PRIVATE BUSINESS USE: A PRIMER

I. GENERALLY

1. What is "private business use"?

Private business use means:

- use (directly or indirectly)
- of the "facilities" (the facilities financed by, or the proceeds of, a tax-exempt financing)
- in a "trade or business" (any activity carried on by a person other than a natural person)
- carried on by a "nonqualified user" (any user other than a "qualified user," as defined below)

A "qualified user" is a state or local governmental unit or, in certain circumstances, a nonprofit, charitable organization described in Section 501(c)(3) of the Internal Revenue Code (a "501(c)(3) Organization") using facilities in furtherance of its tax exempt purpose. **NOTE: the federal government and its agencies are NOT considered qualified users!**

2. Why does private business use matter?

Excessive private business use of the proceeds of facilities financed with tax-exempt bonds may cause the interest on the tax-exempt bonds to be taxable to the holder of the bonds.

For financings by state and local governments or their agencies, private business use related to the qualifying use of the proceeds or facility is limited to 10% or less of the proceeds of facilities financed with tax exempt bonds. Private business use unrelated to such qualifying use of the proceeds or facility is limited to 5% or less of such proceeds.[1]

3. What types of activities generate private business use?

The definition of private business use is broad (see question 1 above). However, common instances of private business use of facilities may include:

- Ownership
- Actual or beneficial use pursuant to:
  - Leases
  - Management or service contracts
  - Research agreements
  - Take and pay (output) contracts
  - Special legal entitlements (for example, priority rights)
  - Special economic benefit to a nonqualified user (if the facilities is not available for use by the general public) – consider:

[1] These rules apply to financings by state and local governments and their agencies. For financings on behalf of 501(c)(3) Organizations, such as private foundations related to public universities, private business use, whether related or unrelated to such qualifying use of the proceeds or facility, is limited to 5% or less of such proceeds.

- whether the financed facilities is functionally related or physically proximate to facilities used in the trade or business of a nonqualified user;
- the number of nonqualified users receiving the special economic benefit; or
- whether the cost of the facilities is treated as depreciable by any nonqualified user

4. Are there any exceptions to private business use?

Yes, depending on the type of private business use.

For any private business use, the following exceptions apply:

- ❖ General public use,
- ❖ Temporary use,
- ❖ Incidental use; and
- ❖ Qualified improvements to existing property.

For management and service contracts and research agreements, the IRS has created specific exceptions to private business use via "safe harbors." If a contract or agreement meets every requirement of a "safe harbor," it is deemed not to create business use.

The universal exceptions to private business use are described in III, below. The use-specific exceptions are described as part of the related private business use in II, below.

II. TYPES OF PRIVATE BUSINESS USE

A. OWNERSHIP, LEASE, AND OTHER SPECIAL LEGAL ENTITLEMENTS

5. What is "ownership" of proceeds or financed facilities?

A nonqualified user's ownership of facilities is private business use of the facilities. The federal tax definition of ownership is used. Thus, generally, the lessee in a lease (i.e., the entity that receives the right to use the facilities) with a term of at least 80% of the economic life of the facilities is treated as the tax owner thereof.

6. What is a "lease" of proceeds or financed facilities?

A nonqualified user's lease of facilities is private business use of the facilities. The federal tax definition of lease is used.

In reviewing the classification of an arrangement to determine if it is a lease under federal tax laws, particular attention should be paid to (1) the degree of control over the facilities exercised by a nonqualified user and (2) whether a nonqualified user bears risk of loss of the facilities.

7. Why are naming rights considered "special legal entitlements," and thus private business use, of proceeds or financed facilities?

A naming right is the right of a nonqualified user to require a facility to be referred to by a certain name, a legal right for which the nonqualified user has agreed to pay. This is considered a "special legal entitlement" which may create private business use of the facility. However, naming rights held by a nonqualified user not involved in a trade or business (e.g., by a natural person) may not generate private business use. Thus, the naming of FedEx Field, the home of the Washington Redskins football team, presents a private business use issue, but the naming of RFK Stadium, the home of the Washington Nationals baseball team, does not. Naming rights are valued using a fair market method: the fair market value of private business use of the facility, including the naming rights, compared to the fair market value of the facility itself, over the term of the bonds.

B. MANAGEMENT AND SERVICE CONTRACTS

8. What is a management or service contract?

A management contract is 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 tax–exempt bond financed facility.

A "qualified user" may be

- a state or local governmental unit or any instrumentality thereof, or
- a § 501(c)(3) Organization if the financed facilities are not used in an unrelated trade or business,

but may NOT be the United States or any agency or instrumentality thereof.

A "service provider" is any person other than a qualified user that provides services under a contract to, or for the benefit of, a qualified user. Common service providers include food vendors and facilities managers.

9. Why are management and service contracts ripe for private business use?

A management or service contract may grant the service provider special legal entitlements with respect to the financed facilities, such as a lease to use part of the facilities for a bookstore or for food service. Such uses may give rise to private business use.

10. How can one avoid entering into management and service contracts that would give rise to private business use?

According to the Treasury Regulations, management and service contracts are evaluated based on a "facts and circumstances test."

As described above, management and service contracts may create private business use. However, IRS guidance provides a "safe harbor" that if met by a management or service contract,

will prevent the contract from giving rise to private business use. The safe harbor conditions are contained in IRS Rev. Proc. 2017-13. Rev. Proc. 2017-13 replaces prior IRS guidance provided under Rev. Proc. 97-13 as supplemented, which required, generally, that such contracts provide for reasonable compensation with no portion of the compensation based on a share of net profits from the operation of the facility, and required that the manager or service provider not be related to the state or local governmental entity. This general theme is continued under Rev. Proc. 2017-13. Prior guidance under Rev. Proc. 97-13 set forth certain acceptable fee arrangements, including capitation fees, periodic fixed fees, and per unit fees which continue to be acceptable under Rev. Proc. 2017-13.

In addition, certain management and service contracts classified as "incidental," as described below, are deemed not to generate private business use.

A word of caution: if the management or service contract results in ownership or lease of the facilities for federal tax purposes, the use nonetheless may be considered private business use.

11. What are the general guidelines provided for in Revenue Procedure 2017-13?

Rev. Proc. 2017-13 replaced the safe harbor provisions of Rev. Proc. 97-13, as supplemented, with new requirements that, if satisfied, are intended to give certainty that use under a compliant management or service contract will not lead to private business use. The new provisions apply to contracts entered into on or after January 17, 2017. The new rules may by election be applied to contracts entered into before January 17, 2017. The new rule contains a transitional provision which permits continued use of the old rules for contracts entered into before August 18, 2017 that are not materially modified or extended after August 18, 2017. The general requirements of Rev. Proc. 2017-13 are these:

- First, the consideration to be paid by the "exempt person" (a governmental entity or a 501(c)(3) organization, i.e. the educational institution) under the contract must be "reasonable" for the services performed.
- Second, the consideration may not be based on a share of net profits derived from the operation of the managed property and the contract must not burden the service provider with any share of net losses from such operation.
- Third, the term of the contract must be limited. The maximum term, including renewal options, may not exceed 30 years or 80 percent of the useful life of the managed property, whichever is less.
- Fourth, the exempt person must retain sufficient control over the use of the managed property.
- Fifth, the exempt person must bear the risk of loss upon damage or destruction of the managed property.
- Sixth, the service provider must agree that it will not take tax positions that are inconsistent with being a service provider.
- Finally, the service provider cannot control the exempt person.

12. Additional notes on compensation under Reve. Proc 2017-13.

- Compensation does not include reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.
- Productivity or 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 timing of the payment of the compensation otherwise meet the requirements of Rev. Proc. 2017-13. No such compensation may be based , or take into account, both the managed property's revenues and expenses.

13. What are "incidental" management or service contracts?

Incidental management or service contracts are contracts for services that are solely incidental to the primary qualified function or functions of the facilities. They include:

- Janitorial contracts
- Office equipment repair contracts
- Management or services contracts in which the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

C. RESEARCH AGREEMENTS

14. Why are research agreements ripe for private business use?

The federal government, corporations, and other entities often enter into agreements with state and local governmental units, such as public colleges and universities, to use governmentally-owned research facilities and equipment. Whether the facilities and equipment are used by those entities themselves or are used in conjunction with the institutions or other state or local government units, the use may be private business use.

15. How can one avoid entering into research agreements that would give rise to private business use?

According to the Treasury Regulations, research agreements are evaluated based on a "facts and circumstances test."

However, the Internal Revenue Service has released Revenue Procedure 2007-47 to address this issue. In 2007-47, the IRS provides three safe harbors. If a research agreement meets the requirements of the applicable safe harbor, use of the research facility or equipment subject to the research agreement is considered not to result in private business use.

The safe harbors cover (1) research agreements with corporate sponsors, (2) research agreements with industry sponsors, and (3) research agreements with federal government sponsors. According to an informal inquiry to the IRS Office of Chief Counsel, the safe harbors address the use of the

resulting technology by a sponsor of the research only. Use by users other than sponsors warrants separate analysis, especially if any are accorded special user status.

A word of caution: if the research agreement results in ownership or lease of the facilities for federal tax purposes, the use nonetheless may be considered private business use.

16. What are the three safe harbors provided for in Revenue Procedure 2007-47?

See below. A few definitional notes:

The "*qualified user*" usually is a state or local governmental unit, although under certain circumstances non-profit, charitable entities described in Internal Revenue Code § 501(c)(3) can be qualified users. Most often, the qualified user will be the college or university or a related 501(c)(3) foundation that owns the research equipment or research facility that has been financed with tax-exempt bonds.

The "*sponsor*" is any party other than the qualified user that is sponsoring the research. A corporate, industry, or federal government participant is likely to be a "sponsor."

"*Basic research*" means any original investigation for the advancement of scientific knowledge not having a specific commercial objective. For example, product testing supporting the trade or business of a specific nongovernmental person is not considered basic research.

Safe Harbor 1: Research agreements with a corporate sponsor.

A research agreement relating to facilities used for basic research supported or sponsored by a corporate sponsor will not create private business use so long as:

1. the qualified user permits any license or other use of resulting technology by the sponsor on the same terms as such use by any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use), *and*

2. the price paid for use of any license or other use of resulting technology is determined at the time the license or other resulting technology is available for use. (NOTE: the qualified user need not permit persons other than the sponsor to use any license or other resulting technology, but the price paid by the sponsor must be no less than the price that would be paid by any nonsponsoring party for those same rights.)

Safe Harbor 2: Research agreements with industry sponsors.

A research agreement relating to facilities used pursuant to an industry research arrangement will not create private business use so long as:

1. one or more sponsors agree to fund basic research performed by a qualified user;

2. the qualified user determines the research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research);

3. the qualified user retains exclusive title to any patent or other product incidentally resulting from the basic research; *and*

4. the sponsor or sponsors receive no more than a nonexclusive, royalty-free license to use the product of any of that research.

NOTE: There has been some confusion about the corporate/industry distinction in the first two safe harbors. According to an informal inquiry to the IRS Office of Chief Counsel, the distinctions are largely historical. Both safe harbors should be available for all potential nonqualified users except the federal government (which is covered by the third safe harbor below). Most corporate sponsors may opt to qualify under the first safe harbor, however, as it provides the corporate sponsor with greater control over the product of the research (e.g,. permitting use only by a sponsor in exchange for payment of a competitive price, whereas the second safe harbor provides only non-exclusive use to the sponsor).

Safe Harbor 3: Research agreements with federal government sponsors.

A research agreement relating to facilities used pursuant to a federally-sponsored research arrangement will not create private business use so long as:

1. the qualified user determines the research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research);

2. the qualified user retains exclusive title to any patent or other product incidentally resulting from the basic research; and

3. any party other than the qualified user is entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research.

17. How are Bayh-Dole research agreements affected by the federal research agreement safe harbor?

A "Bayh-Dole" research agreement must meet all of the elements of **Safe Harbor 3: Research agreements with federal government sponsors**. If it does, the rights of the federal government

and its agencies mandated by the Bayh-Dole Act[2] will not cause a research agreement to fail the safe harbor and will not constitute private use.

III. EXCEPTIONS TO PRIVATE BUSINESS USE

A. EXCEPTIONS AVAILABLE FOR NEW AND EXISTING CONSTRUCTION

18. What is the "general public use" exception?

"General public use" occurs when use of the facilities is available to the general public. Use is considered "general public use" if:

- the facilities are intended to be available and in fact are reasonably available for use on the same basis by natural persons not engaged in a trade or business, as by business users.
- No priority rights or other preferential benefits are conveyed – use is to be available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied, provided that:
  - Different rates may apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable; or
  - A specially negotiated rate arrangement may be entered into, but only if the user is prohibited by federal law from paying the generally applicable rates, and the rates established are as comparable as reasonably possible to the generally applicable rates.

But use is not "general public use" if

- the term of the use under the arrangement, including all renewal options, is greater than 200 days; *or*
- "private business use" is generated by some other use of the facilities, even if it is available to the general public

[2] The Bayh-Dole Act (The Patent and Trademark Law Amendments Act of 1980, as amended, 35 U.S.C. § 200 *et seq.* (2006)) generally applies to any contract, grant, or cooperative agreement with any federal agency for the performance of research funded by the federal government. The policies and objectives of the Bayh-Dole Act include promoting the utilization of inventions arising from and encouraging maximum participation of small business firms in federally supported research and development efforts, promoting collaboration between commercial concerns and nonprofit organizations and ensuring that such inventions are used in a manner to promote free competition and enterprise, and promoting the commercialization and public availability of inventions made in the United States by United States industry and labor.

Under the Bayh-Dole Act, the federal government and sponsoring federal agencies receive certain rights to inventions that result from federally funded research activities performed by non-sponsoring parties pursuant to contracts, grants, or cooperative research agreements with the sponsoring federal agencies. The rights granted to the federal government and its agencies under the Bayh-Dole Act generally include, among others, nonexclusive, nontransferable, irrevocable, paid-up licenses to use the products of federally sponsored research and certain so-called "march-in rights" (rights granted to the sponsoring federal agencies to take certain actions, including, under certain circumstances, granting licenses to third parties) over licensing under limited circumstances. The general purpose of these rights is to ensure the expenditure of federal research funds in accordance with the policies and objectives of the Bayh-Dole Act.

19. What are the "temporary use" exceptions?

Each of the "temporary use" exceptions assumes that the facilities are not owned by a nonqualified user and that it is not financed for the purpose of use by the nonqualified user.

LENGTH OF USE (INCLUDING ALL RENEWAL OPTIONS)	TERMS OF USE
100 days or less	Generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business (e.g., prisons).
50 days or less	The arrangement is a negotiated arm's-length arrangement, and compensation under the arrangement is at fair market value.
Initial development period of an improvement that carries out an essential government function	The issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and to transfer it to a qualified user, and such transfer occurs.

20. What is the "incidental use" exception?

Use of the facilities by a nonqualified user is incidental if:

- the use does not involve the transfer to the nonqualified user possession and control of space that is separated from other areas of the facilities by physical barriers (except for vending machines, pay telephones, kiosks, and similar uses), and
- the nonpossessory use is not functionally related to any other use of the facility by the same person (other than a different nonpossessory use); and
- all nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5 percent of the facilities.

Common incidental uses include pay telephones, vending machines, advertising displays, and use for television cameras, but incidental uses may not include output purchases.

Incidental uses of the facilities are aggregated. If the total of all incidental uses of the facilities is 2.5% or less of the proceeds of the issue used to finance the facilities, they are disregarded.

B. EXCEPTION FOR EXISTING CONSTRUCTION ONLY: THE "QUALIFIED IMPROVEMENTS" EXCEPTION

The "qualified improvements" exception is available only for additions to or renovations of existing structures.

Use of proceeds to provide a qualified improvement to a qualified building (including its structural components and land functionally related and subordinate to the building) are not used for a private business use if--

- The building was placed in service more than 1 year before the construction or acquisition of the improvement is begun;
- The improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for any private business use;
- No portion of the improved building or any payments in respect of the improved building are taken into account under the private security test; and
- No more than 15 percent of the improved building is used for a private business use.