HUNTON& WILLIAMS

Client Alert

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Recent IRS Actions – Management Contracts and Various Arbitrage Rules

The last several months have seen a great deal of regulatory volume from the Internal Revenue Service (the “IRS”) concerning tax-exempt state and local government bonds. Some of this is very significant, containing new concepts for important structural matters affecting issuances, but some is fairly minor, mostly being confirmations or clarifications of existing rules already accepted in the bond issuing community. This Alert addresses both the highpoints and minor elements coming from Rev. Proc. 2016-44 released on August 22, 2016, stating new management contract rules and safe harbors, and the July 18, 2016, IRS final arbitrage regulations (the “Final Regulations”) following on proposed regulations published in 2007 and 2013. **Items which are likely to require a change in current practices are indicated with a red arrow.**

Management Contracts

Rev. Proc. 2016-44 provides a new approach to management contracts under the private activity bond limitations for governmental tax-exempt bonds and qualified 501(c)(3) bonds. It builds on the prior guidance under Rev. Proc. 97-13, as modified by Rev. Proc. 2001-39, and as further amplified by Notice 2014-67. Where the prior guidance was focused on the specifics of several safe harbors by limiting the permitted term of a management contract based on the extent to which the compensation was a fixed amount, the IRS intends for the new guidance to offer a “more flexible and less formulaic approach.” Importantly, Rev. Proc. 2016-44 places new emphasis on the “control” exercised by the governmental entity over the service provider and also offers the possibility to have the term of a qualified management contract be up to 30 years, which may be particularly helpful for management contracts in the P3 context.

Under the new guidance, a management contract that meets all of the following conditions, to the extent applicable, will not result in impermissible private business use under Code Section 141(b) (for governmental tax-exempt bonds) or Code Section 145(a)(2)(B) (for qualified 501(c)(3) bonds):

- No arrangements that involve the sharing of net profits or net losses. (a) payments to the service provider must constitute “reasonable compensation” for the services rendered during the contract term (applicable to both the administrative overhead expenses of the service provider and the actual and direct expenses reimbursed to the service provider); (b) the payment arrangement must not result in the service provider’s sharing the “net profits” from the operation of the managed property (no element of the compensation [including to individuals] taking into account either the managed property’s net profits or both the managed property’s revenues and expenses); and (c) the payment arrangement must not result in the service provider’s bearing any share of the net losses from the operation of the managed property. Incentive-based compensation, however, is still allowed if the compensation is determined by the service provider’s performance in meeting one or more standards that measure quality of service, performance or productivity.

➡ Term. The term of the contract (including all renewal options) cannot exceed the *lesser of* (a) 30 years or (b) 80 percent of the weighted average reasonably expected economic life of the managed property.

- Control. The governmental or 501(c)(3) owner of the property must have rights to exercise a significant degree of control over the managed property (examples include approving (a) the annual budget, (b) capital expenditures, (c) dispositions of property constituting the managed property or (d) rates charged for the use of the managed property). This is an entirely new element of the IRS guidance that may require a change to a number of contracts.

- Risk of loss. The governmental or 501(c)(3) owner of the property must bear the risk of loss upon the damage or destruction of the managed property.

- No inconsistent tax treatment. The service provider must agree not to take a tax position inconsistent with being a service provider (examples include the service provider's agreeing not to take depreciation or amortization, investment tax credit or deduction for any payment as rent with respect to the managed property). This is an entirely new element of the IRS guidance that should be addressed in the contract.

- No substantial limits on rights. The service provider cannot have any role or relationship that, in effect, substantially limits the governmental or 501(c)(3) owner's ability to exercise rights under the management contract, based on all the facts and circumstances.

In addition, Rev. Proc. 2016-44 provides that a management contract does not result in private business use if it qualifies as an "eligible expense reimbursement arrangement," which is defined to mean a management contract under which the only compensation consists of reimbursing the actual and direct expenses paid by the service provider to unrelated parties and the reasonable related administrative overhead expenses of the service provider. Further, use by the service provider of the managed property that is "functionally related and subordinate to performance of its services under the management contract" will not typically be considered private business use (such as use of storage areas to store equipment needed by the service provider in performing the services of the management contract).

The new guidance specifically says that the prior guidance of Rev. Proc. 97-13 and Rev. Proc. 2001-39 are "modified and superseded" and portions (but not all) of Notice 2014-67 are modified and superseded. The provisions in Notice 2014-67 applicable to short-term contracts remain in force.

Effective dates. Rev. Proc. 2016-44 applies to any management contract entered into on or after August 22, 2016, but an issuer has the option of applying the new guidance retroactively to any existing management contract. In addition, for purposes of providing issuers a period of transition to the new guidance, the IRS is allowing issuers to continue to apply the old safe harbors to any management contract entered into before August 18, 2017, and that is not materially modified or extended on or after August 18, 2017 (other than a typical renewal option).

Update. Since the promulgation of Rev. Proc. 2016-44, several Treasury and IRS personnel have publicly commented that (1) providing the new requirements (control, no inconsistent position, no sharing of losses, etc.) are met, the Rev. Proc. 97-13 safe harbors will still be acceptable, and (2) delay of payments to the manager, even if interest on unpaid amounts is included, will not be a concern so long as actual payment is expected to occur within 5 years.

Working Capital

The arbitrage regulations impose various restrictions on the use of proceeds from tax-exempt financings for working capital expenditures. One method by which the regulations limit working capital financings is through the concept of "replacement proceeds." Under the regulations, replacement proceeds related to working capital issues arise if an issuer reasonably expects as of the issue date that (a) the term of the issue will be longer than reasonably necessary for the governmental purposes of the issue, and (b) there will be "available amounts" during the period that the issue remains outstanding longer than necessary. "Available amounts" generally refers to any amount that is available to an issuer to pay working capital expenditures of the type financed by an issue.

- Modified safe harbor for short-term working capital financings. To conform with the permitted temporary investment period for working capital expenditures, the Final Regulations reduced the bond maturity necessary to satisfy the safe harbor for most short-term working capital financings from 2 years to 13 months. However, the Final Regulations also extended this safe harbor so that it applies to all working capital expenditures, instead of only "restricted" working capital expenditures. This change expands the eligible purposes for short-term working capital financings to include extraordinary working capital expenditures.

- New safe harbor for longer-term working capital financings. The Final Regulations also added a new safe harbor that prevents the creation of replacement proceeds for longer-term working capital financings. This safe harbor allows (confirming actual current practice in the bond community) an issuer to purchase eligible tax-exempt bonds (in lieu of costly extraordinary redemptions of the working capital issue) when unexpected available amounts arise. Under the safe harbor, an issuer is required to (a) determine the first year in which it expects to have "available amounts" for working capital expenditures, (b) monitor for actual available amounts in each year beginning with such first year, and (c) apply such available amounts in each year either to redeem or invest in (or some combination thereof) in certain eligible tax-exempt bonds. This safe harbor applies to refunding bonds issued to refinance working capital expenditures in the same way it applies to other bonds.

Testing for available amounts is to occur as of the first day of the issuer's fiscal year and amounts determined are to be used to redeem or invest in eligible tax-exempt bonds within 90 days. Paralleling the existing definition of "tax-exempt bonds" applicable for purposes of the arbitrage investment restrictions, the Final Regulations define "eligible tax-exempt bonds" to include both Demand Deposit SLGS and interests in regulated investment companies if at least 95% of the income to the owners thereof is from non-AMT tax-exempt bonds.

- Notably, among the technical changes to the working capital rules, the Final Regulations removed the restriction against financing a working capital reserve.

Valuation of Investments

(1) Reallocations of investments. There was ambiguity under the prior regulations about when the present value and the fair market value methods of valuation are required for investments. The fair market value method is generally required for any investment on the date the investment is first allocated to an issue or first ceases to be allocated to an issue. Under the prior regulations, an exception to the fair market value rule applies for reallocations of investments between tax-exempt bond issues as a result of the transferred proceeds or universal cap rules. This deterred issuers from refunding tax-exempt bonds with taxable bonds since the exception would not be applicable in that situation. The Final Regulations clarify that only the issue from which the investment is allocated must consist of tax-exempt bonds.

(2) Valuation of purchase and nonpurpose investments. The Final Regulations make a distinction between the valuation of purpose investments and nonpurpose investments, with purpose investments to be valued at their present value.

(3) Fair market value of Treasury obligations. Under the prior regulations, the fair market value of a United States Treasury obligation that is purchased directly from the United States ("SLGS") is its purchase price on the original purchase date. However, there was ambiguity regarding how to determine the fair market value of such an obligation on dates after the original purchase date. The Final Regulations specify that on any date other than the original purchase date, the fair market value of a SLGS security is its redemption price.

(4) Changes to GIC bidding rules. The Final Regulations clarify that, for purposes of meeting the safe harbor for establishing the fair market value of a guaranteed investment contract ("GIC"), the

requirement that bids be "in writing" may be satisfied by being in electronic form and disseminated by fax, email or an internet-based website.

(5) Commingled investment funds. The arbitrage regulations provide certain preferential rules for the treatment of administrative costs of certain "widely held external commingled funds." Under the prior regulations, a fund is "widely held" if the fund, on average, has more than 15 unrelated investors and each investor maintains the prescribed minimum average investment in the fund. This limited the number of "smaller investors" that could participate in an external commingled fund. With the purpose of enabling a fund to be even more widely held, the Final Regulations allow an unlimited number of small investors without restriction so long as at least 16 unrelated investors each maintain the required minimum level of investment in the fund.

Hedges

The existing regulations permit issuers to compute the yield on an issue by taking into account payments under "qualified hedges." Generally, under the existing regulations, a "qualified hedge" requires that (a) the hedge be interest based, (b) the terms of the hedge correspond closely with the terms of the hedged bonds, (c) the issuer duly identify the hedge and (d) the hedge contain no significant investment element. The existing regulations provide two ways in which a qualified hedge may be taken into account in computing the yield on an issue, known commonly as "simple integration" and "super integration." Simple integration factors in all net payments and receipts on the qualified hedge and the hedged bonds in determining the yield on the hedged bonds with the hedged bonds usually treated as variable yield bonds for arbitrage purposes. Super integration requires additional eligibility criteria, and such hedged bonds are treated as fixed yield bonds.

The Final Regulations make the following clarifications and additions concerning hedges:

- Cost-of-funds swaps eligible to be qualified hedges. The existing regulations provide that an interest rate swap requiring any payments other than "periodic payments" contain a significant investment element. The Final Regulations state that the definition of periodic payment includes payments under a cost-of-funds swap, thus eliminating any doubt that cost-of-funds swaps can be qualified hedges.

- Taxable index hedges constitute interest based contracts, but generally are ineligible for super integration. With respect to simple integration of taxable index hedges, the Final Regulations specify that taxable index hedges are interest based contracts and omit any interest rate correlation test for taxable index hedges (as had been contemplated in the 2007 proposed regulations). The Final Regulations also indicate that variances between the interest rate used on the hedged bonds and the rate used to compute payments on the hedge will not prevent the hedge from being an interest based contract if the two interest rates are substantially similar. Except for hedges in which the hedge provider's payments are based on an interest rate identical to that on the hedged bonds (resulting in perfect hedges that clearly result in a fixed yield), taxable index hedges are ineligible for super integration under the Final Regulations.

- Limitation on size and scope of qualified hedges; application to anticipatory hedges. The Final Regulations incorporate an express requirement limiting the size and scope of a qualified hedge to a level that is reasonably necessary to hedge the issuer's risk with respect to interest rate changes on the hedged bonds. The explicit limitation clarifies that certain leveraged hedges are not qualified hedges. The Final Regulations require this limitation be applied to anticipatory hedges based on the reasonably expected terms of the hedged bonds to be issued.

- Correspondence of payments for simple integration. For a hedge to be a qualified hedge, the payments received by the issuer from the hedge provider under the contract must correspond closely in time to either the specific payments being hedged on the hedged bonds or the specific payments required to be made pursuant to the bond documents. The Final Regulations provide that such payments will be treated as corresponding closely in time if the payments are made within 90 calendar days of each other.

- 15-day period to identify hedge. The 2007 proposed regulations introduced an extension of the time for an issuer to identify a qualified hedge from three days to 15 days and to clarify that these are calendar days. The Final Regulations finalize this extension and provide that the date on which the 15-day period begins is the date on which the parties enter into a binding agreement to enter into a hedge contract (as distinguished from the closing date of the hedge or start date for payments on the hedge, if different).

- Hedge provider's certificate. The Final Regulations include the requirement for a hedge provider's certificate on the theory that the hedge provider is uniquely positioned to validate pricing information needed to determine whether a hedge meets the requirements for being a qualified hedge. The certificate must include the following certifications: (a) the hedge transaction constitutes a bona fide, arm's-length transaction between a willing buyer and a willing seller; (b) the hedge provider has not made, and does not expect to make, any payment to any third party for the benefit of the issuer in connection with the hedge (except for those payments the hedge provider expressly identifies in the documents for the hedge); and (c) the amounts payable to the hedge provider pursuant to the hedge do not include any payments for underwriting or other services unrelated to the hedge provider's obligations under the hedge (except for those payments that the hedge provider expressly identifies in the documents for the hedge).

- Modifications and terminations. The Final Regulations offer further guidance on the accounting treatment of modifications and terminations of qualified hedges. The Final Regulations eliminate the existing standard that triggered terminations for offsetting hedges. The Final Regulations provide that a modification, including an actual modification, an acquisition of another hedge or an assignment, results in a deemed termination of a hedge if the modification is material and results in a deemed disposition under Code Section 1001.

  The Final Regulations simplify the treatment of deemed terminations to provide that a material modification of a qualified hedge (that otherwise would result in a deemed termination) does not result in such a termination if the modified hedge is a qualified hedge.

- Continuations of qualified hedges in refundings. The Final Regulations simplify the treatment of a qualified hedge upon a refunding of the hedged bonds when no actual termination of the associated hedge occurs. If the hedge meets the requirements for a qualified hedge of the refunding bonds as of the issue date of the refunding bonds, with certain exceptions, the Final Regulations treat the hedge as continuing as a qualified hedge of the refunding bonds instead of being terminated.

- Terminations of hedges at fair market value. The Final Regulations modify the amounts taken into account for a deemed termination or actual termination of a qualified hedge. They provide that the amount of a termination payment that may be taken into account for arbitrage purposes is the fair market value of the qualified hedge on the termination date based on all of the facts and circumstances.

Grants

By generally finalizing the 2013 proposed regulations on grants, the IRS has confirmed the following treatment of such issues:

- Proceeds spent when grant made. Proceeds will be treated as "spent" when the issuer makes the grant. It follows the grantee may use the funds to reimburse for expenditures not otherwise in compliance with the reimbursement regulations. Caution is still required for the determination of related and unrelated grantees – a grant is not "made" until the funds leave the hands of the issuer or a related party to the issuer.

- <u>Look-through for certain analysis points.</u> In addition to determining whether grant issue proceeds finance capital expenditures or working capital, the regulations now requires a "look-through" to review the use of the funds by the grantee for other criteria under the tax-exempt rules. Thus, private activity considerations apply to grantee financed facilities and other matters, such as the 120% test for issue maturity in comparison to financed facility life, have to be analyzed at the grantee level.

Miscellaneous

Not all the changes made or items confirmed by the Final Regulations were as important as the prior points. But they are worth noting.

(1) <u>Rebate computation credit.</u> The credit is $1400 per year from 2007 with a cost of living adjustment.

(2) <u>Small issuer exception for pool issues.</u> Small issuers may not ignore pool issues in determining if the $5 million limit is exceeded.

(3) <u>Working capital temporary period.</u> Corresponding with the above-described working capital rules, the 13 month working capital temporary period now includes restricted working capital.

(4) <u>Yield reduction payment rules.</u> If an issuer has an agreement to purchase investments on a date when the sale of SLGS is suspended, it may make yield reduction payments in lieu thereof. This includes hedged advance refunding bond issues. Also yield reduction payments may now be used for qualified student loan and qualified mortgage loan issues.

(5) <u>Yield calculation rules.</u> Joint yield computations for qualified student loan and qualified mortgage loan issues are no longer permitted. Also the "yield-to-call" bond provision in the yield calculation methodology was modified to confirm for such bonds the year used is determined by the lowest yield on that maturity, not the lowest yield on the issue.

(6) <u>Anti-abuse rules.</u> Changed the language about the Commissioner's authority to attack facially correct issues to the extent "necessary to clearly reflect the economic substance of the transaction." The new language is "to reflect the economics of the transaction to prevent such financial advantage." The language in the rules about working capital issues was modified to correspond with the previously described changes.

(7) <u>Certain guarantee programs.</u> Rules limiting amounts of issues guaranteed by certain trust funds were modified.

(8) <u>Definition of tax-advantaged.</u> The 2013 definition was confirmed but with "tax benefit" instead of "subsidy."

(9) <u>Tax-exempt and taxable issues as separate.</u> Confirmed separateness of tax-exempt and taxable issues of several types.

(10) <u>Effective dates of certain allocation rules.</u> A transition rule under the October, 2015, allocation and accounting rules was added for certain refunding issues.

(11) <u>Closing agreements.</u> Rev. Proc. 97-15 on closing agreements is now obsolete since the program under Notice 2008-31 is broader.

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