

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EOEG:TEB-GENIN140904-02

Date:

March 25, 2003

LEGEND:

Issuer =

Bonds =

Facility =

Year =

Date 1 =

Date 2 =

Dear

This is in response to your request on behalf of Issuer and  
for the following rulings with respect to the Bonds for the Facility:

the Participating Customers' (defined below)  
payments under the Agreements (defined below) that are attributable to Issuer's  
ordinary and necessary business expenses may be disregarded for purposes of  
applying § 1.141-7(f)(1) of the Income Tax Regulations.

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FACTS AND REPRESENTATIONS:

the Facility, an electric  
generating facility owned and operated by Issuer.

Prior to commencing construction of the Facility, Issuer entered into separate but substantially identical contracts to sell to  
("Participating Customers"), each such customer  
purchasing a designated percentage share . In exchange, each  
Participating Customer agreed to pay Issuer its pro rata share of Issuer's annual costs incurred in the ownership, operation, and maintenance of the Facility and of the debt service on the notes and bonds issued for the Facility.

The  
contractual relationships among the parties to these agreements is referred to as the  
"Agreements".

Issuer issued

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its first debt for the costs of the Facility on Date 1. Issuer commenced construction of the Facility in Year and began commercial operation on Date 2.

Issuer wants to issue the Bonds to finance certain capital improvements to the Facility. The Bonds will be paid with revenues of the Facility, including revenues from the Agreements.

#### LAW AND ANALYSIS:

Section 103(a) of the 1986 Code<sup>1</sup> 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) defines "private business use" as use (directly or indirectly) in a trade or business carried on by a person other than a governmental unit. Section 1.141-3(a) provides that the 10 percent private business use test is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person.

Section 141(b)(2) provides that, except as otherwise provided, an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly (A) secured by any interest in (i) property used or to be used for a private business use, or (ii) payments in respect of such property, or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Section 141(c) provides generally that an issue meets the private loan financing test if the amount of the proceeds of the issue which are to be used (directly or indirectly) to make or finance loans to persons other than governmental units exceeds the lesser of 5 percent of such proceeds, or \$5,000,000. Section 1.141-5(a) provides that bonds of an

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<sup>1</sup> Unless otherwise specified, references to the Internal Revenue Code are to the Internal Revenue Code of 1986.

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issue are private activity bonds if more than the lesser of 5 percent or \$5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to person other than governmental persons.

Section 1.141-1(b) defines a nongovernmental person as a person other than a governmental person. Section 1.141-1(b) defines governmental person as a state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof. Section 1.103-1(a) defines "state or local governmental unit" as a state, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof.

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### Treatment of Payments

Section 1.141-4(c)(2)(C) provides that payments by a person for a use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses (as defined under § 162) directly attributable to the operation and maintenance of the financed property used by that person. For this purpose, general overhead and administrative expenses are not directly attributable to those operations and maintenance.

Section 1.141-7(c)(1) provides that the purchase pursuant to a contract by a nongovernmental person of available output of an output facility (output contract) financed with proceeds of an issue is taken into account under the private business tests if the purchase has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on bonds used (directly or indirectly) to finance the facility (the benefits and burdens test).

Section 1.141-7(e) provides that the measurement of payments made or to be made by nongovernmental persons under output contracts as a percent of debt service of an issue is determined under the rules provided in § 1.141-4.

Section 1.141-7(f)(1) provides that an output contract for the use of a facility is not taken into account under the private business tests if the average annual payments to be made under the contract do not exceed 1 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility, determined as of the effective date of the contract.

Under § 1.141-7(e), § 1.141-4 applies for purposes of measuring payments made or to be made by nongovernmental persons under output contracts as a percent of debt service. The small purchases exception contained in § 1.141-7(f)(1) applies based on a measurement of the payments under a contract as a percent of debt service. Therefore, payments attributable to ordinary and necessary business expenses should be disregarded to the extent permitted under § 1.141-4(c)(2)(C) for purposes of determining whether an output contract qualifies for the small purchases exception under § 1.141-7(f)(1).

This result is consistent with the benefits and burdens test. Under the benefits and burdens test, an output contract is taken into account under the private business tests if it has the effect of transferring to a nongovernmental person the benefits of owning the facility and the burdens of paying the debt service on bonds issued to finance the

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facility. The small purchases exception focuses on the burdens side of the test, and applies to contracts that pay a portion of the debt service on an issue that is sufficiently small to warrant a conclusion that the contract does not transfer the burdens of paying debt service on the issue. As a result, it is appropriate to apply the small purchases exception in a manner that only takes into account payments that are, in fact, available to pay debt service on the bonds. Moneys that are to be used to pay ordinary and necessary business expenses are not so available.

CONCLUSIONS:

We conclude as follows:

The Participating Customers' payments under the Agreements that are attributable to Issuer's ordinary and necessary business expenses may be disregarded for purposes of applying § 1.141-7(f)(1).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer(s) 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 rulings, 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. Specifically, no opinion is expressed concerning whether the interest on the Bonds will be excludable from gross income under § 103(a).

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) 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 taxpayer(s).

Sincerely,

Assistant Chief Counsel  
(Exempt Organizations/Employment  
Tax/Government Entities)

By: \_\_\_\_\_

Bruce M. Serchuk

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Senior Technician Reviewer  
Tax Exempt Bond Branch

cc: