INTERNAL REVENUE SERVICE

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February 19, 2002

LEGEND

Issuer

Bonds

Owner

Manager

Independent Organization

State Law

Date 1

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Dear :

This responds to the Issuer's request for a ruling that the management contract more fully described below (the "Management Contract") does not constitute private business use under Rev. Proc. 97-13, § 5.03(1), 1997-1 C.B. 632, or, in the alternative, under § 1.141-3(b)(4) of the Income Tax Regulations

FACTS AND REPRESENTATIONS

The Issuer issued the Bonds and loaned a portion of the proceeds to the Owner to finance the construction of a hotel ("the Hotel"). The useful life of the Hotel is 40 years as determined under Rev. Proc. 62-21, 1962-2 C.B. 418.

The Owner is a non-profit local government corporation under the State Law. The Issuer represents that the Owner is an instrumentality of the Issuer according to factors set forth in Rev. Rul. 57-128, 1957-1 C.B. 311. The Owner will be the legal owner of the Hotel and is authorized to enter into all contracts with respect to the Hotel.

The Owner and the Manager entered into the Management Contract on Date 1. The stated term of the Management Contract is 15 years, beginning on the date the Hotel is placed in service. Date 1 is approximately three years before the date on which the Hotel will be placed in service.

On Date 1, the Owner and the Manager also entered into the Technical Services and Preopening Agreement ("the Preopening Agreement"). The terms of the Management Contract require the Manager and the Owner to enter into the Preopening Agreement. The term of the Preopening Agreement began on Date 1 and will terminate on the date on which the Hotel is placed in service, the same date on which the 15-year term of the Management Contract begins. The approximate term of the Preopening Agreement is 3 years. Under the Preopening Agreement, the Manager is to provide technical services, which include advising the Owner regarding the Hotel's design, construction; and preopening services. The preopening services include preparing an initial plan for the organization and operation of the Hotel, booking the initial reservations for Hotel rooms and facilities, and developing and implementing an initial marketing plan. The Manager's compensation under the Preopening Agreement is a stated dollar amount payable in equal monthly installments.

The Manager will be paid the following amounts under the Management Contract: (1) the management fee; (2) the productivity reward; (3) the centralized service fee; (4) the inducement fee deemed repayment; and (5) expenses incurred by the Manager for certain employees and third parties.

(1) <u>The management fee</u>: The management fee is a fixed dollar amount payable per year for each year of the term of the Management Contract. During the first four years of the term of the Management Contract, the fee will not be adjusted. Beginning with the fifth year of the Management Contract, the amount of the fee in effect the previous

year will be adjusted annually by a specified percentage (the "Adjustment Percentage"). The Adjustment Percentage is the percentage change from the prior year in total revenues per available room (the "market room revenues") for a comparable group of hotels in the City, excluding the Hotel (the "comparable hotels"). The market room revenues for any year will be determined by dividing the total revenues from the available rooms of comparable hotels for a period specified in the Management Contract by the total rooms available for occupancy in the same hotels over the same time period. Each of the comparable hotels must meet the standards and criteria prescribed by the Independent Organization for hotels that have same rating as the Hotel.

Beginning with the third year of the Management Contract and in each year thereafter, the Owner has the right to defer paying a stated dollar amount of the management fee if the Owner's net operating revenues are not sufficient to fund the Hotel's primary capital replacement reserve and to pay the Owner a percentage specified in the Management Contract of the total cost of the Hotel, but not to exceed $a (the "preferred return"). Any deferred amount of the management fee will be payable after these two funding obligations have been met. However, any amounts that are deferred must be paid when the Management Contract expires or is terminated regardless of whether the primary capital replacement reserve and preferred return funding obligations have been met. The feasibility study commissioned by the Issuer and the Owner projects that no deferrals will occur.

(2) <u>The productivity reward</u>: The Manager will be eligible for a single productivity reward during the term of the Management Contract in the amount of $b. In order for the Manager to qualify for this reward, the Hotel's gross revenues per available room for a period specified in the Management Contract must equal or exceed c percent of the market room revenues. The market room revenues will be computed in the same manner as those revenues will be computed for purposes of determining the adjustment percentage for the management fee component described above. The productivity reward is also subject to deferral in the same manner as the deferred portion of the management fee. As noted above, the feasibility study projects that no deferrals will occur.

(3) <u>The centralized services fee</u>: The centralized service fee is a stated dollar amount per year for each year of the term of the Management Contract for certain group services that the Manager provides to a majority of hotels that it owns or manages. Beginning in the fifth year of the Management Contract, the amount of this fee will be adjusted annually according to the Revised Consumer Price Index for All Urban Consumers (the "CPI") in effect for the preceding year.

(4) <u>The inducement fee deemed repayment</u>: The Manager is required to pay the Owner an inducement fee in the amount of $d within the period specified in the Management Contract. The Owner is deemed to repay the Manager a fixed amount per month over the term of the Management Contract. If the Owner terminates the Management Contract other than for cause, the Owner is obligated to repay the

remaining outstanding balance of the inducement fee. If the Owner terminates the Management Contract for cause, the Owner is entitled to retain the remaining outstanding balance of that fee as liquidated damages for the costs of finding a replacement manager. The parties expect that the entire inducement fee will be deemed to be repaid to the Manager over the term of the Management Contract because the parties do not expect that the Management Contract will be terminated prior to the end of the stated term.

(5) <u>The expenses incurred by the Manager for certain payments to employees and third parties</u>: The Management Contract provides that the Owner will reimburse the Manager for third party expenses and for the salaries of the Manager’s on-site employees. The Owner will also reimburse the Manager for the salaries and expenses of the Manager’s off-site employees who provide services to the Hotel. The reimbursed salaries and expenses will not be based on a share of the Hotel's net profits and will not exceed the fair market value of the services provided. The Manager’s on-site and off-site employees do not include the Hotel executive staff.

The Owner has the right to terminate the Management Contract for various reasons provided in the Management Contract including, but not limited to, the Manager’s default under any provision, term, or material covenant under the Management Contract, and the failure of the Hotel to generate revenues at levels specified in the Management Contract.

The Manager has no role or relationship with the Owner that, in effect, substantially limits the Owner’s ability to exercise its rights, including cancellation rights, under the Management Contract. None of the voting power of the governing body of the Owner in the aggregate is vested in the Manager and its directors, officers, shareholders, and employees. There are no overlapping board members between the Manager and either the Issuer or the Owner. The Manager is not a related party, as defined under § 1.150-1(b) of the Income Tax Regulations, to the Issuer or the Owner.

<u>LAW</u>

Section 103(a) generally provides that gross income does not include interest on any state or local bond. Section 103(b)(1) provides that this exclusion does not apply to any private activity bond unless it is a qualified bond (as defined under § 141). Section 141(a) provides that a bond is a private activity bond if the bond satisfies the private business tests of § 141(b).

Under §§ 141(b)(1) and 141(b)(6)(A), private business use occurs if more than 10 percent of the proceeds of the bonds are used, directly or indirectly, in a trade or business carried on by any person other than a governmental person. Under § 141(b)(6)(B), any activity carried on by a person other than a natural person is treated as a trade or business. Under § 1.141-3(b)(1), in general, a nongovernmental person is treated as a private business user of the proceeds 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.

As material to this ruling request, § 1.141-3(b)(4)(i) provides 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. *Id*. Under § 1.141-3(b)(4)(iii)(D), a contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties, is generally not treated as a management contract that gives rise to private business use.

Rev. Proc. 97-13 sets forth conditions under which a management contract does not result in private business use under § 141(b). Section 5.01 provides that if the requirements of § 5 are satisfied, the management contract does not itself result in private business use. Under § 5.02(1) of Rev. Proc. 97-13, the management 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 facility. Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation. *Id.* Section 5.02(3) of Rev. Proc. 97-13 further provides that for purposes of § 1.141-3(b)(4)(i) and Rev. Proc. 97-13, 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.

Section 5.03 of Rev. Proc. 97-13 sets forth six specific arrangements that satisfy the requirements of § 5. Under § 5.03(1), at least 95 percent of the compensation for services for each annual period during the term of the contract must be based on a periodic fixed fee. Section 5.03(1) further provides that 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 § 5.03(1), 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 expenses target (but not both) is reached if that award is equal to a single, stated dollar amount.

Section 3.05 of Rev. Proc. 97-13 provides as follows. A “periodic fixed fee” means 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 stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the

Consumer Price Index and similar external indices that track increases in revenues or costs in an industry are objective external standards.

Section 5.04(1) of Rev. Proc. 97-13 generally provides that a service provider must not have any role or relationship with the qualified user (the state or local government or instrumentality that is a party to the management contract) that substantially limits the qualified user’s ability to exercise its rights, including cancellation rights, based on all the facts and circumstances. Under § 5.04(2), the qualified user’s rights are not substantially limited if the following requirements are satisfied: 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; 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 the qualified user and the service provider under the contract are not related parties, as defined in § 1.150-1(b).

ANALYSIS

The Management Contract must meet all requirements of Rev. Proc. 97-13 for that contract to be deemed not to result in private business use of the Hotel by the Manager. If any requirement is not met, then whether the Management Contract results in private business use depends on all of the facts and circumstances. In the latter case, the principles set forth in Rev. Proc. 97-13 are useful reference points, *i.e.*, the manager's compensation, the term of the management contract, and the relationship of the manager to the owner. *See* Rev. Proc. 97-13, § 5.

Whether the Manager's compensation meets the requirements of Rev. Proc. 97-13 first requires an analysis of the amounts paid to the Manager, *i.e.*, (1) the management fee; (2) the productivity reward; (3) the centralized services fee; (4) the inducement fee deemed repayment; and (5) expenses incurred by the Manager for certain employees and third parties.

The following amounts paid to the Manager satisfy the Rev. Proc. 97-13, § 3.05 definition of a periodic fixed fee because each is a stated dollar amount for a period specified in the Management Contract and is adjusted only by a specified, objective, external standard. The centralized services component is a stated dollar amount for services rendered for a specified period that will be adjusted by the CPI. The non-deferrable amount of the management fee component is a stated dollar amount for services rendered for a specified period that will be adjusted by the Adjustment percentage. The Adjustment Percentage is based on an external indicia that tracks revenues and is, therefore, based on a specified, objective, external standard that is not linked to the efficiency of the Hotel.

The following amounts do not constitute compensation to the Manager. The inducement fee is analogous to a discount of the total amount of Manager’s fee in the amount of $d that is deemed to be amortized over the term of the contract and that the parties use as a measure for liquidated damages in the event that the Management Contract is terminated for cause. Hence, the deemed repayment of the inducement fee does not constitute compensation to the Manager. The expenses incurred by Manager for third parties and certain employees, not including the Hotel executive staff, are based on fair market value and are not based on a share of Hotel net profits. Hence, because these reimbursements are for the Manager's actual and direct expenses to unrelated third parties, they are not treated as compensation to the Manager under Rev. Proc. 97-13, § 5.02(1). For similar reasons, these reimbursements are not treated as compensation under § 1.141-3(b)(4)(iii)(D).

The Owner's right to defer a stated dollar amount that represents a portion of the management fee and the full amount of the productivity reward (the "deferred fees") under the circumstances presented raises the issue of whether the these fees are based on a share of Hotel net profits. Although the timing of payment of the deferred fees is based on Hotel net profits and, therefore, indicates private business use of the Hotel by Manager, we think that the circumstances support a conclusion otherwise. The full amount of all deferred fees will be payable regardless of the existence and amount of net profits when the Management Contract expires or is terminated. In addition, the deferrable portion of the management fee is a stated dollar amount and is not, itself, a percentage of Hotel net profits. The productivity reward is analogous to the productivity reward approved by Rev. Proc. 97-13, § 5.02(3) because it is to be made only once and is based on an increase in gross revenues for a period specified in the Management Contract. Finally, the feasibility study projects that no deferrals will occur. Thus, although the deferred elements of the Manager's compensation do not satisfy the requirements of Rev. Proc. 97-13, § 5.03(1), on balance, these deferred elements do not indicate private business use under § 1.141-3(b)(4).

To satisfy Rev. Proc. 97-13, § 5.03(1), the term of the Management Agreement cannot exceed 15 years. The Management Contract requirement that the Owner and the Manager to enter into both the Preopening Agreement and the Management Contract (the "Contracts") on Date 1 suggests that it may be appropriate to aggregate the terms of the two Contracts so that the total term is of the Contracts is 18 years. Nevertheless, assuming aggregation, the emphasis of the Preopening Agreement is on supervision of the design and construction of the Hotel prior to the date the Hotel is placed in service. Hence, the management phase of the Contracts occurs primarily during the 15-year term of the Management Contract. As a result, the management phase of the Contracts, standing alone, would be limited to a term that satisfies Rev. Proc. 97-13, § 5.03(1). Hence, based on these facts, the term of the Contracts does not indicate private business use under § 1.141-3(b)(4).

The Management Contract meets the requirements of Rev. Proc. 97-13, § 5.04, because the Manager does not have a relationship with Owner that would limit Owner's rights under the Management Contract, including the Owner's cancellation rights.

CONCLUSION

Although the Management Contract does not satisfy all requirements of Rev. Proc. 97-13, § 5.03(1), based on all facts and circumstances, we conclude that the Management Contract does not result in private business use under § 1.141-3(b)(4). This conclusion is based upon information and representations submitted by the Issuer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the Issuer.

Sincerely,
Assistant Chief Counsel (Office of Tax Exempt/
Employment Tax/Government Entities)
By: Timothy L. Jones
Assistant Branch Chief

Enclosure (1)