Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Telephone Number:

Refer Reply To:
CC:FIP:B05
PLR-100245-22

Date:
May 03, 2022

LEGEND:

Issuer =

Service Provider =

State =

Hotel =

Bonds =

a =

b =

c =

d =

e =

f =

g =

h =

FY1 =

FY2 =

FY3 =

FY4 =

Date =

Dear :

This letter is in response to a request for a ruling dated December 9, 2021, and subsequent correspondence, submitted on behalf of Issuer, that a proposed agreement between Issuer and Service Provider with respect to the management of the Hotel ("Agreement"), will not result in private business use of the Hotel under § 141(b) of the Internal Revenue Code (Code).

Facts and Representations

According to the information submitted and representations made, Issuer was formed under State law to function as an instrumentality of State for the purpose of economic development of State. Issuer was authorized under State law to issue bonds on behalf of State as a constituted authority.

Issuer owns the Hotel. Issuer issued the Bonds on Date, the proceeds of which were used in part to refund prior bonds that financed the Hotel. The Hotel is operated and managed by Service Provider, a third-party entity not related to Issuer.

Under the Agreement, to compensate Service Provider for management services provided with respect to the Hotel, Issuer will pay Service Provider a management fee consisting of three components (collectively, "Management Fee"). First, Issuer will pay Service Provider on a monthly basis a hotel services fee ("Hotel Services Fee"), based on a tiered percentage of the gross revenue from the Hotel operation each fiscal year. As more specifically provided under the Agreement, the Hotel Services Fees will be in an amount equal to *a*% of the gross revenue of the Hotel for each fiscal year through FY1. For FY2, if the gross revenue of the Hotel is at or below $*b*, the Hotel Services Fee will be *a*% of the gross revenue of the Hotel, and, if gross revenue of the Hotel is at or below $*c*, but above $*b*, *d*% of the gross revenue of the Hotel. For FY3, if the gross revenue is at or below $*e*, the Hotel Services Fee will be *a*% of the revenue of the Hotel, and, if the gross revenue of the Hotel is at or below $*c*, but above $*e*, *d*% of the gross

revenue of the Hotel. For FY4 and the fiscal years through the end of the term of the Agreement, if the gross revenue of the Hotel is at or below $*f*, the Hotel Services Fee will be *a*% of the gross revenue of the Hotel, and, if the gross revenue of the Hotel is at or below $*c*, but above $*f*, *d*% of the gross revenue of the Hotel. Notwithstanding the foregoing, in any fiscal year in which the gross revenue of the Hotel exceeds $*c*, the Hotel Services Fee for such year will be *g*% of the gross revenue of the Hotel.

Second, Issuer will reimburse Service Provider for operating expenses with respect to the Hotel operation and management, including Service Provider's employee costs, such as employee salaries, fringe benefits, incentive compensation, bonuses, employee performance and service awards, and other operating expenses from the gross revenue of the Hotel operation.

Incentive compensation and bonuses to senior management employees of Service Provider are evaluated based on formulas used to measure performance of the Hotel, by factors such as the Hotel's financial performance, guest experience, and individual goals. Incentive compensation and bonuses to senior management employees are payable on a yearly basis as a percentage of the respective employees' salaries, subject to Service Provider's discretion.

Third, Issuer will reimburse Service Provider for the Hotel's allocable share of the costs of the various system services Service Provider provides, such as promotion and marketing, centralized reservations, guest incentive programs, and technology services, from the gross revenue of the Hotel operation.

The Agreement requires Issuer to establish and maintain an operating account, with a required minimum balance, funded by the gross revenue of the Hotel operation in the amount determined by the parties to be sufficient to make timely payment of all current liabilities of the Hotel, including the Management Fee (the "Operating Account"). In the event that the amount in the Operating Account falls below the required minimum balance and Service Provider reasonably projects insufficient funds to pay the operating expenses of the Hotel for a specified period, and, if the account is not replenished as provided under the Agreement, the parties must collaborate in good faith to develop a plan for the suspension or curtailment of the Hotel operation until such time as there are sufficient funds to fully operate the Hotel in accordance with the Agreement.

