

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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**Legend:**

Issuer =  
State =  
Corporation =  
Facility =

a =  
b =  
c =  
d =  
e =

Dear :

This letter is in response to your request for a ruling that (1) for purposes of determining whether the Bonds (described below) are private activity bonds under § 141 of the Internal Revenue Code (the "Code"), the output from the Issuer's reserved portion of the Facility's net rated capacity under the Power Sales Contract (described below) taken by issuer is treated as the government use portion of the Facility under the Advance Notice of Proposed Rulemaking, published on September 23, 2002 (67 FR 59767), 2002-2

C.B. 685 (the "Advance Notice"), and (2) the Operation Agreement (described below) between Issuer and Corporation is not treated as a management contract that results in private business use under § 1.141-3(b)(4) of the Income Tax Regulations.

## FACTS AND REPRESENTATIONS

Issuer is a political subdivision of the State. Issuer owns electric generation, transmission, and distribution facilities, including the Facility. Corporation is a nongovernmental electric cooperative organized under the laws of the State. Issuer has entered into several arrangements with Corporation with respect to the Facility, only two of which are subject to this private letter ruling, the Power Sales Contract and the Operation Agreement. The governing body of the Issuer establishes and approves the rates for power produced from Issuer's reserved net rated capacity of the Facility and sold to the Issuer's customers.

Under the Power Sales Contract, Issuer retains the right to reserve a certain amount of net rated capacity of the Facility's total net rated capacity for its use. Corporation has the right and obligation to take and pay for the remaining net rated capacity of the Facility. Currently, Issuer has reserved a megawatts of b megawatts of the Facility's net rated capacity, which constitutes c percent of such capacity. Issuer's reserved net rated capacity may be adjusted by Issuer annually up or down in increments of d megawatts. The Facility's net rated capacity equals its nameplate capacity minus the auxiliary power needed to run the Facility.

Under this Power Sales Contract, for each year, Issuer has the right to schedule or take the portion of power generated by the Facility equal to the percentage of the Facility's net rated capacity reserved by Issuer for that year. If Issuer does not schedule or take all of the output from its reserved portion of the Facility's net rated capacity, it must offer the unused output to Corporation before offering to third parties.

Under the Operation Agreement, the Facility is operated by Corporation. Issuer reimburses Corporation, on a monthly basis, for Issuer's share of the actual and direct expenditures incurred by Corporation in the operation and maintenance of the Facility. Issuer's share of the costs is equal to Issuer's reserved percentage share of the Facility's net rated capacity. The costs of the auxiliary power are also shared between Issuer and the Corporation in proportion to their respective shares of the net rated capacity. These reimbursements are the only amounts payable to Corporation by Issuer for its management and operation of Issuer's share of the Facility under the Operation Agreement.

Issuer is contemplating making various capital improvements to the Facility. Responsibility for financing improvements to the Facility is allocated between Issuer and Corporation on the basis of their respective reservation and allocation of the net rated capacity of the Facility under the Power Sales Contract. Issuer's resolution authorizes

the issuance, over several years, of up to \$e of bonds (the “Bonds”) to finance Issuer’s portion of the costs of the improvements to the Facility. Issuer represents that while the bonds are outstanding it will (a) maintain its reserved net rated capacity, and (b) of the total energy generated at the Facility, take a sufficient amount, so that no more than ten percent of the Facility’s improvements that are to be financed with the Bonds will be used for private business use under § 141.

## LAW AND ANALYSIS

Section 103(a) of the 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 141(a) provides that a private activity bond is any bond issued as part of an issue that meets either (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, generally, a bond 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) provides that 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) defines a nongovernmental person as a person other than a governmental person. A governmental person means a state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof.

Section 1.141-2(a) provides, in part, that the private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits. The regulations under § 141 may not be applied in a manner that is inconsistent with these purposes.

Section 1.141-3(a)(2) provides that, in determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of proceeds. For example, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and subleased to a governmental person or if it is leased to a governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person’s use is in a trade or business. Similarly, the issuer’s use of the proceeds to engage in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met. In addition, proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

Section 1.141-3(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property 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.

Under § 1.141-3(b)(4)(i), management contracts may result in private use depending on all the facts and circumstances. Certain arrangements are not treated as management contracts that result in private business use. One of these, described in § 1.141-3(b)(4)(iii)(C), is a contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

Section 1.141-1(b) provides that “public utility property” means public utility property as defined in § 168(i)(10). Section 168(i)(10) provides that the term “public utility property” means property used predominantly in the trade or business of the furnishing or sale of, among other things, electrical energy, if the rates for such furnishing or sale, as the case may be, have been established or approved by, among other entities, a state or political subdivision thereof.

The Advance Notice, upon which issuers may rely for bonds sold before the date of publication of the final regulations under § 1.141-6, or the date specified in the final or future proposed regulations, provides that tax-exempt bonds may be issued to finance costs attributable to the government use portion of a mixed-use output facility (plus any costs attributable to *de minimis* private business use permitted under § 141) without the bonds being characterized as private activity bonds. With respect to arrangements for the purchase of output from a power generating facility, the government use portion of a facility is determined based on the percentage of the available output of the facility that is not used for a private business use as determined under § 1.141-7. Section 1.141-7(b)(1) provides that the available output of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the measurement period of that facility for that issue. Under § 1.141-7(b)(1)(i) the number of units produced or to be produced by a generating facility in one year is determined by reference to its nameplate capacity or its equivalent, which is not reduced for reserves, maintenance or other unutilized capacity.

In this case, the Facility consists of property used predominantly in the trade or business of the furnishing or sale of electricity. The Issuer’s governing body establishes and approves the rates for electricity provided by the Issuer from Issuer’s reserved

share of the net rated capacity of the Facility. Therefore, to the extent of such share, the Facility constitutes public utility property under § 168(i)(10).

The allocation of output under the Power Sales Contract based upon reserved net rated capacity of the Facility is the equivalent of an allocation based upon the available output of the Facility. Corporation has the right to the output from the remaining net rated capacity of the Facility. In addition, it may purchase some or all of Issuer's output not scheduled or taken. The amount or output taken by Corporation under these rights is private business use of the Facility. Thus, Issuer's portion of the net rated capacity of the Facility reduced by Corporation's purchases of Issuer's output not scheduled or taken and any other private business use of the Facility is the government use portion of the Facility. Therefore, in accordance with the Advance Notice, Issuer may issue the Bonds in an amount to cover the costs of the government use portion of the Facility and its improvements (plus any costs attributable to the *de minimis* private business use permitted under § 141).

The Operation Agreement is an arrangement with respect to Issuer's share of the Facility, which is measured by its reserved net rated capacity and which constitutes public utility property. Under the Operation Agreement, only actual and direct expenses incurred in the operation and maintenance of Issuer's share of the Facility are payable to Corporation for its management of such share. Consequently, the Operation Agreement is an arrangement that is not treated as a management contract that results in private business use and which, in and of itself, does not cause the Issuer's share of the Facility to be privately used by Corporation.

## CONCLUSION

Based on the foregoing, we conclude that (1) Issuer may treat the output from the net rated capacity of the Facility reserved for Issuer's use under the Power Sales Contract, reduced by Corporation's purchases of Issuer's output not scheduled or taken from such reserved capacity and any other private business use of such output, as the government use portion of the Facility under the Advance Notice, and (2) the Operation Agreement between Issuer and Corporation is not treated as a management contract that results in private business use under § 1.141-3(b)(4)(C)(iii).

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. In particular, no opinion is expressed or implied concerning whether (a) the interest on the Bonds will be excludable from gross income under § 103(a), or (b) other than the Operating Agreement (to the extent described herein), any arrangement, including an arrangement that would cause Issuer's portion of the total net rated capacity to be other than that reserved at the time of issuance of the Bonds, or would cause Issuer to sell any amount of energy to which it is entitled to Corporation or any

other private user, will not cause the Bonds to meet the private business use test under § 141 of the Code.

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 your authorized representatives.

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,

Associate Chief Counsel  
(Financial Institutions & Products)

By: \_\_\_\_\_  
Timothy L. Jones  
Senior Counsel  
Branch 5

cc: