



The winners and losers of IRS revenue procedure 2016-44

15 Sep 2016

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The release of IRS released procedure 2016-44 in August, but the market is still considering the ramifications. *InfraDeals'* Co-Head of Research Daniel Davies explores what market participants are saying about the procedure, and how it could affect P3s.

The IRS on 22 August released revenue procedure 2016-44. However, the new sector opportunities and implications of the procedure for companies involved in DBFOM contracts is not immediately clear, as the industry continues to struggle for consensus.

According to Barney Allison, a partner with Nossaman, the procedure is a follow on to changes made in 2014 that amplified the 1997 guidance.

"This was the start of the IRS indicating a softening or a liberalizing of the safe harbor rules to reflect growth in the US P3 market", he said.

Charlie Henck, a partner at Ballard Spahr, attributed the new rules to the administration.

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"This is a loosening of the rules to make tax-exempt financing available for a broader range of P3 transactions."

The driving forces behind this change are mixed according to sources. One source attributed this change to anti-P3 sentiment in favor of a pro-63-20 or "traditional business" solution. Another source said that large O&M firms that wanted to lock in longer-term management contracts were at the heart of the procedure.

A third source opined that the procedure may have been a knee jerk reaction to the specific financing structure associated with a P3 project such as Kentucky Wired or the Long Beach Civic Center.

Notably, Kentucky Wired combined tax exempt and taxable financing alongside sub debt in a 501(c)(3) structure. Prior to reaching financial close, Long Beach pivoted away from the initially proposed 63-20 model to a taxable private placement solution.

The new ruling procedure modifies management contract guidance for governmental and 501(c)(3) owners of tax-exempt bond financed facilities, said Mike Pikiel, a partner at Norton Rose.

"The new safe harbor rules retains the prohibition on net profits arrangements and restrictions on the relationship between the parties involved in a project," he added.

There are two main changes that come out of Revenue Procedure 2016-44, Allison noted. Firstly, the term for qualified management contract has been extended to 30 years from 15 previously. Secondly there are fewer constraints on how a service provider is compensated.

"The new safe harbor rules do go pretty far in providing that flexibility: It is a less rigid and formulaic approach," Doug Bird a partner at Ashurst said. "It enables you to look at different facts and circumstances and get comfortable that you don't have a private use issue."

The new ruling provides municipalities with a bit more flexibility in structuring O&M contracts, but this cannot be mistaken as a panacea to fuel P3s, said Performance Based Building Coalition Founder Samara Barend. She noted that 63-20 structures do not include equity, so the role of private finance, is negligible.

Barend said that private finance brings discipline that delivers accountability, innovation, long-term performance, and massive cost savings. She added that understanding the difference between the DBFOM and 63-20 model is at the heart of assessing the ramifications of the procedure.

John Finke, President of Public Facilities Group and a proponent of the 63-20 model, has said the losers of this procedure are the private equity investors.

Stuart Marks of Plenary, said an expansion of the safe harbor rules is unlikely to have a profound change.

"I don't see this as a game changer to the status quo", said Marks. "It appears to promote the 63-20 model, and while it may give the service provider the ability to lock in a longer contract and provide more flexibility in payment terms, there does not appear to be any significant change in long term risk transfer".

Henck, on the other hand, does not see this as a boom opportunity for the 63-20 model.

"I am skeptical of their use to address tax problems, he said. "They are used to avoid other problems like voting, debt limit and constitutional issues, not getting around tax problems."

Michael Palmieri, president of p3point, which was the lead P3 financial advisor to the city of Long Beach on the civic center deal, said that the lower interest rates for tax exempt debt compared to taxable rates, plus the 30-year O&M term will tempt governments into doing "P3" projects with muni debt and a 30 year O&M contract.

However, it is possible that this will actually bring attention to the benefits of long term O&M said Palmieri. He added that governments may now start considering the benefits of transferring O&M over 30 year periods, which could result in a path to a true P3.

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Equity and accountability

For John Finke the positives of the procedure are the lessening of the role of conventional equity and conventional debt.

"Equity financing is more expensive than conventional debt, and conventional debt is more expensive than tax exempt debt," he said. "My instinct is this will shift the balance of financing toward the 63-20 model and tax exempt debt.

On the other hand Barend noted that there a major concern about the absence of equity.

"The structure enabled here is tricky, complicated and does not enable the same level of risk transfer," Barend said.

Equity investment and the use of private debt is the glue that holds a DBFOM together, said Marks, because it holds the developer accountable for the long term.

"When a developer has an equity stake, they are answerable to the lenders," said Marks. "In a 63-20 model, is it really the government entity that has issued the debt, not the non-profit or developer. There is no real private capital at risk."

Marks added that, with a 63-20 structure, once construction is complete, the contractor is out the door, while in a DBFOM, they are still answerable to construction defects.

"In a 63-20, the service provider has no capital risk, and so what is stopping them from leaving the project?" he said. "All roads lead back to the government body."

Barend said that the industry has to understand what structure this is enabling.

Finke said that by saying under the 63-20 model the development team has to guarantee the price and completion.

"They don't have equity, but they do have skin in the game as they will get an incentive if they perform," he said. "I don't necessarily buy the equity skin in the game model: it is just more expensive money.

"The 63-20 structure does not preclude investors from participating in sub debt, nor does it prevent

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them from generating typical RORs, although it does limit their maximum upside said, Andrew Smith, a senior associate at Ashurst.

Marks indicated that investors do have the flexibility to do sub debt and that [Plenary] have done so in other projects.

A further source referred to the 63-20 model as a "bastardized P3 structure."

"It is a funky structure and that's what we have competed against all these years," the source said. "Now it has been strengthened, and it is part of the tax code."

With regard to the 15 year O&M extension period, Alison believes it will help big management companies.

"They can make money and show themselves to be better than their competitors," one source said.

"The problem with that is the absence of equity means the government takes on most of the risks traditional P3 projects were designed for equity to take, including replacement of O&M or construction firms in addition to potentially missing out on design innovations. Thus, the final deal is really just a traditional muni project with a 30-year O&M contract and not a P3," said Palmeri.

Bankers and lawyers

A banker source added that for a bank operating in the municipal and P3 markets there are two ways to look at the procedure.

From a muni desk perspective, enhanced deal flow can only be a good thing, the source said. However, for a bank with P3 clients it's not necessarily good.

"For those equity clients we can refinance deals and work on M&A sell or buy side opportunities with them," he said.

The source added that a 63-20 structure can also lead to higher underwriting costs.

"When you are underwriting a not for profit, it is not a known creditworthy entity," the source said.

"When compared to a government entity or a private company or consortium with a history, it adds a few basis points."

Finke dismissed the notion of higher legal and underwriting fees. The legal costs of a DBFOM using an availability payment model have so far been more expensive.

From a legal perspective, the 63-20 model, legal structuring is pricey as it is complicated, said one source. Another added that the lack of equity, and therefore accountability, means that legal fees can soar as organizations within the 63-20 model take legal action against one another and the government agency.

Long Beach Civic Center and the taxable market

Recounting the path to financial close for the Long Beach Civic Center, Marks said that the project had initially been slated to go down the 63-20 route. He noted that, when the consortium went to lock in final financing, they found that a taxable private placement and equity was more cost effective than the tax exempt 63-20.

"The city approved the change based on the overall cost of financing but also the significantly better risk transfer," he said.

Palmieri noted how Long Beach considered 501(c)3, 63-20, COPs and LRB structures but all of these would have been restricted to 15 years O&M, prior to the new IRS 30-year ruling. He noted that the Civic Center has a 40-year O&M.

"We were working on structures to ameliorate the risk of the 'changeover' every 15 years, he added.

Finke has noted the importance of a different O&M length under the 63-20 model. He has encouraged three, four and five- year management contracts.

"We found that short contracts, kept them competitive and lowered the cost."

However, Marks noted that while the procedure generally permits variable compensation for longer term management contracts, it also expressly focuses on governmental bearing of risk of loss. In particular, it refers to a requirement that the governmental body approve annual budgets and capital expenditures with respect to the managed property.

Marks questioned what would happen if the governmental body failed to approve the lifecycle

capital expenditure required to replace a roof in years 15-20 or failed to approve an annual maintenance budget. He noted that under a privately financed structure, this would not be in question because performance risk resides with the private sector whose investment capital is fully at risk.

Social infra PABs bill

The procedure comes at a time when a bill is in both the house and senate for the use of Private Activity Bonds (PABs) for social infrastructure.

The legislation, would authorize USD 5bn in PABs for “qualified public buildings.” Those buildings include: elementary or secondary schools; state college and university facilities; libraries and courthouses; hospitals; health care and laboratory facilities; public safety facilities, including police and fire facilities; and government offices.

Allison said the bill would help level the government building playing field by normalizing the cost of debt capital for the p3 delivery model. Marks added he hoped that this new revenue procedure does not detract from that main mission.

Whilst opinion may be divided with regard to the tax procedure, and there may be a legislative fix for DBFOMs on the floor, Henck noted that the uncertainty in the market will continue.

“One thing is clear,” Henck said. “Market participants are going to be asking lawyers over the next few months, ‘Can we do this?’ or ‘Can we do that?’”

Related literature

As a result of the procedure, law firms have released written statements outlining their thoughts. The written statements can be found below along with further information on PBBC, their house and senate bill and the 63-20 (also known as the American model) model can also be found below.

Full Revenue Procedure 2016-44

Norton Rose

Nixon Peabody

Squire Patton Boggs

Ballard Spahr

NDC Academy 2015 Model - presentation slides

PBBC

Senators propose public building PAB bill - *InfraAmericas*

Legislation introduces bill to use PABs for public buildings - *InfraAmericas*



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