, to address situations not resulting in private business use for purposes of sections 141 and section 145

24 See Reg. §1.141-7(i) Ex. 1.
26 See, e.g., PLR 200324047 (March 5, 2003) (finding that a joint operating agreement among nonprofits did not result in private business use, even though revenue splitting existed because the purposes of section 145 of the Code were served); see also PLR 199929041 (July 26, 1999) (reaching a similar result).
29 This program is described in sections 3022 and 10307 of the Patient Protection and Affordable Care Act, Pub. L. 111-148, 124 Stat. 395 (March 23, 2010), relating to participation in the Shared Savings Program.
30 42 U.S.C. 1395 et seq.
of the Code. Recognizing that an arrangement with an ACO might take a variety of forms and that governmental entities (and 501(c)(3) organizations) will typically be participating through ACOs, the safe harbor is designed to encompass a variety of structures and provides that the participation in the Shared Savings Program through an ACO will not result in private business use of a tax-exempt bond financed facility if all of the following conditions are met:

1. The terms of the ACO participation are set forth in advance in a written arm’s length arrangement;

2. The ACO has been accepted into the Shared Savings Program via the Center for Medicare and Medicaid Services;

3. The Qualified User’s share of economic benefits derived from the ACO arrangement is proportional to the benefits or contributions it provides to the ACO;

4. The Qualified User’s share of losses do not exceed the share of benefits to which it is entitled;

5. All transactions between the Qualified User and the ACO (and certain other participants) are at fair market value; and

6. The Qualified User does not generally contribute or otherwise transfer the property financed with tax-exempt bonds to the ACO.

The intent of Notice 2014-67 is to provide a flexible safe harbor to address a variety of possible situations confronted by Qualified Users endeavoring to participate with an ACO in achieving the goals of the Affordable Care Act, which include quality care and affordability.

III. Facilitating P3s. Similar to the situations addressed in Notice 2014-67, P3 Models for public infrastructure improvements might involve a variety of arrangements, including the examples previously discussed, and are intended to facilitate quality service, efficient operations, and flexibility to the public at the lowest practicable cost. Further, similar to ACOs, which are not intended to receive the benefits of tax-exempt financing, private entities involved in P3 Models typically are expected to receive the lowest cost compensation for the provision and maintenance/operation of improvements (without regard to tax-exempt financing). Consequently, we believe that a safe harbor, comparable to that provided for ACOs, is appropriate for P3 Models where there is no transfer of the benefits of tax-exempt financing to a private person, even if a joint venture is created. Thus, we suggest that a safe harbor is appropriate (including situations where there is tax-exempt financing for a Qualified User’s proportionate share in a facility involving joint ownership or a partnership) if the following factors are satisfied:
1. The arrangement is determined in advance, in writing, with market-rate terms.\(^{31}\)

2. Similar to the safe harbor for ACOs, the permitted arrangements only include those in which the contractor is compensated at an amount no greater than fair market value regardless of whether tax-exempt financing is utilized.\(^{32}\)

3. The arrangement does not shift losses to the Qualified User that are in excess of its pro rata interest in the applicable facility.\(^{33}\)

4. The Qualified User’s share of benefits derived from the P3 transaction is at least proportional to the contributions it provides.\(^{34}\)

In contrast to the safe-harbor for ACOs, which was created to address the particular interrelationship between ACOs and hospitals and does not typically involve facility ownership issues, we suggest that for P3 Models the operator could have a percentage tax ownership interest (e.g., a partnership interest or a leasehold interest) in the applicable facilities. While we note that in many P3 Models, the applicable Qualified User retains tax ownership of the facilities and the arrangement is inconsistent with a lease, we suggest that the above-described safe harbor permit tax-exempt (non-AMT) bond financing with respect to the percentage shares of P3 facilities that are allocable to such Qualified User.\(^{35}\)

It is important to note that the suggested alternative approach is intended to prevent the transferring of the benefits of tax-exempt financing from a Qualified User to a private entity. We suggest that by ensuring that in the applicable compensation structure or revenue division formula, as applicable, each respective party is responsible for the cost of their own respective borrowings (including any tax-exempt financing by the Qualified User), there is no shifting to a private entity of tax-exempt financing benefits. For example, in the Toll Road Example above, the parties receive their percentage shares of revenue after the payment of operational expenses (which might include a fee payable to the operator for the services provided to the Qualified User under the contracting arrangement but not the cost of the borrowing), with the residual receipts being proportionately divided among the parties. Allocation of revenues in that matter should be permitted so long as each party remains separately and independently responsible for the payment of its respective debt service on its borrowings. In this instance, the Qualified User fully realizes the benefits of tax-exempt financing of its respective contribution to the Project as it is solely responsible for, and bears the cost of, its own financing and the corresponding risk of loss and economic benefits associated with such portion of the facilities.

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\(^{31}\) We note that P3 arrangements are often heavily negotiated, arm’s length arrangements, specified in writing, and frequently the result of a competitive public bidding process.

\(^{32}\) Thus, similar to ACOs, the contractor would not receive a benefit that is in excess of the benefit or contribution the contractor provides to the Qualified User. We note that many of these contracts are subject to state law restrictions relating to public procurement which are intended to ensure market-rate terms.

\(^{33}\) One typical aspect of P3 Models is the shifting of losses from the Qualified User to an operator. For example, with respect to the Availability Payment Model, the operator accepts liability for failure of a project to be at design level operation over a relatively long period of time.

\(^{34}\) The Economic Policy Paper suggests various possible compensation structures that involve permitting a contractor to obtain a return on invested capital.

\(^{35}\) Clarification would be needed to address the ownership requirement of section 145(a) of the Code.
We note that guidance with respect to the alternative approach suggested above might be accomplished by either a safe harbor in a notice (or other guidance) or as part of proposed Treasury Regulations addressing mixed use projects.

**Conclusion**

For the reasons stated herein, to clarify that private business use does not exist and to facilitate the use of tax-exempt financing with respect to facilities provided under P3 Models, we recommend that the Guidelines be amended and broadened to include a longer safe-harbor term (at least 30 years but not longer than 80% of the useful life of the applicable facility) with a flexible compensation structure. Additionally, we suggest that a new safe harbor be created (similar to the safe harbor for ACOs in Notice 2014-67) for P3 Models involving operators with percentage residual interests in mixed use facilities. The new safe harbor would include safeguards to assure that the benefits of tax-exempt financing are not shifted to the private operator.