OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated February 4, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A	=
State	=
City	=
County	=
C	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Year 1	=

Year 2	=	
a%	=	
$b	=	
$c	=	
d	=	
$e	=	
Series A Bonds	=	
Series B Bonds	=	

ISSUE(S):

1. Whether a private corporation's operation of a correctional facility constructed with the proceeds of bonds that are purportedly tax-exempt results in private use.

2. Whether a private corporation's guarantee of the payment of debt service on the bonds satisfies the private payment or security test.

3. Whether an examining agent should rely on the Trust Indenture or the Official Statement when the two documents are inconsistent with respect to the property that secures payment of debt service on the bonds.

CONCLUSION:

1. There is insufficient information to determine if the corporation's operation of the correctional facility resulted in private use. The exact amount of the corporation's compensation, the method for calculating such compensation and the actual services provided must be determined before evaluating whether the corporation's compensation is permissible.

2. Based on the corporation's guarantee of debt service, it appears that the private payment or security test may be met. However, before a final determination is made with respect to this issue, it is necessary to review the documentation related to the transaction to clarify the terms of the guarantee.

3. The Trust Indenture is the legal document that establishes the trust estate to secure payment and debt service on the bonds. In contrast, the Official Statement is an offering document that discloses to prospective buyers the material

terms of the bonds. While the two documents serve different purposes, from an examination standpoint, they are both useful in that they provide information as to the substance of the financing. With respect to the instant case, however, the two documents do not appear inconsistent.

FACTS:

The facts, as stated below, are based solely on the representations in your memorandum.

A was formed in Year 1 under State's Nonprofit Corporation Act. A is a mutual benefit corporation with its principal office located in City. A has one member, County.

C is a publicly traded corporation with headquarters in City. C is in the business of managing prisons for governmental entities.

On Date 1, A adopted and approved a resolution for the issuance of tax-exempt bonds for the purpose of constructing a medium security correctional facility (the "Facility") in County. It was intended that bonds would be issued in Year 1, but the financing was delayed due to litigation resulting from community resistance to the construction of the Facility.

A Preliminary Limited Offering Memorandum dated Year 1 provides that the payment of principal and interest and premium, if any, on bonds issued to construct the Facility will be guaranteed by C. The Preliminary Limited Offering Memorandum also states that C will unconditionally guarantee to the trustee the full and prompt payment of the principal and interest and premium on the bonds. As a result of C's guarantee, the bonds were not offered to the public.

On Date 2, the Series A Bonds were issued in the amount of $b. On Date 3, A's board of directors approved a resolution to issue additional bonds for construction related to the Facility. Subsequently, on Date 4, the Series B Bonds were issued in the amount of $c.

The Official Statements for the Series A and Series B Bonds (collectively referred to as "the Bonds") provides that A has pledged the gross revenues of the Facility to pay the principal or redemption price, interest and expenses of the Bonds. The Official Statements also provide that the Trust Estate for the Bonds includes any deficit agreements in which A has rights. Further, the Official Statements provide that the security for the Bonds includes amounts pledged pursuant to a Deficit Agreement executed by A and C. Pursuant to the Official Statements, C is responsible during the term of the Management Agreement with A, as described below, for the payment of all expenses in the construction of the Facility, including the payment of all debt service incurred to finance the construction of the Facility.

On Date 5, C entered the Debt Service Deficit Agreement with A. Pursuant to that agreement, C agrees to pay to the Trustee on behalf of the Issuer, to the extent amounts are not otherwise available under the Bond Indenture for that purpose, the full and prompt payment of moneys sufficient to pay any debt service deficits consisting of (1) principal on the Bonds when the same become due on stated maturity dates and on mandatory sinking fund installment dates as provided in the Indenture, (2) interest on the Bonds semi-annually, and (3) in the event State exercises its option to purchase the Facility from the Issuer, the difference between the principal and interest owing on the Bonds on the date set for redemption of the Bonds and all amounts paid by the State for the Facility and deposited with the Trustee and all other funds on deposit with the Trustee and available for such purpose on the date for the redemption of the Bonds to pay the redemption price of the Bonds to be redeemed. The Debt Service Agreement was amended so that it would also apply to the Series B Bonds

On or about Date 6, A and C entered into the Management Agreement whereby C agreed to construct and manage the Facility. The Facility opened in Year 2 and has a capacity of d beds. Under the agreement, A receives all revenue from the operation of the Facility. C is entitled to the operating per diem payments set forth under the State Incarceration Agreement, described below, in addition to amounts negotiated for other services. For other incarceration contracts, A and C negotiate a fixed fee per diem rate. C may provide additional services for unspecified additional compensation. The term of the contract between A and C is three years from the Service Commencement Date, which is Date 7, and may be extended for two additional years. The operating per diem payments due to C under the Management Agreement are purportedly net of the amount required to pay principal, premium, if any, and interest on the Bonds.

On Date 7, A leased the Facility to County. County, in turn, entered into Incarceration Agreement with State for the placement of State inmates at the Facility. As stated above, State pays a per diem amount for its use of the Facility. The Incarceration Agreement provides that the obligations of County may be performed in whole or in part by subcontractors.

If the State requires less than 100 percent of Facility's capacity, C can solicit contracts from other jurisdictions. C is liable for any shortfall in revenues available to A necessary to meet its debts service obligation on the Bonds.

In addition, if C is required to make any payments of debt service under the Debt Service Agreement, A is required to terminate any management contract with an operator of the Facility other than C and contract with C to manage the Facility pursuant to a "qualifying management contract."

The Official Statement grants State the right to purchase Facility according to a set schedule. During each period in which the option is exercisable, the purchase price of the Facility is less than the scheduled principal indebtedness outstanding on the Bonds during the corresponding period. If State exercises the option to purchase the Facility, the Bonds are subject to mandatory redemption at the redemption price equal to 100% of the principal amount, plus interest.

An undated letter from A to C states that in recognition of exemplary performance in operating the Facility, C is to receive additional compensation in the amount of $e as additional management fees.

LAW AND ANALYSIS

1. Private Use

Section 103(a) of the Code[1] provides, in part, that except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(b) provides that the exemption provided by subsection (a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of section 141).

Section 141(a) defines the term "private activity bond" as any bond issued as part of an issue that meets the private business use test of section 141(b)(1) and the private security or payment test of section 141(b)(2).

Section 141(b)(1) states that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(6) defines private business use as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. Use as a member of the general public is not private use.

Section 141 was added to the Code by the Tax Reform Act of 1986 (the "1986 Act") and generally applies to bonds issued after October 13, 1987. The legislative history to the 1986 Act, H.R.Rep. No. 426, 99th Cong., 1st Sess. 521 (1985), 1986-3 (Vol.2) C.B. 521 (the "House Report"), indicates that the rules established under prior law to determine when bond proceeds are used by persons

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[1] All Code references are to the Internal Revenue Code of 1986 unless specifically stated otherwise.

other than governmental units generally apply under section 141 of the Code. Thus, a person may be a user of bond proceeds under section 141 as a result of (1) ownership of bond-financed property, (2) actual or beneficial use of the property pursuant to a lease, a management or incentive payment contract, or certain other arrangements such as a take-or-pay or other output-type contract.

With respect to a contract between a private management or other service company and a governmental unit to operate bond-financed governmental facilities, section 1301(e) of the 1986 Act indicates that such use generally is not treated as trade or business use by a private person provided (1) the term of such contract (including renewal options) does not exceed 5 years, (2) the exempt owner has the option to cancel such contract at the end of any 3-year period, (3) the manager under the contract is not compensated (in whole or in part) on the basis of a share of net profits, and (4) at least 50 percent of the annual compensation of the manager under such contract is based on a periodic fixed fee.

Final regulations under section 141, published on January 16, 1997, provide guidance on whether a management contract with respect to bond-financed property results in private business use. Specifically, Treas. Reg. § 1.141-3(b)(4)(i) provides that a management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility. The determination as to whether a management contract (within the meaning of section 1.141-3(b)(4)(ii)) with respect to financed property results in private business use is based on all the facts and circumstances. Id.

The final regulations under section 141 are generally applicable only to bonds issued on or after May 16, 1997. As noted above, the Series A and Series B bonds were issued prior to the effective date of the regulations. Moreover, there is no indication that there was an election to apply the final regulations to this transaction. However, while the final regulations may not be controlling with respect to the arrangement at issue, the rules enunciated are instructive in evaluating the current arrangement in that the regulatory language reiterates the basic principles set forth in section 1301(e) of the 1986 Act.

Moreover, simultaneously with the publication of section 1.141-3 of the regulations, the Service issued Rev. Proc. 97-13, 1997-5 I.R.B. 18, which mirrors much of the language of section 1.141-3 and sets forth certain operating guidelines for contracts to manage bond-financed facilities. If those guidelines are satisfied, a management contract will not cause the facilities to be treated as used in a private business use. While Rev. Proc. 97-13 is generally effective for any management contract entered into, materially modified, or extended (other than pursuant to a renewal option) on or after May 16, 1997, an issuer may apply the revenue procedure to any management contract entered into prior to May 16, 1997.[2]

Under section 3.03 of Rev. Proc. 97-13, the term management contract means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. A contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

Section 5.02(1) of Rev. Proc. 97-13 provides that, to meet the safe harbor, a contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the managed facility. Arrangements that are generally not considered to be based on a share of net profits include those where compensation is based on: (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; (b) a capitation fee[3]; or (c) a

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[2] Prior to the issuance of Rev. Proc. 97-13, Rev. Proc. 93-19, 1993-1 C.B. 526, contained advance ruling guidelines for determining whether a management contract results in private business use under section 141(b) of the 1986 Code. That revenue procedure, obsoleted upon the effective date of Rev. Proc. 97-13, applies to any service contract entered into, materially modified, or extended (other than pursuant to a renewal option) after March 15, 1993. The permissible compensation arrangements delineated in Rev. Proc. 93-19 are repeated in Rev. Proc. 97-13, along with several additional compensation arrangements. As Rev. Proc. 97-13 is generally less restrictive than Rev. Proc. 93-19 and since issuers may apply Rev. Proc. 97-13 to contracts entered into prior to May 16, 1997, our analysis of the current arrangement is based primarily on the provisions of Rev. Proc. 97-13.

[3] Section 3.02 of Rev. Proc. 97-13 defines a capitation fee to mean a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially. For example, a capitation fee includes a fixed dollar amount payable per month to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified period. A capitation fee may include a variable component of up to 20 percent of the total capitation fee designed to protect the service provider against risks such as catastrophic loss. The definition is essentially identical to that provided in Rev. Proc. 93-19.

per-unit fee.[4] Section 5.02(1) further provides that reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated third parties is not by itself treated as compensation.

Section 5.02(3) of Rev. Proc. 97-13 provides that a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract generally does not cause the compensation to be based on a share of net profits.

A permissible compensation arrangement under Section 5.03 of Rev. Proc. 97-13 includes an arrangement where at least 95 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. Section 3.05 of the revenue procedure defines a periodic fixed fee as a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 15 years. For purposes of this section, a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount. Section 5.03(1).

The safe harbor also permits certain arrangements where at least 80 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. Section 5.03(2). The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 10 years. For purposes of section 5.03(2), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which

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[4] A per-unit fee is defined as a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fee arrangements.

compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

The safe harbor also includes certain arrangements where either at least 50 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee or all of the compensation for services is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee. Section 5.03(4). The term of the contract, including all renewal options, must not exceed 5 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term. Id.

In addition, to satisfy the safe harbor requirements, the service provider may not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under the contract, based on all the facts and circumstances. See Section 5.04. This requirement is satisfied if (a) not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees; (b) overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and (c) the qualified user and the service provider under the contract are not related parties, as defined in section 1.150-1(b).

Based on the information provided, it appears that compensation under the Management Agreement is based primarily on the per diem payments paid by State for retaining prisoners at the Facility. If State utilizes less than 100 percent of the Facility, C may obtain prisoners through contracts with other jurisdictions. In such cases, however, C's compensation is still based on a fixed per diem rate negotiated between A and C. The Management Agreement allows for additional compensation to C upon the furnishing of additional services, but neither the type of services nor the manner of computing the additional compensation is specified.

While, facially, the payments to C may share similarities with both periodic fixed fees and capitation fees in that the payments are based on a per diem amount, it also appears that the compensation to C is net of certain expenses. In particular, the facts indicate that the per diem payments under the Management Agreement are net of the amount needed to pay debt service on the bonds. Thus, the fees may not qualify as either periodic fixed fees or capitation fees as defined by Rev. Proc. 97-13 and may be based on the net profits of the Facility. Moreover, although the contract provides for compensation for additional services rendered by C, neither the type of additional services nor the manner of calculating compensation for such services is specified.

In addition, C was purportedly paid an additional $e due to its “exemplary performance” operating the Facility. While section 5.02(3) of Rev. Proc. 97-13 allows for certain productivity rewards, there is simply no information to determine how the additional amount to C was calculated and whether the payment meets the requirements of section 5.02(3). Accordingly, additional information regarding the specific services provided by C and the method of calculating the compensation for such services is needed to further analyze the nature of the compensation in question.

Further information regarding the term of the Management Agreement is also needed. The available facts indicate that the contract with C has a term of five years with renewals. However, there is no indication as to whether the contract is terminable by a qualified user[5] on reasonable notice, without penalty or cause, at the end of the third year of the contract term. Such termination provision is required under Rev. Proc. 97-13 if additional facts reveal that either at least 50 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee or all of the compensation for services is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee.

In addition, there are no facts to indicate that C will have a role or relationship that substantially limits, directly or indirectly, A’s ability to exercise its rights under the Management Agreement. There is no information that A and C have overlapping boards of directors or that they are related parties within the meaning of Treas. Reg. § 1.150-1(b). See Rev. Proc. 97-13, § 5.04.

Moreover, the provision which requires A to terminate a management contract with an operator of the Facility other than C if C is required to make any payments of debt service indicates, at the very least, that there may be a period of time when C does not operate the Facility.

Finally, while additional information is necessary to properly consider whether the safe harbor requirements have been met, a failure to satisfy Rev. Proc. 97-13 is not necessarily determinative. As stated, all facts and circumstances must be considered to determine whether the contract at issue results in private business use. That stated, we are willing to supplement our advice with respect to this issue once additional information has been obtained.

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[5] For purposes of Rev. Proc. 97-13, a qualified user means any state or local governmental unit as defined in section 1.103-1 of the regulations or any instrumentality thereof. The term also includes a section 501(c)(3) organization if the financed property is not used in an unrelated trade or business under section 513(a) of the 1986 Code. Section 3.07.

2. Private Security/Private Payment Test

Section 141(b)(2) provides that an issue meets the private security or payment test if the payment of the principal of or the interest on more than 10 percent of the proceeds of such issue is directly or indirectly (i) secured by any interest in property used or to be used for a private business use, or payments in respect of such property, or (ii) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

The private security or payment test of section 141 was enacted as part of the 1986 Act. Under the test, both direct and indirect payments made by any person (other than a governmental unit) who is treated as using the bond proceeds are counted. Such payments are counted whether or not they are formally pledged as security or are directly used to pay debt service on the bonds. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-688 (1986), 1986-3 (Vol. 4) C.B. 688.

Section 103(b) of the Internal Revenue Code of 1954 provided similar rules regarding private business use and private payments. Under former Treas. Reg. § 1.103-7(b)(4), the security interest test can be met by the terms of the bond indenture or by an underlying arrangement. The underlying arrangement can result from separate agreements between the parties or from all the facts and circumstances of the issuance.

In the instant case, the Preliminary Limited Offering Memorandum, the Official Statements for the Bonds, the Debt Service Agreement and the Management Agreement all purportedly reference C's obligation to pay debt service on the Bonds in the event revenues from the Facility are insufficient. While it appears that the private security or payment test may be met, the terms of C's guarantee must be clarified before a final determination is made.

Further, advice was requested as to whether the bonds at issue are governmental bonds or private activity bonds. Generally, governmental bonds means an issue of State or local bonds if, as of the date of issue, either the interest on the issue is excluded from gross income under section 103(a) of the Code and none of the bonds are private activity bonds under section 141(a) of the Code. As stated, a private activity bond is any bond that meets the private business use test of section 141(b)(1) and the private security or payment test of section 141(b)(2).

As there is insufficient information to determine if the private business tests are met, the classification of the Bonds as either governmental or private activity bonds must await the resolution of these issues.

3. Conflict Between Bond Documents

In addition to the above, advice was requested as to the legal weight to be accorded particular documents in the bond transcript, particularly in situation where conflicts between the Official Statement and Trust Indenture exist.

As a general rule, the preliminary official statement and the official statement are offering documents. The official statement discloses to prospective buyers the material terms of the offering. The information provided in the official statement is regulated by the Securities and Exchange Commission.

In contrast, the Trust Indenture is one of the basic legal documents prepared in connection with a bond issuance. The Indenture is a contract between the issuer and the bond trustee. It is the Indenture which provides for the creation of the trust estate to secure payment and debt service on the bonds. In the event of a default, bondholders look only to items specified as part of the trust estate. See Examination Guidelines for Municipal Financing Arrangements, Ann. 95-61, 1995-32 I.R.B. 54.

With respect to the instant transaction, there is a suggestion that there is a conflict between the Trust Indenture and the Official Statement. Specifically, the Indenture indicates that A pledges the revenues of the Facility to pay debt service on the Bonds while the Official Statement provides that C guarantees the payment of debt service. Viewed in isolation, these provisions may appear inconsistent. Considering the financing as a whole, however, the documents do not appear to conflict.

In addition to the provision mentioned above, the Official Statement also provides that C is liable only to the extent amounts are not otherwise available under the Indenture for debt service. In addition, compensation to C under the Management Agreement is net of the amounts required to pay the debt service on the Bonds. The Debt Service Agreement, A's rights to which are pledged to the trust estate, clarifies that C is liable for any deficit in funds available to A for debt service on the Bonds. Rather than conflicting, these provisions clarify that debt service on the Bond is to be paid from the revenues generated from the operation of the Facility and C is liable for any resulting deficit.

Although apparently not an issue in the present case, conflicting statements in bond documents should not be ignored on the premise that one document carries greater legal weight than another. For examination purposes, all relevant documents should be considered. For example, although the Indenture is the legal document that creates the trust estate and the document that bondholders will look to in the event of default, the private payment test for purposes of section 141 may be satisfied by the existence of any underlying arrangement. In addition, the

Official Statement, serves as an important starting point for understanding the basic details of the financing. Inconsistent statements in documents, even if not documents typically viewed as part of the bond transcript, may provide evidence that the economic reality of the financing does not reflect its purported form.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As discussed, there is insufficient information to determine if the private business tests are met. To clarify this issue, it is not only necessary to review all contracts and agreements related to this transaction, but the agent must determine the extent of services provided by C and the manner in which total compensation is computed. [redacted]

[redacted] That stated, you should also ascertain whether the issuer elected into the final regulations under section 141. Such a determination will assist with the final evaluation of this transaction. As stated, we will be glad to supplement this advice once you have obtained additional information.

Please call if you have any further questions.

By: ______________________________
JOEL E. HELKE
Branch Chief
Financial Institutions & Products