The term of the Agreement, including all renewal options, is *h* years, which is not greater than the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the Hotel. Under the Agreement, Issuer has significant rights and powers over the Hotel operation, including the power to approve and determine the annual budget, capital expenditures, and disposition of the Hotel property as well as determining how the Hotel is to be used. Further, with respect to the Hotel room rates charged, Issuer has the power to approve a general methodology for setting such rates proposed by Service Provider in connection with Issuer's approval of the annual budget.

Issuer bears the risk of loss in case of any damage to, or the destruction of, the Hotel, and is responsible for repairs.

Finally, Service Provider represents that it will not take any inconsistent tax position with respect to the Hotel. Issuer will have no role or relationship with Service Provider that would, in effect, substantially limit Issuer's ability to exercise its rights under the Agreement. None of the voting power of the governing body of Issuer is vested in the directors, officers, shareholders, partners, members, or employees of Service Provider. There are no overlapping board members of Issuer and Service Provider or any related parties (as defined in § 1.150-1(b) of the Income Tax Regulations).

Law and Analysis

Section 103(a) of the Code provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond.

Section 103(b) provides, in part, that § 103(a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(a) provides that the term "private activity bond" means any bond issued as part of an issue which meets (1) the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2), or (2) the private loan financing test of § 141(c).

Section 141(b)(1) provides that, except as otherwise provided, 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)(A) generally provides that the term "private business use" for purposes of § 141(b) means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For purposes of § 141(b)(6)(A), use as a member of the general public shall not be taken into account. Section 141(b)(6)(B) provides that, for purposes of § 141(b)(6)(A), any activity carried on by a person other than a natural person shall be treated as a trade or business.

Section 1.141-3(a)(1) provides generally that the private business use test relates to the use of the proceeds of an issue. The 10 percent private business use test of § 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds.

Section 1.141-3(a)(2) provides that in determining whether an issue meets the private business use test, it is necessary to look to both the direct and indirect uses of proceeds. Section 1.141-3(b)(1) provides generally that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases,

the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

Section 1.141-3(b)(3) provides, with certain exceptions, that the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. In determining whether a management contract is properly characterized as a lease, it is necessary to consider all of the facts and circumstances, including (i) the degree of control over the property that is exercised by a nongovernmental person; and (ii) whether a nongovernmental person bears risk of loss of the financed property.

Section 1.141-3(b)(4)(i) provides, with certain exceptions, that a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. 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.

Section 1.141-3(b)(4)(ii) defines a management contract as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, 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.

Revenue Procedure 2017-13, 2017-6 I.R.B. 787, provides safe harbor conditions under which a management contract does not result in private business use under § 141(b). If a management contract meets all of the applicable conditions of sections 5.02 through 5.07 of Rev. Proc. 2017-13, the management contract does not result in private business use under § 141(b). *See* Rev. Proc. 2017-13, Section 5.01.

Section 5.02 of Rev. Proc. 2017-13 provides in part that the payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract. Compensation includes payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider. Further, the contract must not provide to the service provider a share of net profits from the operation of the managed property. Compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon,

either the managed property's net profits or both the managed property's revenues and expenses (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties) for any fiscal period. Incentive compensation will not be treated as providing a share of net profits if the eligibility for the incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity, and the amount and the timing of the payment of the compensation meet the requirements of section 5.02. In addition, the contract also must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property.

Section 5.03 of Rev. Proc. 2017-13 provides in part that the term of the contract, including all renewal options (as defined in § 1.141-1(b)), must not be greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. For this purpose, economic life is determined in the same manner as under § 147(b) as of the beginning of the term of the contract.

Section 5.04 of Rev. Proc. 2017-13 provides in part that the qualified user must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property, and the general nature and type of use of the managed property (for example, the type of services). As an example, a qualified user may show approval of rates charged for use of the managed property by expressly approving such rates or a general description of the methodology for setting such rates (such as a method that establishes hotel rates using specified revenue goals based on comparable properties), or by requiring that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (such as a medical insurance company).

Section 5.05 of Rev. Proc. 2017-13 provides in part that the qualified user must bear the risk of loss upon damage or destruction of the managed property (for example, due to force majeure).

Section 5.06 of Rev. Proc. 2017-13 provides in part that the service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property.

Section 5.07 of Rev. Proc. 2017-13 provides that (1) the service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract, based on all the facts and circumstances, and (2) as a safe harbor, a service provider will not be treated as having a role or relationship prohibited under § 5.07(1) of the revenue procedure if: (a) no more than 20 percent of the voting power of the governing body of the qualified user is vested

in the directors, officers, shareholders, partners, members, and employees of the service provider, in the aggregate; (b) the governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and (c) the chief executive officer of the service provider is not the chief executive officer of the qualified user or any of the qualified user's related parties (as defined in § 1.150-1(b)).

In the instant case, the contractual arrangement with respect to the management of the Hotel, based on the Agreement between Issuer and Service Provider, is a management contract as defined under § 1.141-3(b)(4)(ii). However, because the compensation to Service Provider includes the reimbursement of employee costs of Service Provider, the terms of the Agreement do not meet section 5.02(2) of Rev. Proc. 2017-13. Since not all of the applicable safe harbor conditions of sections 5.02 through 5.07 of Rev. Proc. 2017-13 are met, under § 1.141-3(b)(4), whether the Agreement will result in Service Provider's private business use of the Hotel depends on all of the facts and circumstances.

Under the Agreement, the Hotel Services Fee paid by Issuer to compensate Service Provider for its services is a tiered percentage of the gross revenue from the Hotel operation each fiscal year. Incentive compensation and bonuses to senior management employees of Service Provider are determined based on formulas used to measure performance of the Hotel, using factors such as the financial performance of the Hotel, guest experience, and individual goals, and payable as a percentage of the employees' respective salaries, the timing or amount of which is not contingent upon the net profits from the Hotel operation. Therefore, the Hotel Services Fee and the incentive compensation and bonuses as provided under the Agreement are not compensation based, in whole or in part, on a share of net profits from the Hotel operation.

Issuer will also pay all current expenses of the Hotel, including the Management Fee, from the Operating Account. Under the Agreement, the Operating Account is maintained with a required minimum balance sufficient to pay all reasonably expected expenses, funded by the gross revenue of the Hotel operation. In the event that the amount in the Operating Account falls below the required minimum and Service Provider reasonably projects insufficient funds to pay the operating expenses of the Hotel for a specified period, and, if the account is not promptly replenished, the Agreement requires that the parties, among other things, collaborate in good faith to develop a plan for the suspension or curtailment of the Hotel operation until such time as there are sufficient funds to fully operate the Hotel in accordance with the Agreement. Thus, the Agreement does not impose on Service Provider the burden of sharing in net losses of the Hotel operation, including in the unlikely event that there are insufficient funds in the Operating Account to pay all of the current expenses of the Hotel.

Further, the term of the Agreement, including all renewal options, is *h* years, no greater than the lesser of 30 years or 80% of the weighted average reasonably expected

economic life of the Hotel. Under the Agreement, Issuer, as the sole owner of the Hotel, retains many powers and rights over the Hotel operation, including those to approve and determine the annual budget, capital expenditures, dispositions of the Hotel property, general methodology for setting the rates charged for the Hotel rooms, as well as determining how the Hotel is to be used. Therefore, Issuer exercises a significant degree of control over the use of the Hotel.

Finally, Issuer also bears the risk of loss upon all damage and destruction to the Hotel and is responsible for repairs. Service Provider agrees not to take any inconsistent tax position with respect to being a service provider to the Hotel. None of the voting power of the governing body of Issuer is vested in the directors, officers, shareholders, partners, members, or employees of Service Provider. There are no overlapping board members of Issuer and Service Provider or any related parties (as defined in § 1.150-1(b)). Therefore, Service Provider does not have any role or relationship with Issuer that, in effect, substantially limits Issuer's ability to exercise its rights under the agreements.

Accordingly, under all of the facts and circumstances of this case, the Agreement between Issuer and Service Provider with respect to the Hotel operation does not result in private business use of the Hotel.

Conclusion

Based solely on the information submitted and representations made, we conclude that, the Agreement between Issuer and Service Provider with respect to the management of the Hotel is a management contract that does not result in private business use of the Hotel under § 141(b) and § 1.141-3(b)(4)(i).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any transaction or item discussed or referenced in this letter, including whether the interest on the Bonds is excludable from gross income under § 103(a).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. Because this office has not verified any of the material

submitted in support of the request for rulings, such material is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representatives.

Sincerely,

_____
Jian H. Grant
Branch Chief, Branch 5
Office of Associate Chief Counsel
(Financial Institutions and Products)

Enclosure (1):
Copy for § 6110 purposes

cc: