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CC:TEGE:EOEG:TEB  
PLR-157115-04

Date:  
March 16, 2005

In Re:

**LEGEND:**

Agency =

Subsidiary =

State =

A =

Dear

This is in response to your request for rulings on behalf of Agency that (1) Agency and Agency's Subsidiary are instrumentalities for purposes of § 141 of the Internal Revenue Code; (2) income of Agency and Agency's Subsidiary is excludable from gross income under § 115(l) and (3) Agency's use of bond proceeds will not constitute use meeting either the private business tests of § 141(b) or the private loan tests of § 141(c).

Facts and Representations:

**AGENCY**

Agency was formed by its members and is organized under the nonprofit corporation laws of State for the purpose of benefiting its members. Agency currently has A members. Agency represents that its members consist of natural gas and electric joint action agencies and natural gas and electric distribution systems. Agency also represents that all of its members are political subdivisions. Agency was formed to perform the functions of, or to carry out the purposes, of its members with a view towards maximizing the efficient acquisition, management and delivery of natural gas

supplies and reducing operating costs of its members. To fulfill this purpose Agency will (a) acquire and finance long-term natural gas supplies, through the acquisition of interests in natural gas producing properties for the benefit of its members and provide ongoing management of such natural gas supplies and balance deliveries of such supplies into the relevant pipeline transportation system; (b) acquire, construct, own, manage, operate and finance natural gas pipelines, liquefied natural gas facilities, storage and related facilities and equipment as may be necessary or convenient in connection with the ownership, transportation, management, operation or storage of long-term natural gas supplies; and (c) contract with joint action agencies and public gas or power systems to provide them with natural gas supplies for their operations.

Agency's governing documents provide that membership in Agency is limited to a state or local governmental unit or an instrumentality the income of which is excludable from gross income under § 115 ("Governmental Entity"). The governing documents also provide that any member of Agency that ceases to be a Governmental Entity will cease to be a member of Agency, will have no rights or privileges as a member of Agency, will have no beneficial interest in Agency or its assets, and will have no right to receive any further distributions of income or assets from Agency as a member of Agency.

Agency is organized and will be operated at all times exclusively for the benefit of its members. Agency will not make any distributions of its net earnings except to its members and no part of the net earnings of Agency will inure to the benefit of, or be distributable to any director, officer or trustee of Agency or any private person. In the event of dissolution, Agency will dispose of its assets to its members.

Agency is required to deliver quarterly financial statements to each member within 60 days after the end of each fiscal quarter and annual audited financial statements within 150 days after the end of each fiscal year. Each member also has the right to conduct, at its option and at its own expense, internal audits of the books, records and accounts of Agency.

Agency is controlled by a Board of Directors ("Board") that is composed exclusively of representatives of its members. The Board is responsible for, among other items, making policy decisions with respect to the business and affairs of Agency, approving Agency's annual budget, approving all projects that are proposed to be implemented by Agency and approving the dissolution of Agency and the winding up of its affairs.

Each member appoints one director to the Board, and may remove and replace any such director by resolution or other action taken by its governing body. Each director appointed to the Board serves until (i) a successor is designated by the member that appointed such director or (ii) until the director's earlier resignation, removal, death or inability to serve. A director may be removed either for or without cause by the member that appointed him. Vacancies on the Board are filled by the member that

appointed the director previously holding the position. Generally, at meetings of the Board, two thirds (2/3) of the directors are necessary to constitute a quorum for the transaction of business. Except as otherwise provided in its bylaws, an act of a majority of the directors present at a meeting at which a quorum is present at the time shall be an act of the Board.

Agency's officers consist of a Chairman, Vice Chairman, President, Secretary and Treasurer designated by the Board. The Chairman, Vice Chairman, Secretary and Treasurer serve for two year terms beginning on the date prescribed by the Board and thereafter until their successors have been elected and qualified or until their earlier death, resignation, removal, retirement, or disqualification. The President and any other officer appointed by the Board will serve at the will of the Board and until their successors have been elected and qualified or until their earlier death, resignation, removal or retirement. Any officer elected by the Board may be removed by the Board whenever in its judgment the best interests of Agency will be served.

Agency will obtain interim financing necessary to acquire natural gas producing properties and other long-term sources of natural gas supplies (a Project). All costs and expenses associated with the interim financing will be included in the costs billed to the member on a monthly basis in accordance with the terms of a project agreement. Within six months after notice from Agency, a member must make a payment to Agency for the acquisition of its share of a Project. Member may use the proceeds of tax-exempt bonds to make such payment for its share of the Project.

#### AGENCY SUBSIDIARY

Agency formed Subsidiary as a limited liability company under State law to acquire, own and operate on behalf of Agency, the natural gas reserves or other sources of natural gas supplies comprising Agency's initial project. Agency represents that Subsidiary will hold acquired properties on behalf of Agency to afford a measure of protection to Agency and its members against environmental and other liabilities arising with respect to the acquired properties.

Subsidiary's governing documents provide that Agency is its sole member and that its membership interest may not be assigned or transferred in whole or in part, and no other person may be admitted as a member of Subsidiary. Its stated purposes are to act on behalf of Agency with respect to properties, facilities, equipment, rights or assets acquired as part of a program of acquiring long-term natural gas supplies for the benefit of Agency and its members. Subsidiary's articles of organization limit its activities to those consistent with its purpose and the requirements for an organization to qualify as a governmental instrumentality the income of which is excludable from gross income for federal income tax purposes. Subsidiary's governing documents provide that no part of the assets, funds or earnings of Subsidiary will be distributed to or inure to the benefit of any person other than Agency. The governing documents also provide that management of the business and affairs of Subsidiary will be vested solely in Agency.

Upon dissolution of Subsidiary, its assets, after payment of all debts, charges and expenses of dissolution will be distributed solely to Agency. Agency is responsible for maintaining complete and accurate books and records appropriate for Subsidiary's business.

## Law and Analysis

### A. SECTION 141

#### AGENCY AS INSTRUMENTALITY

Section 103(a) of the Internal Revenue Code provides that gross income does not include interest on any State or local bond. Section 103(b)(1) provides that § 103(a) does not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 1.103-1(a) of the Income Tax Regulations provides that interest upon obligations of State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as "State or local governmental unit") is not includable in gross income except as provided under §§ 103(c) and (d) and the regulations thereunder.

Section 1.103-1(b) provides, in part, that obligations issued by or on behalf of any governmental unit by a constituted authority empowered to issue such obligations are the obligations of such a unit.

Section 141(a)(1) provides that a "private activity bond" is any bond issued as part of an issue that satisfies the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2), or the private loan financing test of § 141(c).

Section 141(b)(1) provides that 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 test.

Section 141(b)(6)(A) provides that for purposes of § 141(b), the term "private business use" means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit.

Section 1.141-1(b) provides in part that a "governmental person" means a state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof. Under § 1.103-1 "governmental unit" includes any state or political subdivision thereof

Revenue Ruling 57-128, 1957-1 C.B. 311, sets forth the following factors to be taken into account in determining whether an entity is an instrumentality of one or more governmental units: (1) whether the organization is used for a governmental purpose

and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in a public authority or authorities; (5) whether express or implied statutory or other authority is necessary for the creation and/or use of the organization, and whether this authority exists; and (6) the degree of financial autonomy of the entity and the source of its operating expenses.

Applying the factors of Revenue Ruling 57-128 to this case, we conclude that Agency is an instrumentality of its members for purposes of § 141. Agency was formed to acquire and manage long-term natural gas supplies for the benefit of its members. In doing so, Agency coordinates and performs duties which are common to each of its members and which each member otherwise would have to perform. By aggregating the purchasing power of its members, Agency expects to maximize the efficient acquisition, management and delivery of natural gas supplies on behalf of its members, reduce operating costs, increase operating revenue and minimize risk through the diversification of natural gas supply resources. Agency's functions will enable its members to better serve their customers. Agency thus will be used for a governmental purpose and perform a governmental function on behalf of its members who are all Governmental Entities.

There are no private interests in Agency and the members have the powers and interests of an owner. The governing documents provide that membership in Agency is limited to Governmental Entities. No part of the assets will be paid or inure to the benefit of any private person. The expenses of Agency are allocated among its members in a manner reflecting the participation of its members in each Project. In the event of dissolution, members receive the assets of the Agency to the extent that any remain after payment of Agency's debts.

Control and supervision in Agency rests with its members, all Governmental Entities. All of the members of Agency's Board are appointed by the members. Each member may remove a director it appointed, at any time, with or without cause, and appoint a replacement.

Statutory authority for the creation and use of Agency is found in the nonprofit corporation law of State. No other authority is necessary for the creation or use of Agency.

The financial affairs of Agency are controlled by its members. Agency is required to deliver quarterly financial statements to each member within 60 days after the end of each fiscal quarter and to deliver annual audited financial statements within 150 days after the end of each fiscal year. Each member also has the right to conduct at its own expense internal audits of the books, record and accounts of Agency.

Agency satisfies the factors in Revenue Ruling 57-128. Accordingly, we conclude that Agency is an instrumentality of its members for purposes of § 141.

#### AGENCY SUBSIDIARY AS INSTRUMENTALITY

Based on the facts, we also conclude that Subsidiary will be an instrumentality of Agency's members for purposes of § 141. Subsidiary was formed as a limited liability company to protect Agency and Agency's members from environmental and other liabilities that might arise as a result of owning the natural gas properties. Subsidiary's sole member is Agency, an instrumentality of its members. By owning Agency's assets for a Project, Subsidiary is assisting Agency in performing duties for its members so that Subsidiary is used for a governmental purpose and performs a governmental function on behalf of Agency and its members who are all Governmental Entities. Subsidiary's governing documents provide that no part of the assets or earnings of Subsidiary may inure to the benefit of or be distributed to any person other than Agency. Under Agency's governing documents, Agency will not make any distributions of its net earnings except to its members, all Governmental Entities. In the event of dissolution, Subsidiary's assets will be distributed to Agency, who must upon its dissolution distribute its assets to its members. Control and supervision of Subsidiary is vested exclusively in Agency who is controlled by its members. Furthermore, statutory authority for the creation of Subsidiary is found in the limited liability law of State and no other authority is necessary for the creation or use of Subsidiary. Last, Subsidiary's financial affairs are controlled by Agency, its sole member and Agency's financial affairs are controlled by its members. Accordingly, weighing the factors of Revenue Ruling 57-128, we conclude that Subsidiary is also an instrumentality of Agency's members for purposes of § 141.

#### PRIVATE USE OF BOND PROCEEDS BY AGENCY

Under § 1.141-1(b) a governmental person includes a state or local governmental unit or any instrumentality thereof. Since private business use requires use by a person other than a governmental person, use by an instrumentality of state or local government is not private business use. Thus we conclude that the use by Agency of any proceeds of bonds issued by Agency members will not of itself cause private business use of the proceeds. However, private business use of bond proceeds depends on the direct or indirect uses of the bond proceeds. Thus, whether or not

proceeds of bonds issued by members are privately used will depend on the ultimate use of those bond proceeds.

## B. SECTION 115

Section 115(1) provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, is excludable from gross income for federal income tax purposes under § 115(1). The ruling indicates that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under § 115(1). In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

## AGENCY'S INCOME

Agency facilitates the cost effective acquisition, management and transportation of natural gas supplies by, and improves the operations of, utility businesses operated by its members, all functions that the members would otherwise perform themselves. Agency represents that all of its members are political subdivisions. Accordingly, Agency performs an essential governmental function.

Based on Agency's representations, for purposes of § 115(1) the net income of Agency accrues solely to entities that are political subdivisions. No part of Agency's income will inure to the benefit of or be distributed to any party other than its members, each of which must at all times be a state or local governmental unit or an instrumentality thereof the income of which is excludable from gross income under § 115, other than incidentally as reasonable compensation for services or to make payments in furtherance of Agency's purposes as set forth in its Articles of Incorporation. Upon the dissolution of Agency, all assets remaining after satisfaction of its liabilities shall be distributed to its members.

The income of Agency is derived from an essential governmental function and accrues to a political subdivision. Accordingly, the income of Agency is excludable from gross income for federal income tax purposes under § 115(1).

#### SUBSIDIARY'S INCOME

Subsidiary's purposes are limited to acquiring, owning, and operating natural gas resources on behalf of Agency, its sole member. Subsidiary assists Agency in carrying out its essential governmental purposes and provides protection to Agency against liabilities arising with respect to properties acquired in connection with the transmission of natural gas supplies to its members. Accordingly, Subsidiary performs an essential governmental function.

In addition to deriving income from the performance of an essential governmental function, the income of Subsidiary must accrue to a state, a political subdivision of a state, or another § 115 organization. Upon dissolution, Subsidiary's remaining assets will accrue to Agency. Therefore, the income of Subsidiary meets the accrual requirement. Finally, Agency's membership interest in Subsidiary may not be assigned or transferred. Thus, private interests do not benefit from Subsidiary's activities.



Because the income of Subsidiary is derived from an essential governmental function and accrues to a political subdivision of a state or to an entity the income of which is excludable from gross income under § 115, the income of Subsidiary is excludable from gross income for federal income tax purposes under § 115(1).

### Conclusion

Based on the facts and representations submitted, we conclude that Agency and Subsidiary are instrumentalities of their members for purposes of § 141. However, this ruling does not apply in the event any member is other than a political subdivision. We also conclude that the use by Agency of any proceeds of tax-exempt bonds issued by Agency members will not of itself constitute use meeting either the private business tests of § 141(b) or the private loan tests of § 141(c).

We also conclude that Agency's income is excludable from gross income under § 115(l) and the income of Subsidiary is also excludable under § 115(l). However, this ruling does not apply to any subsidiaries created by Agency in the future.

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 1986 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 your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer 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.

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

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

Timothy L. Jones  
Senior Counsel  
Tax Exempt Bond Branch

cc: