Rev. Proc. 2016-44: A Catalyst for Public-Private Partnerships?

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A discussion of the meaning and potential significance of IRS Revenue Procedure 2016-44 on the US public private partnership (P3) market.

The public private partnership (P3) model offers several potential advantages over the design-bid-build (DBB) method and other more traditional methods of public infrastructure procurement. It allows governments and public agencies to achieve innovative project design, obtain access to private capital, and realize "life-cycle" benefits that accrue with the transfer of long-term project operation and maintenance (O&M) risk to a private, for-profit project developer under a concession agreement (see Practice Note, Negotiating Concession Agreements for Public Infrastructure Projects (7-506-2112)). P3s have played an important role in international public infrastructure procurement for several decades by supplementing the resources of national governments and agencies with private capital and providing innovative design and life-cycle benefits.

FINANCING INFRASTRUCTURE IN THE US

The US, however, has historically taken a very different approach to much of its infrastructure development and finance. For more than a century, state and local governments ("public owners") have borrowed in the US municipal finance market to finance much of the country's public infrastructure, securing relatively low interest rates due to their creditworthiness and the tax-exempt status of interest on their borrowings. Unfortunately, Internal Revenue Code requirements have made it difficult for a public owner to borrow on a comparable tax-exempt basis and realize the life-cycle benefits that the P3 model offers (see Practice Note, Public Private Partnerships: Issues and Considerations: Advantages of PPPs (3-504-9995)).

In most P3 models (for example, design-build-finance (DBF) and design-build-finance-operate and maintain (DBFOM)), the private developer is responsible for financing project costs (see Practice Note, Public Private Partnerships: Issues and Considerations: Types of PPPs (3-504-9995)). That private, taxable financing is typically more expensive than the financing public owners can secure on a tax-exempt basis. Even though life-cycle benefits may be substantial and exceed any savings associated with a public owner's direct, tax-exempt financing of project costs, those benefits are less certain and more difficult to quantify than interest savings. These considerations can foster doubt as to the value of the P3 model and provide P3 skeptics with a facile argument against its use.

With the release of Revenue Procedure (Rev. Proc.) 2016-44 on August 22, 2016 (and amended on September 2, 2016) (2016-36 I.R.B. 316), public owners should face with less frequency the costly choice between using tax-exempt financing and capturing life-cycle benefits. This is because Rev. Proc. 2016-44 facilitates public owners' use of the P3 model in combination with the same type of direct, tax-exempt borrowing in the US municipal finance market that they could achieve using the DBB or a design-build (DB) model. The availability of tax-exempt financing comparable to that available under a DBB model should, therefore, eliminate any argument against the P3 model based on the difference in cost between tax-exempt public financing and taxable private financing.

While at first blush, Rev. Proc. 2016-44 would seem a powerful catalyst for widespread adoption of the P3 model, facilitating a potent combination of low-cost, tax-exempt financing and life-cycle benefits, it has yet to be hailed by P3 market participants as such a "game-changer."

US STATE AND LOCAL GOVERNMENT INFRASTRUCTURE FINANCING AUTHORITY

In the US, state and local governments have considerable legal authority and discretion, subject to constituent support, to do all of the following:

- Determine the type, amount and quality of their public infrastructure.
- Raise revenue from special assessments, taxes, and user charges to pay for infrastructure projects.
- Borrow money in anticipation of the collection of that revenue to finance projects.

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This legal authority is combined with an institutional framework and legal processes that have long provided a high degree of assurance that each of the following will occur:

- Levies will be imposed.
- Revenues will be collected.
- Debt obligations will be repaid.

Since the 1800s, this legal authority and institutional support have made US state and local governmental units among the most creditworthy borrowers globally and led to the creation of the US municipal bond market, a nationwide, public capital market through which public owners have efficiently, cost-effectively and readily raised massive amounts of capital for local infrastructure investment.

ADVANTAGES OF MUNICIPAL FINANCE

The credit strength of US state and local governments and security for repayment of their debt, coupled with the market's depth and liquidity, make it easier and less expensive for public owners to obtain infrastructure financing by borrowing directly in the US municipal finance market than for a private developer to borrow from banks or institutional investors. This is the case even if a private developer's project-specific borrowing is ultimately secured by a public owner's obligation to make payments to the developer under a concession agreement and, therefore, based to a significant degree upon the public owner's creditworthiness.

The public owner's financing advantage is magnified by the fact that, subject to compliance with Internal Revenue Code requirements, interest on debt issued by a public owner is excluded from the gross income of bondholders for federal income tax purposes (26 U.S.C. § 103). As a result of the tax savings, bondholders are willing to accept a lower interest rate when they invest in tax-exempt municipal bonds.

FEDERAL TAX REQUIREMENTS AND THE P3 MODEL

The Internal Revenue Code sets out requirements that must be satisfied for interest on debt issued by US state and local governments to be exempt from federal income tax. The rules and regulations are complex, detailed and lengthy, and deep experience and expertise with respect to their meaning and application, together with a thorough understanding of P3 structures and the P3 market, are required to fully appreciate their potential significance for use of the P3 model in the US. This Article analyzes and discusses the potential impact of Rev. Proc. 2016-44 on state and local government procurement and financing of public infrastructure in the US.

TYPES OF MUNICIPAL BONDS

Interest on a municipal debt obligation can generally qualify for exclusion from a bondholder's gross income for federal income tax purposes if either of the conditions set out below is met:

- Less than 10% of the proceeds of the bond-financed facility are used in the trade or business of a private entity ("private business use" limit).
- Less than 10% of the debt service on the bonds is payable from or secured by payments to be made by a private, for-profit entity or revenue generated in connection with that entity's use of the bond-financed facility (the "private payment/security" limit).

Municipal debt obligations that satisfy at least one of these limits are generally referred to as governmental bonds (Governmental Bonds) and interest on them is:

- Excluded from gross income for federal income tax purposes.
- Not subject to the federal alternative minimum tax (AMT) imposed on individuals and corporations.

The exemption from the AMT makes Governmental Bonds even more attractive to investors. As a result, the interest rates on these bonds are generally lower than if they were subject to the AMT.

If both the private business use and private payment/security limits are exceeded, the bonds are private activity bonds (PABs), and interest payable on them is subject to federal income taxation unless certain conditions are met. Regardless of whether those conditions are met and interest on the PABs is excluded from gross income for federal income tax purposes, interest on PABs is subject to the AMT.

(26 U.S.C. § 141 (a)-(b).)

PRIVATE ACTIVITY BONDS

Interest on a PAB is excluded from gross income for federal income tax purposes if both:

- The bond-financed facility is an "exempt facility" as narrowly defined in the Internal Revenue Code (26 U.S.C.§ 142).
- Certain other requirements are satisfied, including the allocation of limited federal "volume cap" equal to the amount of the bonds for certain types of exempt facilities.

To date, PABs comprise most, if not all, of the tax-exempt bonds issued to finance airport facilities, toll roads, and water and sewage facilities procured in the US using the P3 model. Use of PABs (rather than Governmental Bonds) has been required in these instances because long-term O&M obligations (which are a hallmark of most P3s) result in private business use and private payments/security in amounts exceeding the limits that must be satisfied to qualify for Governmental Bond financing. General government facilities do not typically qualify as "exempt facilities" for which tax-exempt PABs may be issued.

MANAGEMENT CONTRACTS

Public owners have often entered into management contracts with private, for-profit entities to operate and maintain facilities financed with tax-exempt Governmental Bonds, relying on "safe harbors" established in a series of IRS pronouncements to avoid creation of the "private business use" and "private payment/security" that would otherwise result from these agreements and cause them to be PABs. For many years, the municipal finance market relied on Rev. Proc. 97-13 for these safe harbors (1997-5 I.R.B. 18, 1997-1 C.B. 632, 1997 WL 8805).

To qualify for these safe harbors, Rev. Proc. 97-13 established formulaic restrictions on arrangements for compensation of private, for-profit managers and operators, and a maximum permitted term of 15 years for a qualifying agreement. However, fifteen years is much shorter than the term:

- The P3 market is accustomed to seeing with respect to the transfer of O&M obligations.
- Necessary to achieve the P3 model's O&M life-cycle risk transfer benefits.

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Although Rev. Proc. 97-13 was substantially broadened in Notice 2014-67 (2014-46 I.R.B. 822, 2014 WL 5406347) to provide a less formulaic approach to compensation arrangements, the maximum permitted term of a qualifying agreement remained 15 years.

SAFE HARBOR PROVISIONS OF REVENUE PROCEDURE 2016-44

Rev. Proc. 2016-44 moved substantially beyond Notice 2014-67 by extending the maximum permitted term of a qualifying management contract to 30 years. To qualify for this safe harbor, under this Revenue Procedure:

- The contract must:
  - provide only for "reasonable compensation" to the "service provider";
  - not give the service provider "a share of net profits" from the operation of the "managed property" (the portion of the project to which the services relate); and
  - not impose on the service provider the burden of bearing the share of any net losses of the managed property.
- The contract term, including renewal options, must not exceed the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property.
- The qualified user (i.e., the public owner) must exercise a "significant degree of control" over the managed property.
- The public owner must bear the risk of loss after damage or destruction of the managed property (subject to insuring that risk or requiring a third party to do so).
- The service provider must agree "not [to] take any tax position that is inconsistent with being a service provider," for example, by claiming depreciation regarding (and presumably ownership of) the managed property or by claiming a deduction for a payment as rent (and presumably classifying itself as a lessee of some or all of the managed property).
- The service provider must not have any role or relationship with the public owner that in effect "substantially limits" the public owner's ability to exercise its rights under the contract. This requirement is satisfied if there is compliance with each of the following:
  - certain individuals affiliated with the service provider (for example, directors and officers) do not control 20% or more of the voting power of the public owner's governing body;
  - the public owner's governing body does not include the service provider's chief executive officer (CEO) or its chairperson (or the equivalent) of the service provider's governing body; and
  - the CEO of the service provider is not the CEO of the public owner (or CEO of any entity related to the public owner).

Rev. Proc. 2016-44 articulates concepts for achieving the safe harbor that have long been understood. It follows Notice 2014-67 in abandoning the formulaic compensation rules of Rev. Proc. 97-13. Most importantly, it extends the permitted term of a qualifying agreement from 15 to 30 years, which, as discussed below, is the potentially "game changing" element of Rev. Proc. 2016-44.

APPLICATION TO P3 MODELS

Any conclusion that Rev. Proc. 2016-44's extension of the permitted term of a qualifying agreement is "game changing" is dependent on satisfaction of all of the foregoing requirements in any particular P3 model. A key differentiator between P3 models in the case of revenue generating projects is whether the public owner or the private developer assumes the risk (revenue risk) that revenues produced by the project will be sufficient to cover financing charges and meet O&M and scheduled capital replacement costs. If a private developer is asked to accept revenue risk, it will expect its compensation to be based, at least in part, upon the net profits or net losses of the managed property, which would preclude satisfaction of the Rev. Proc. 2016-44 requirements and use of Governmental Bonds.

Therefore, subject to exploration and potential development of hybrid models and regardless of whether a project is revenue generating, Rev. Proc. 2016-44 creates the greatest potential opportunity for increased use of Governmental Bond financing in the P3 context where the P3 model features availability payments and no part of the private developer's compensation is based upon net profits or losses of the managed property.

For more information on revenue risk and availability payments, see Practice Note, Public Private Partnerships: Issues and Considerations: Availability Based PPPs (3-504-9995).

P3 BENEFITS AND COMPATIBILITY WITH TAX-EXEMPT FINANCE

A P3 concession agreement typically includes an obligation on the part of the private developer to provide ongoing, timely maintenance and repair at a set price, as well as scheduled replacement of key components. That risk transfer has the beneficial effect of increasing the incentive for the private developer to design and engineer a facility that is capable of the most cost-effective long-term O&M. Moreover, when long-term O&M and capital replacement responsibilities are retained by the public owner, property upkeep tends to be dictated by fluctuating budget conditions and periodic election cycles that often results in irregular rehabilitation and reinvestment that is far more costly than regular maintenance and repair.

If properly maintained, most public infrastructure remains useful for many decades absent extraordinary changes in technology and patterns of social activity. The life-cycle for meaningful maintenance and capital replacement is thus measured in decades rather than years. This, together with the fact that, conceptually, it makes sense for the public owner to amortize the cost of risk transfer over the infrastructure's life cycle, has led to risk transfer under most P3 concession agreements for a minimum term of 30 years. Before the issuance of Rev. Proc. 2016-44 that length of risk transfer, a "sweet spot" for public owners and private developers, could not be achieved in combination with tax-exempt Governmental Bonds. Now, it can be.

INTEGRATING P3 AND US MUNICIPAL TAX-EXEMPT FINANCE

Two principal areas of concern have been raised regarding the meaning and impact of Rev. Proc. 2016-44 as applied to P3 structures. These are whether:

- Equity has a place in a model that includes Governmental Bonds and, if not, whether risk transfer to the private developer can effectively be achieved.
- Rev. Proc. 2016-44 imposes requirements that are simply incompatible in practice with the P3 model.

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MEANING AND ROLE OF EQUITY

The nature of equity in the P3 model can be confusing. In the context of project finance, equity often means the non-borrowed funding a developer contributes to finance a project owned by the developer (see Practice Notes, Project Finance: Overview (7-382-7004) and Advantages and Disadvantages of Project Financing (0-382-8846)). The term is used differently in the P3 model. In a P3 transaction, equity is the investment made (directly or indirectly) by private parties in the special purpose entity that contracts with the public owner to DBFOM infrastructure owned by the public owner. In the traditional DBFOM model, the equity is used by the private developer, together with money borrowed by the private developer, to pay project costs. The equity provides "first loss" protection for lenders to the private developer. The potential loss of equity also provides security to the public owner for performance by the private developer of its long-term O&M obligations.

There is no prohibition under the Internal Revenue Code on using both Governmental Bonds and the type of equity contemplated by the P3 model to finance the costs of a project. If a public owner issues Governmental Bonds to pay a portion of project costs, the balance of the costs can be funded by the private developer, whether from equity contributions by private investors in the private developer or money borrowed by the private developer. A public owner could, for example, commit to issue Governmental Bonds up to a fixed amount and invite consortia to make proposals to design-build-operate and maintain the project and provide any additional private financing required to pay project costs. The amount of private developer financing is a function of the total anticipated project construction cost. It is conceivable, given the lower financing cost associated with Governmental Bonds, that a public owner would issue Governmental Bonds in an amount sufficient to cover all of the upfront project costs. In this event, the private developer would not be required to raise any private capital, whether borrowed or equity, for that purpose. This raises two questions:

- Whether existing private sector P3 market participants would be willing to accept long-term transfer of O&M and scheduled capital replacement responsibility if the usually contemplated investment return on equity funding were not available.
- Whether the absence of private equity funding would essentially eliminate the security for the private developer's long-term performance of its obligations (i.e., its "skin in the game").

In response to the first question, there is no limit under the Internal Revenue Code (or otherwise) on the absolute amount of compensation a private developer may be paid for the long-term transfer of these responsibilities with respect to a project financed with Governmental Bonds (other than that the private developer receive no more than fair market value for its services, which would be presumed in an arms-length transaction).

Regarding the second question, the market must speak to whether other forms of security for a private contractor's performance, whether reserves, guarantees, performance security or insurance exist or are capable of being developed to cover this risk. Ultimately, the market must and undoubtedly will determine whether viable long-term O&M and scheduled capital replacement arrangements are feasible without private developer equity. As a legal matter, we believe these matters can be addressed successfully.

COMPATIBILITY OF THE NEW REVENUE PROCEDURE WITH P3 PRACTICE

The second general area of concern expressed regarding Rev. Proc. 2016-44 is whether certain conditions for a qualifying agreement are inconsistent with the P3 model as currently structured by market participants. In particular, Rev. Proc. 2016-44 sets forth a specific set of criteria for satisfying the governmental control requirement providing, in part, that the condition is satisfied if, among other matters, the public owner is "required to approve the annual budget of the [facility], capital expenditures with respect to the [facility], each disposition of property that is part of the [facility] [and] rates charged for use of the [facility] …." Some have read these to apply to all types of facilities and manner of P3 procurement.

We understand, however, based on discussions with the Internal Revenue Service as to the intent and meaning of Rev. Proc. 2016-44, as well as our experience with the application of Rev. Proc. 97-13 and subsequent guidance, that the stated criteria presume a particular set of facts and circumstances and are intended to provide only one means of satisfying the control requirement. A public owner is not precluded from otherwise satisfying the control requirement, especially where certain of the specified criteria are simply not relevant or consistent with the structure and objectives.

An example might be a social infrastructure facility that a private operator agrees to operate and maintain in consideration of a periodic availability payment. The private developer:

- Bears the risk of normal wear and tear through usage.
- Is responsible for accelerated repair and maintenance required by greater usage than anticipated.
- Is responsible for scheduled replacement of key mechanical components to meet hand-back requirements (which may be accelerated if required to satisfy performance obligations).
- Is responsible for the facility's ongoing availability and performance.
- Bears the risk of inflation beyond a certain level in the cost of supplies and subcontractor services.

In this example, there is no reason for the public owner to approve the private developer's annual budget and, subject to basic structural changes to the facility that could affect availability and performance, the public owner would not retain the right to approve or disapprove particular capital expenditures or dispositions. The public owner asserts control under the concession agreement from the outset and has no particular interest, given the private developer's absolute performance obligations, in the details of the developer's budget for operation and maintenance or when particular capital components should be replaced or removed. A knowledgeable representative of the IRS, albeit informally, has indicated that this type of arrangement is not incompatible with the standards of Rev. Proc. 2016-44.

As discussed earlier, Rev. Proc. 2016-44 prohibits a private developer from sharing net profits or the burden of net losses of a project. This is a common feature of revenue risk P3 models which precludes satisfaction of the safe harbor conditions. Accordingly, Rev. Proc. 2016-44 is most likely to promote expanded use of Governmental Bond financing in P3 models based on availability payments, although hybrid models, in which compensation to the private developer is based, at least in part, on gross revenues or

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gross expenses (but not both), may be worth exploring. For more information, see Application to P3 Models.

These are the only practical areas of concern we have heard expressed, or otherwise have identified, about whether Rev. Proc. 2016-44's requirements are consistent with existing market expectations regarding the structure of P3 arrangements.

IMPLICATIONS FOR THE P3 MARKET

Rev. Proc. 2016-44 offers US state and local governments a potentially powerful blend of tax-exempt Governmental Bond financing and access to life-cycle benefits under the P3 model. It is a welcome response by the IRS to state and local government efforts to address their pressing infrastructure needs. The market must speak, however, to the practicality of using Governmental Bond financing and achieving reliable, long-term operation and maintenance risk transfer. At a minimum, we anticipate increasing use of a combination of Governmental Bonds and the P3 model as:

- The US P3 market becomes more fully informed regarding tax-exempt financing requirements, including the impact of Rev. Proc. 2016-44.
- US state and local governments and the US municipal finance market continue to gain familiarity with the benefits of the P3 model.

Federal legislation targeted to encourage expanded use of tax-exempt finance with the P3 model would provide an even greater catalyst for that to occur. Until then, we have Rev. Proc. 2016-44 and must rely on the expertise and creativity of market participants to explore and evaluate the benefits available to state and local governments and private developers.

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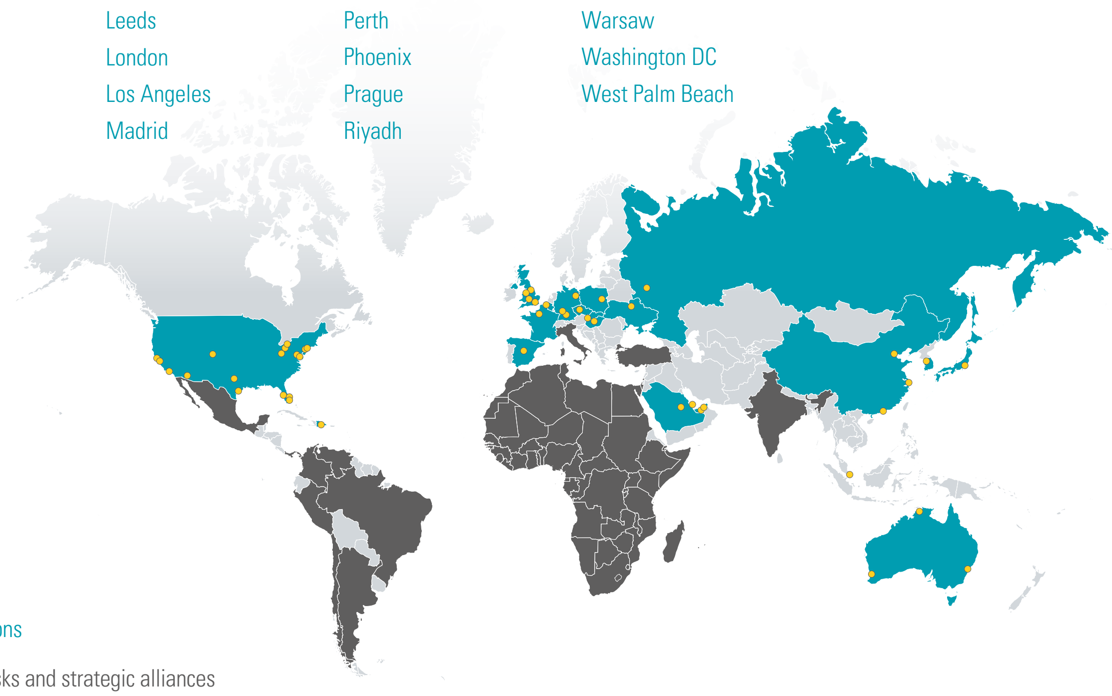

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