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Federal Tax Limitations on Private Business Use

This memorandum discusses certain federal income tax considerations relating to the financing of facilities by The University of Texas System with the proceeds of tax-exempt bonds. The rules relating to the use of the facilities and the source of payment of the bond issue are reviewed to determine whether the bonds are classified "private activity bonds".

Private Use Test. In general, interest on state or local bonds is exempt from federal income taxation only if the proceeds are used by governmental units. Limited exceptions to this rule apply to "private activity bonds." However, numerous additional federal income tax requirements come into play if bonds are classified as "private activity bonds". Whether a bond is a "private activity bond" depends upon the use of the proceeds of the bonds and the source of payment for debt service on the bonds. The private business test manifests itself in various forms. Any special contractual right to use a facility which grants rights to a private person which are superior to those of members of the general public constitutes private use. Thus, for example, the use of a facility by a lessee is private use. In particular, certain non-possessory, contractual rights can also cause private business use.

The general rule is that no more that ten percent (10%) of the proceeds may be used in a disqualified manner. A bond is tested both (1) on the date of issue, and (2) over the term. The tests are applied to analyze the character of the bond on the date of issue, based on how the issuer expects to use the proceeds and the bond-financed property. This is known as the "reasonable expectations" standard. The reasonable expectations standard will be the basis of the statement of expectations incorporated into the Federal Tax Certificate.

The tests also continuously are applied during the term of the bonds to determine whether there has been a deviation from those expectations. This is known as the "change of use" standard. The regulations contemplate the possible change by providing certain remedial actions to preserve the tax-exempt status of the bonds. If a change of use, i.e., a disposition or other disqualified use, occurs in connection with bond-financed property, then the issuer is required to undertake certain remedial action. In effect, the issuer is required either (1) to provide alternate property which qualifies for bond financing, or (2) to retire a portion of the bonds. Depending on the nature of the change of use, the amount of bonds subject to the remedial action is equal to either the disposition proceeds or, if the disqualified use is not caused by a sale of the bond-financed property, the fair market value of the disqualified use.

Space Utilization. The sale of a bond-financed facility to a non-governmental person would cause a private business use problem if that facility involved the use of more than ten percent (10%) of the bond proceeds. Since state law often prohibits a governmental issuer from lending credit, this circumstance generally does not occur. Leases, however, also can be a problem because such arrangements grant a possessory interest in the facility which results in the lessee receiving a right to use the facility which is

superior to members of the general public. The question is whether the benefits and burdens of ownership have transferred to the private user, as in the case of a sale or lease, or, as will be discussed later in the memo, whether such benefits and burdens have been limited in such a way as to permit the use to be disregarded, as in the case of certain management agreements, cooperative research agreements or other beneficial use agreements. If these benefits and burdens have not transferred, such use may be disregarded for purposes of measuring private business use.

Private business use is measured on a bond issue or facility basis. For this purpose, the ten percent (10%) limitation on bond-financed property is measured based on any reasonable and consistently applied method. On a bond issue basis, the proceeds of the bond issue are allocated to private and governmental (or public) use of the facility to determine the amount of private business use over the term of the bond issue. On a facility basis, such use is generally measured by relative square footage, fair market rental value, percentage of cost allocable to the private use or by relative time of usage. As an example of one such method, the ratio of rentable square footage (not including common areas) or, in some cases, the relative fair market values of the differing public and private interests in the property are compared. In the case of time, on the other hand, the relative number of days or hours of public or private use are measured (noting that any periods during which the facility is not used by any such party are disregarded). Thus, if a stadium or arena is used by a school team for 180 days a year and by a professional team for 30 days a year, then the professionals team's use exceeds 10 percent (i.e., 30 days / 210 days = 14%).

Special Agreements. Under some circumstances, agreements which otherwise might be treated as transferring benefits and burdens by virtue of granting superior interests in the property, e.g. management contracts and cooperative research contracts, can be disregarded. This is because the IRS has established safe-harbor limitations that, if met, will be deemed such use to be incidental to the use by the governmental issuer. Notably, where there is such a qualifying agreement then no private use results and the income derived from such enterprise is not treated as disqualified for purposes of measuring the use of proceeds. Therefore, without regard to the amount of income received by the issuer from these agreements, no adverse federal tax consequences to the bonds results. To the extent an agreement does not meet the Private Use and/or Space Utilization tests described above, it may still *not* result in private business use if other agreement-related IRS safe harbors are met, as further described below.

Management Contracts. The following types of agreements are specifically described by the tax regulations as *not* resulting in private business use:

- Contracts for services incidental to the facility's primary functions (e.g., janitorial services);
- The granting of hospital admitting privileges to a doctor, in certain cases;
- Contracts for operation of public utility property (e.g., water and wastewater systems, electric systems), if compensation is limited to reimbursement for direct expenses and reasonable overhead of the service provider; or
- Contracts for services, if compensation is limited to reimbursement for direct expenses paid to unrelated third parties.

Otherwise, having a private manager will give rise to private business use unless there exist certain terms of the management contract which demonstrate that beneficial use has not been passed to the manager. The primary focus of these management contract rules is on the manager's compensation and the length of the contract's term. In general, the manager's compensation must be reasonable and not be based, in whole or in part, on a share of net profits. The management contract will avoid private business use treatment if it falls within one of the five safe harbors, as follows:

- *95% Periodic Fixed Fee Arrangement* – 95 percent of annual compensation for services is a fixed amount, and term is not more than the lesser of 15 years or 80 percent of expected useful life;

- *80% Periodic Fixed Fee Arrangement* – 80 percent of annual compensation for services is a fixed amount, and term is not more than the lesser of 10 years or 80 percent of expected useful life;

- *50% Periodic Fixed Fee Arrangement* – 50 percent of annual compensation for services is fixed or based on a capitation fee or both, and term is not more than 5 years and is terminable by user in 3 years;

- *Per-Unit Fee Arrangement* – 100 percent of compensation for services is based on a per-unit fee or a fixed fee or both, and term is not more than 3 years, terminable by user in 2 years; and

- *Percentage of Revenue or Expense Fee Arrangements* – 100 percent of compensation for services is based on a percentages of fees charged or on a combination of a per-unit fee and a percentage of revenues or expenses, and term is not more than 2 years and is terminable by user in 1 years (only allowed for contracts where services are provided primarily to third parties, or contracts during an initial start-up period where reasonable estimates of revenues and expenses are unavailable).

In general, the reimbursement of the manager for direct out-of-pocket expenses is not considered as compensation. Therefore, these costs can be excluded from consideration of the compensation structure.

Finally, the manager may not have any role or relationship with the governmental unit that would limit the ability of the governmental unit to exercise its rights under the contract. Any voting power of either party which is vested in the other party, including its officers, directors, shareholders and employees, may not exceed twenty percent (20%). Further, the chief executive officer of either party may not serve on the governing board of the other party. Similarly, the two parties must not be members of the same controlled group or be related persons, as defined in certain provisions of federal tax law.

Cooperative Research Agreements. A cooperative research agreement with a private sponsor whereby the private party uses bond-financed facilities may cause a private business use problem. Nevertheless, such use of a bond-financed facility by a non-governmental person is to be

disregarded for purposes of private business use if the arrangement is in one of the following forms. First, the arrangement may be disregarded if the sponsoring party is required to pay a competitive price for any license or other use of resulting technology, and such price must be determined at the time the technology is available. Second, an arrangement may also qualify if a four-part requirement is met: (1) multiple, unrelated industry sponsors must agree to fund university-performed basic research; (2) the university must determine the research to be performed and the manner in which it is to be performed; (3) the university must have exclusive title to any patent or other product incidentally resulting from the basic research; and (4) sponsors must be limited to no more than a nonexclusive, royalty-free license to use the product of any such research.

Gifts and Naming Rights. It generally is considered that the naming of a bond-financed facility in honor of a donor is not, in and of itself, viewed as use. However, the grant of intangible rights in connection with a bond-financed facility, such as a right to the use of the name, can be treated as private business use. As such, receipt of a gift, in and of itself, does not result in use.[1] A gift generally is conceded to mean a voluntary payment motivated by disinterested generosity. Generally, no consideration is received by the donor. Where the recipient of the gift names the bond-financed facility in the honor of the donor, it does not convey a legal right to the donor nor does it oblige the recipient to assure the donor of the continued use (absent some restriction in the gift). A gift may be deductible as a charitable contribution and the amount of the gift so deductible by the taxpayer may be limited in any taxable year.

On the other hand, the sale of naming rights is characterized by a payment made in consideration for the receipt of an enforceable contractual right. There is one federal tax document discussing the treatment of naming rights. This document describes a number of aspects of this type of contractual use. For example, in the case discussed, the official name was used in all advertising published in connection with the bond-financed facility, the contract was negotiated at arm's length and the amount paid by the naming party was equal to the fair market value of the rights received. A contractual payment may be deductible as a business expense and the amount deducted in any taxable year generally is not subject to a limit.

If the payment constitutes consideration for the sale of a naming right, then use will result. If the payer is engaged in a trade or business then the use is private business use. In order to avoid adverse federal tax consequences for the Bonds, the amount of such use must be limited to no more than ten percent (10%) of the proceeds used for the bond-financed facility. Since the IRS has determined that the amount of the use is equal to the fair market value, then the payment received should be

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[1] If the payment constitutes a gift, then there is no issue as to whether the donor is a user of the bond-financed facility. However, there may be some arbitrage considerations. If the gift is not restricted, then no federal arbitrage consequence arise for the bonds until such time as the institution expects to use the gift to pay debt service. If the use of the gift is actually or implicitly restricted by the donor, then the courts have concluded that the gift must be used for the purpose intended by the donor. If the gift is solicited for the purposes of defraying the cost of a bond-financed facility, then courts require that the gift be used either to pay a portion of the cost of the bond-financed facility not otherwise borrowed or to retire a portion of the bonds. In the former case, there are no federal arbitrage restrictions. In this latter case, the institution will have no choice except to use the gift to pay debt service and, as such, the gift is subject to the federal arbitrage limitations.

equal to the amount of use. So, for example, if the institution receives a payment of ten dollars ($10.00) and the cost of the bond-financed facility is equal to one hundred dollars ($100.00), then the amount of private business use is equal to ten percent (10%). If that use, together with all other private business use, exceeds ten percent (10%), then interest on the Bonds would be taxable. There are two ways to avoid this problem. The institution either (a) could use the payment to defer a portion of the cost of the bond-financed facility, e.g., use ninety dollars ($90.00) of proceeds of the Bonds and ten dollars ($10.00) received from the payer, or (b) issue taxable obligations and pledge the naming right payment to secure the debt service on the taxable obligations, e.g., use ninety dollars ($90.00) of proceeds of the Bonds and ten dollars ($10.00) received from the issuance of the taxable obligations.

How Much "Bad Use" is Too Much? In general, there is too much private business use if an amount in excess of 10 percent of the proceeds of the bond issue are used, directly or indirectly, in a trade or business carried on by persons other than governmental units, and other than as members of the general public. All trade or business use by persons on a basis different than that of the general public is aggregated for the 10 percent limit. In addition, if the private use is considered "unrelated or disproportionate" to the governmental purpose for issuance of the bonds, the private business use test is met if the level of the prohibited private use rises to five percent (5%) . The "unrelated" question turns on the operational relationship between the private use and use for the governmental purpose. In most cases, a related use facility must be located within or adjacent to the related governmental facility, e.g., a privately-operated school cafeteria would be related to the school in which it is located. Whereas, the use of a bond-financed facility as an administrative office building for a catering company that operates cafeterias for a school system would not be a related use of bond proceeds. Nonetheless, even if a use is related, it is disproportionate to the extent that bond proceeds used for the private use will exceed proceeds used for the related governmental use.

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