

# An Alternative Structure for Certain P3 Projects – The 63-20 Financing

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With all of the talk about the need for infrastructure legislation, **public-private partnerships (or “P3s”)** are receiving increased national attention. What exactly constitutes a P3 is an ever-evolving question, and the answer often depends upon who you ask. For us, P3s are essentially **arrangements in which a governmental unit engages a private party to deliver an integrated solution for the design, construction, financing, operation and/or management of new or existing government-owned infrastructure projects.**

P3s have been used to procure a wide variety of infrastructure projects, from roads and airports, to courthouses and college dorms, and almost everything in between. And just as they come in a variety of forms (design-build-finance, design-build-finance-operate, etc.), P3s are also financed through multiple financing structures, from syndicated bank loans to the issuance of tax-exempt or taxable bonds, or even structures involving the securitization of payment streams in some jurisdictions.

When considering structures that achieve a lower cost of capital with tax-exempt bonds, it might be perfectly appropriate for the city, county, or other governmental unit associated with the project to directly issue the bonds, and then rely on the private sector for some or all of its design, build, and management pursuant to a qualified management contract (click [here](#) for an overview of the IRS safe harbor set forth under Revenue Procedure 2017-13). In other instances, however, there may be legitimate reasons, both political and practical, as to why the state or local government would not want to issue the bonds directly and be the initial legal owner of the project. Some jurisdictions, such as Texas, address this issue by authorizing the creation of governmental instrumentalities, such as local government corporations and public facility corporations, to issue the bonds and own the project. In other jurisdictions, the use of a “63-20” nonprofit corporation may be a desirable alternative structure for financing the P3 project if the particular jurisdiction’s laws do not readily provide a viable alternative.

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## General Overview of 63-20 Financings

In general, the Internal Revenue Code and the Treasury regulations promulgated thereunder provide that interest on the obligations of any state, territory, or possession of the United States, or any of their political subdivisions, or of the District of Columbia (each, a “Governmental Unit”) is not includible in the gross income (i.e., such obligations are “tax-exempt bonds”) of the holder.

In Revenue Ruling 63-20 (from which the oh-so-creative “63-20” financing gets its name), the IRS ruled that, in certain circumstances, bonds issued by a nonprofit corporation (the “Nonprofit”) will be considered issued on behalf of a Governmental Unit – thus allowing the interest on such bonds to be eligible for tax-exempt treatment. The IRS provided additional detail with respect to the requirements of a 63-20 financing in Revenue Procedure 82-26, described below.

Although the rules applicable to “traditional” tax-exempt governmental financings continue to apply (limitations on private business use, arbitrage and rebate, etc.), a 63-20 financing may help avoid certain political and legal hurdles that otherwise might be present if the Governmental Unit were to issue the bonds directly.

### Requirements under Revenue Procedure 82-26

In order for the Nonprofit’s bonds to be considered issued on behalf of a Governmental Unit, the following requirements generally must be satisfied:

***1) The Nonprofit must engage in activities that are essentially public in nature.***

- This requirement will be met if: (i) the Nonprofit’s activities and purpose are those permitted under the general nonprofit corporation law of the state under which the Nonprofit is created; and (ii) the property to be provided by the Nonprofit’s bonds is located within the geographical boundaries of, or has a substantial connection with, the Governmental Unit on whose behalf the bonds are issued.

***2) The Nonprofit must not be organized for profit except to the extent of retiring indebtedness.***

- This requirement will be met if: (i) the Nonprofit is organized under the general nonprofit corporation law of the state in which the Governmental Unit is located and on whose behalf the Nonprofit will issue its bonds; and (ii) the organizing document (i.e., articles of incorporation or certificate of formation) of the Nonprofit provide that it is not organized for profit.

***3) The Nonprofit’s income may not inure to any private person.***

- This requirement will be met if the Nonprofit’s organizing document (i.e., articles of incorporation or certificate of formation) provides that its income will not inure to any private person, and in fact, the income does not inure to any private person.

***4) The Governmental Unit must have a beneficial interest in the Nonprofit while the***

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***indebtedness remains outstanding.***

- This requirement will be met if:
  - The Governmental Unit has exclusive beneficial possession and use of at least 95% of the bond-financed property (as well as any additions thereto), measured by the property's fair rental value for the life of the bonds, which exclusive possession and use must extend to any other bonds issued by the Nonprofit either to make improvements to the property or to refund a prior issue of the Nonprofit's bonds;
  - or
  - The Nonprofit has exclusive beneficial possession and use of at least 95% of the bond-financed property (as well as any additions thereto), measured by the property's fair rental value for the life of the bonds, and the Governmental Unit on whose behalf the Nonprofit is issuing the bonds (i) appoints or approves the appointment of at least 80% of the members of the governing board of the Nonprofit, and (ii) has the power to remove, for cause, either directly or through judicial proceedings, any member of the governing board and appoint a successor. (Note that representatives of the Governmental Unit who serve ex officio as members of the governing board of the Nonprofit are counted for purposes of the 80% requirement);
  - or
  - Subject to additional restrictions against certain subsequent conveyances, the Government Unit has the right at any time to obtain unencumbered fee title and exclusive possession of the bond-financed property (as well as any additions thereto), by paying sufficient amounts to defease the bonds. In such a case, the Nonprofit generally must cancel all encumbrances on the property, including leases and management contracts, within 90 days.
  - and
  - In the event the Nonprofit defaults on debt service payments on the bonds, the Governmental Unit has an exclusive option to purchase the bond-financed property (as well as any additions thereto) for the amount of the outstanding indebtedness and accrued interest to the date of default. In such a case, the Governmental Unit shall have (i) not less than 90 days from the date it is notified by the Nonprofit of the default in which to exercise the option, and (ii) not less than 90 days from the date it exercises the option to purchase the property. (Note that this requirement does not apply if the Governmental Unit has exclusive beneficial possession and use of the bond-financed property).

***5) The Governmental Unit must obtain full legal title to the property of the Nonprofit with respect to which the indebtedness was incurred upon retirement of the indebtedness.***

- This requirement generally will be met if:
  - The Nonprofit's bonds are issued on behalf of no more than one Governmental Unit

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and unencumbered fee title to the property will vest solely in that Governmental Unit when the bonds are discharged; and

- All of the original proceeds and investment proceeds of the bonds are used to provide tangible real or personal property and a reasonably required reserve fund. It should be noted that unlike a traditional governmental tax-exempt financing in which up to 5% of the proceeds can be used for working capital expenses related to the project, in a 63-20 financing other sources of financings (e.g., taxable bonds) must be used to finance working capital. If excess proceeds remain on hand after the acquisition or completion of construction or reconstruction of the property, these requirements will be considered met if (i) on the issue date of the bonds, the face amount (taking into account estimated investment proceeds) was based on reasonable estimates of the cost of the property, and (ii) the excess proceeds are used to redeem or defease bonds in accordance with the applicable remedial action provisions set forth in the Treasury regulations;

and

- The Governmental Unit obtains upon discharge of the bonds unencumbered fee title and exclusive possession and use of the bond-financed property (as well as any additions thereto), without demand or further action on its part. As a result, all leases, management contracts, and other similar encumbrances must terminate upon discharge of the bonds. If a Nonprofit sells interim short-term bonds on behalf of a Governmental Unit in anticipation of selling permanent financing, this requirement will be met if (i) the Government Unit obtains unencumbered fee title and exclusive possession and use of the property upon discharge of the permanent financing, and (ii) the last issue of interim short-term bonds used to provide the property is discharged not later than 5 years after the issue date of the first issue of short-term bonds;

and

- Before the bonds are issued, the Governmental Unit adopts a resolution stating that it will accept title to the bond-financed property (as well as any additions thereto) when the bonds are discharged;

and

- The indenture or other documents under which the original bonds are issued provide that any other bonds issued by the Nonprofit either to make improvements to the property or to refund a prior issue of the Nonprofit's bonds will be discharged no later than the latest maturity date of the original bonds, regardless of whether the original bonds are callable at an earlier date. In addition, the maturity date of the original bonds or any other bonds issued by the Nonprofit with respect to the property may not be extended beyond the latest maturity date of the original bonds, regardless of whether the original bonds are callable at an earlier date;

and

- The proceeds of fire or other casualty insurance policies received in connection with

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damage to or destruction of the bond-financed property (as well as any additions thereto), will, subject to the claims of the bondholders, (i) be used to reconstruct the property, regardless of whether the insurance proceeds are sufficient to pay for the reconstruction, or (ii) be remitted to the Governmental Unit;

and

- (i) A reasonable estimate of the fair market value of the property (determined without including in the value any addition to the property or any increase or decrease for inflation or deflation during the term of the bonds) on the latest maturity date of the bonds, regardless of whether the bonds are callable at an earlier date, is equal to at least 20% of the original cost of the property financed by the bonds; and (ii) a reasonable estimate of the remaining useful life of the property on the latest maturity date of the bonds, regardless of whether the bonds are callable at an earlier date, is the longer of 1 year or 20% of the originally estimated useful life of the bond-financed property. (Note that exceptions apply in the event that the Nonprofit is required to periodically replace the property, and further note that these requirements do not apply if the Governmental Unit has exclusive beneficial possession and use of the bond-financed property).

***6) The Governmental Unit must approve both the Nonprofit and the specific bonds to be issued by the Nonprofit.***

- This requirement will be met if, within one year prior to the issuance of the bonds, the Governmental Unit adopts a resolution approving the purposes and activities of the Nonprofit and the specific bonds to be issued. If the Nonprofit intends to issue bonds for a single project through a series of bonds to be issued over a period not to exceed five years, the Governmental Unit may meet these requirements by adopting a single resolution, approving the purposes and activities of the Nonprofit and all bonds to be issued in the series, within one year prior to the issuance of the first issue in the series.

## **Using 63-20 Financings in P3s**

While 63-20 financings were presumably envisioned as a way for Governmental Units to outsource certain projects to related “alter-ego” entities, they also could be used in the context of a P3. We understand that 63-20 financings have already been employed in various P3s, and are currently being contemplated in additional infrastructure projects. We note that, in projects where the private party is to be remunerated by the government with availability payments and where the government seeks to deliver the project at the lowest reasonable cost or within a certain affordability ceiling, a 63-20 financing could result in lower overall project costs (and consequently availability payments) as a result of the lower financing costs obtained by the tax-exempt interest rate while incentivizing the private sector to invest capital and to assume long-term management responsibilities for the relevant assets.

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