

INTERNAL REVENUE SERVICE

Number: **200026020**

Release Date: 6/30/2000

UIL: 141.01-00

CC:DOM:FI&P:5/PLR-116054-99

April 3, 2000

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This letter is in reply to your request for a ruling that interest on the Bonds will be excluded from the gross income of holders of the Bonds under § 103(a) of the Internal Revenue Code. Your request is submitted as a reviewable ruling under § 4 of Rev. Proc. 96-16, 1996-1 C.B. 630.

Facts and Representations

City is organized under the laws of State and, under those laws, has taxing powers, police powers, and powers of eminent domain. City owns and operates a subregional sewage enterprise system (the "sewage system"), which includes a treatment plant and a reservoir for storing treated effluent from the plant, for the benefit of residents within the jurisdiction of City, several other cities in the vicinity of City and a portion of County. The sewage system serves approximately X people within these jurisdictions.

Effluent generated by the City's sewage system (the "wastewater") receives tertiary treatment prior to disposal. Because of significant population growth, finding an acceptable method to dispose of the treated wastewater has become a serious problem for City. Different disposal alternatives were explored as long-term solutions to this problem. After evaluating these alternatives, City selected the project described below as the best choice and entered into the Contract with Company. The term of the Contract is Z years.

The project (the "City Project") consists of a pipeline, four pumping stations, tanks,

connection equipment, control systems, power systems, and a storage tank located at the geyser field. The anticipated cost to City for the City Project is \$T. The principal component of City Project is the pipeline running from City's existing sewage system to a thermally active geyser field. The pipeline will consist of one section E miles long (the "Multi-Use Pipeline") and another section F miles long (the "Geysers Field Pipeline") that will transport the wastewater from City's sewage system to the storage tank at the geyser field. After the wastewater is delivered to the geyser field, it will be injected into the ground, become heated, and produce steam, which will be used to generate electricity to be sold by Company.

Company owns or leases the geyser field, the facilities for injecting the wastewater into the ground, and the facilities for generating electricity at the geyser field (the "Company Project"). Company will pay the costs of operating and maintaining the Company Project and the electrical costs of three of the four pumping stations along the pipeline. Other than the electrical costs of the three pumping stations, City will pay for the costs of operating and maintaining the City Project.

The Multi-Use Pipeline will have a capacity of A gallons per day. The Geysers Field Pipeline will have a capacity of B gallons per day. Under the Contract, City will be obligated to deliver an average of approximately C gallons of wastewater per day, which is about 27% of the capacity of the Multi-Use Pipeline and nearly 100% of the capacity of the Geysers Field Pipeline, to the geyser field during the term of the Contract. The remaining capacity of the Multi-Use Pipeline will be available to provide irrigation water to various entities and persons (the "irrigators") along its route. Section 8 of the Contract provides that wastewater will meet the State requirements for tertiary treatment. Under that section, Company will have the right to access City facilities and records to test the wastewater or to verify the quality of the water.

City expects to enter into contracts with the irrigators that will have a term of 10 to 30 years. Under the contracts, specific amounts of wastewater will be delivered at a price to be negotiated at the time of the contract. City represents that aggregate dollar amounts received from irrigation contracts will not exceed 5% of the debt service on the Bonds. Currently, there are no contracts with the irrigators for use of wastewater in the Multi-Use Pipeline.

Apart from the electricity provided for the pumping stations, Company will neither pay the City for the wastewater nor share with City, directly or indirectly, any revenues from the sales of electricity it generates at the geyser field. During the last one-third of the term of the Contract, Company can terminate the Contract at any time by giving notice to the City and by paying City \$V for each year that the term of the contract is reduced (the "contingent payment"). It is not expected that the Contract will be terminated before the end of its term.

If wastewater is not delivered or taken in accordance with the Contract, the parties are required to mediate any differences. If mediation fails, the non-defaulting party can either declare the defaulting party in breach of the Contract or seek specific performance of the Contract. If the Contract is breached by Company during the first two-thirds of its term, the City can terminate the Contract and collect a predetermined amount of damages (the "liquidated damages"). Specific performance rights are described in section 21 of the Contract. Under that section, a non-defaulting party can request a temporary restraining order and a preliminary

injunction to prevent a default under the Contract or to compel performance by the defaulting party. The City does not expect that the Contract will be breached by either party or that Company will pay City any liquidated damages.

City represents that the City Project serves several public purposes. The most important purpose is the disposal of City's wastewater. In addition, the City Project allows the City to release the wastewater into the Q River at an alternative location that will not degrade the quality of the River to the same extent as the present release location. Finally, the City Project allows the wastewater to be delivered to areas that have chronic shortages of irrigation water.

City adopted a resolution on Date 1 to issue the Bonds. It is represented that the Bonds will be issued within 60 days of a favorable resolution of the tax issue raised by this ruling request. Part of the proceeds of the Bonds will be used to refund taxable bonds issued in 1998 to pay construction costs of the first phase of the City Project. The rest of the Bond proceeds will be used to finance the remaining costs of the City Project. Debt service on the Bonds is secured and paid by sewer fees charged to persons receiving sewer service from the City's sewage system (the "ratepayers"). City anticipates that sewer fees will have to be increased to pay for the City Project. The sewer fees are set by City ordinance. There are no specially negotiated sewer fee arrangements.

The Bonds have a maximum maturity of 30 years and an expected weighted average maturity of 22 years. The expected economic life of City Project is at least 50 years. The expected yield of the Bonds is R%. It is expected that a portion of the Bond proceeds will be invested at an unrestricted yield for a temporary period not to exceed three years as permitted in § 1.148-2(e)(2) of the Income Tax Regulations. Other than the provisions under § 141(b), which are the subject of this letter ruling, City represents that it will meet all requirements so that interest on the Bonds will be excluded from the gross income of the holders of the Bonds under § 103(a).

Law and Analysis

Generally:

Under § 103(a), gross income does not include interest on any state or local bond. Section 103(b)(1) provides, however, that § 103(a) does not apply to a private activity bond, unless it is a qualified bond under § 141. Section 141(a)(1) defines a private activity bond as any bond issued as part of an issue that meets either (1) the private business use test in § 141(b)(1) and the private security or payment test in § 141(b)(2) (collectively referred to as the "private business tests") or (2) the private loan financing test in § 141(c).

The private business use test of § 141(b)(1) is met if more than 10% of the proceeds of an issue are to be used for any private business use. The private security or payment test is met if the payment of the principal of, or the interest on, more than 10% of the proceeds of an issue is directly or indirectly (1) secured by an interest in property used or to be used for a private business use, (2) secured by an interest in payments in respect of such property, or (3) 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.

Output Facility:

City argues that use of the City Project should be evaluated under § 1.141-7T because the City Project is operating as an output facility and the Contract is an output contract. We disagree. We do not believe that the City Project is within the definition of an output facility under § 1.141-1(b). However, even if the City Project is an output facility, the Contract still must be analyzed under §§ 1.141-3 and 1.141-4 because it provides Company with specific performance rights.

Section 1.141-7T provides special rules to determine whether arrangements for the purchase of output from an output facility cause an issue of bonds to meet the private business tests. Under § 1.141-7T(c)(1), the purchase of output from an output facility by a nongovernmental person is taken into account under the private business tests if the purchase has the effect of transferring substantial benefits of owning the facility and substantial burdens of paying the debt service on bonds used (directly or indirectly) to finance the facility. City argues that the Bonds would not meet the private business tests under § 1.141-7T(c) because the Contract does not transfer substantial burdens of paying debt service.

An output contract transfers substantial benefits of owning a facility if the contract gives the purchaser (directly or indirectly) rights to capacity of the facility on a basis that is preferential to the rights of the general public. Section 1.141-7T(c)(2)(i). An output contract transfers substantial burdens of paying debt service on an issue to the extent that the issuer reasonably expects that it is substantially certain that payments will be made under the terms of the contract (disregarding default, insolvency, or other similar circumstances). For example, an output contract is treated as transferring burdens of paying debt service on an issue if payments must be made upon contract termination. Section 1.141-7T(c)(2)(ii).

An output facility is defined by § 1.141-1(b) as electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.

An output contract is a contract under which the available output from an output facility is purchased. Section 1.141-7T(c)(1). Take contracts and take or pay contracts are defined in § 1.141-7T(b)(5). A take contract is an output contract under which a purchaser agrees to pay for the output under the contract if the output facility is capable of providing the output. A take or pay contract is an output contract under which a purchaser agrees to pay for the output under the contract, whether or not the output facility is capable of providing the output.

Under § 1.141-7T(c)(5), an output contract that provides the purchaser with specific rights to control the output of a facility or with other specific performance rights to the use of output of a facility is generally taken into account under the private business tests, even if the benefits and burdens test is not met.

City's argument that the City Project should be analyzed under § 1.141-7T is based on its assertion that the City Project, when viewed separately from the City's sewage system, is a water

facility. It argues that City Project meets the definition of a water facility under § 142(e), because it will be used to distribute water to members of the general public (including electric utility, industrial, agricultural, or commercial users), and will be operated by a governmental unit.

For purposes of § 142(a)(4), facilities for the furnishing of water are defined by § 142(e) as any facility for the furnishing of water if generally (1) the water will be made available to members of the general public and (2) the facility is operated by a governmental unit or the rates for the sale of water have been established or approved by a political subdivision, an agency of the United States, or a public utility commission.

Assuming for argument's sake that a water facility under § 1.141-1(b) is the same as a water facility under § 142(e), we nevertheless must reject City's argument. The wastewater delivered by the City Project will not be available to the general public even if the irrigators are viewed as the "public" despite their small number. Section 141-3(c)(3) states that an arrangement is not treated as general public use if the term of the use under the arrangement is greater than 180 days. In this case, the long-term contracts between City, the Company, and the irrigators are arrangements that prevent use under the contracts from being general public use. Thus, the City Project fails to meet the definition of a water facility.

We also believe that the City Project is not a water facility because it is an integral part of the City's sewage system.¹ City represents that the wastewater carried in the City Project is generated by City's subregional sewage facility. It also represents that the City Project was chosen as the best alternative for disposing of the wastewater generated at its sewer plant. The treatment plant could not exist without functionally related subsystems like the City Project to remove the wastewater generated at the sewer plant.

Further, even if City Project could be viewed separately from the City's sewage system, it would still fail to be an output facility. The term output facility is defined narrowly for purposes of § 141 and does not include facilities for the disposal of treated wastewater. Under § 1.141-1(b), output facilities are limited to electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.

The negotiated contracts with the users of wastewater are also indicative that the City Project is not an output facility under any circumstance. The special rules for output facilities exist because owners of output facilities are generally under an open-ended obligation to serve members of the public, and members of public are ordinarily required to make continuing payments for service.² These attributes are inapplicable to City Project. The only users of wastewater to be delivered by City Project are Company and the potential irrigators, each of which will be served pursuant to a separately negotiated, long-term contract. Outside of these contracts, City will be under no obligation to deliver wastewater to anyone from City Project.

¹ We were not asked to rule whether City Project meets the definition of a sewage facility under § 142.

² Explanation of Provisions related to T.D. 8757 (§ 1.141-7T), 1998-1 C.B. 755.

The wastewater will be delivered to Company under the Contract at no charge. Under contracts with the irrigators, specified amounts of wastewater will be delivered to the irrigators at varying charges.

The special benefits and burdens test of § 1.141-7T(c) is not applicable even if the Contract is an output contract. Under § 1.141-7T(c)(5), contracts that permit a nongovernmental purchaser to control the output or with other specific performance rights to the use of output of a facility generally are taken into account under §§ 1.141-3 and 1.141-4. This is the case under the Contract. Section 21 of the Contract provides Company with the right to specific performance of the Contract including a right to a preliminary injunction to compel the City's performance. These rights require that the Contract be analyzed under §§ 1.141-3 and 1.141-4.

Private Business Use:

Under § 141(b)(6)(A), private business use means use directly or indirectly in a trade or business that is carried on by a person other than a governmental unit. Use by a member of the general public is not taken into account.

Under § 1.141-3(b)(1), 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 if a nongovernmental person has special legal entitlements to use the bond financed property under an arrangement with the issuer. For example, an arrangement that conveys priority rights to the use or capacity of the bond-financed facility generally results in private business use. Section 1.141-3(b)(7)(i).

Use as a member of the general public is not private business use under § 1.141-3(c)(1). Use of financed property by nongovernmental persons in their trades or business is treated as general public use only if the property is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business. In general, use under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public. Section 1.141-3(c)(2). Also, an arrangement is not treated as general public use if the term of the use under the arrangement is longer than 180 days. Section 1.141-3(c)(3).

In this case, one requirement imposed by Company is that approximately C gallons of wastewater be delivered each day to the geyser field during the term of the Contract. This represents a reservation of about 27% of the capacity of the Multi-Use Pipeline and nearly 100% of the Geyser Field Pipeline. This special legal entitlement of Company, a nongovernmental person, causes City Project to be privately used in the trade or business of Company. Because more than 10% of the Bond proceeds will be used by a nongovernmental person in its trade or business, the private business use test of § 141(b)(1) will be met if the Bond proceeds are used as proposed.

City argues that the use of Company Project by Company and the irrigators is general public use. We reject City's argument. The use by Company and the irrigators will be pursuant to contracts that are greater than 180 days. Under § 1.141-3(c)(3), long-term arrangements are

not treated as general public use. Also, the City Project will not be available for use on the same basis by natural persons who are not engaged in a trade of business. *See* § 1.141-3(c)(1). The City Project is used by Company, the irrigators, and the ratepayers. Use of the City Project by the ratepayers is based on removing and ultimately disposing of their sewage. In contrast, use of the City Project by the Company and the irrigators is based on supplying the wastewater for use in the geyser field or on irrigable property. In addition, the ratepayers' use of City Project is based on their residence within the City's service area, while the Company and irrigators' use of the City Project is based on long-term contracts. Finally, as between the irrigators and the Company, each use of City Project is or will be pursuant to a contract with different terms. For example, Company is not paying for the wastewater but the irrigators will be required to make some payment.

Private Security or Payment Test:

Section 1.141-4(a)(1) provides, in part, that the private security or payment test relates to the security for, and the source of, the payment of debt service on an issue. The test takes into account the payment of the debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property used or to be used for a private business use. The private security portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use.

Under § 1.141-4(c)(2)(i)(A), both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user. Payments are not made in respect of financed property if those payments are directly allocable to other property being directly used by the person making the payment and those payments represent fair market value compensation for that other use.

Section 1.141-4(d)(4) provides that property used or to be used for a private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. For this purpose, the phrase "any interest in" is to be interpreted broadly and includes, for example, any right, claim, title, or legal share in property or payments.

Section 1.141-4(d)(5) provides that the payments taken into account as private security are payments in respect of property used or to be used for a private business use. Except as otherwise provided in §§ 1.141-4(d)(5) and (d)(6), the rules of §§ 1.141-4(c)(2)(i)(A), 1.141-4(c)(2)(i)(B), and 1.141-4(c)(2)(ii) apply to determine the amount of payments treated as payments in respect of property used or to be used for private business use. Thus payments by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private security for the period of time that the property is used by a private

business user.

There are three possible sources of private payments: the sewer fees paid by the ratepayers; the contingent payment; and the liquidated damages payment. Because of the contingencies associated with the liquidated damages payment and the contingent payment, we conclude that neither should be taken into account as a private payment.

The sewer fees are another matter. The sewer fees are paid by the ratepayers who will use the City Project to finally dispose of their sewage after treatment at the City's sewage plant. Although the sewer fees will be used to pay for other parts of the City's sewage system, they also will be used to pay the debt service on the Bonds that financed City Project. Indeed, City has specifically pledged the sewer fees to payment of the debt service on the Bonds. Also, City represents that it will have to increase sewer fees to pay for City Project. The ratepayers are similarly situated to the patients paying for hospital services in § 1.141-4(g), Example 5. In that example, a hospital owned by City P is operated by D in a manner that results in private use of the hospital under § 1.141-3. Revenues from the hospital are used to pay debt service on tax-exempt bonds that financed renovations of the hospital. The bonds meet the private security or payment test because the revenues from the hospital are payments in respect of property used for a private business use.

Like the hospital in Example 5, the City Project is used in the trade or business of Company. While this use is occurring, the ratepayers pay sewer fees, which are pledged to debt service on the Bonds, for processing and disposing of their sewage. Thus, the sewer fees, like the patient fees in Example 5, are payments in respect of property (the City Project instead of the hospital) used for a private business.

Nevertheless, City argues that the sewer fees are neither private payments nor private security because they are directly allocable to the public purpose of wastewater disposal associated with the City Project. City cites § 1.141-4(g), Example 4, as authority for its argument that the sewer fees are not private payments because they are allocated to the public purpose of wastewater removal. Example 4 involves the undergrounding of existing power lines for public safety purposes. The power lines are owned by a private utility company that is under no obligation to underground the lines. City Y uses the proceeds of tax-exempt bonds to pay for the undergrounding and tax assessments on the customers of the utility to pay debt service on the bonds. Although utility lines are privately owned and the utility customers make payments to the utility company for the use of the lines, the assessments are not private payments because they are in respect of the relocation costs and are not made in respect of property used for a private business use.

City misunderstands Example 4. Example 4 is an example of when payments will not be taken into account because they are directly allocable to other property being used by the person making the payment. Section 1.141-4(c)(2)(i)(A). In the example, there are two separate, distinct items of property: the existing private utility lines and the governmental undergrounding project. Although there is a public benefit from having electricity delivered within City Y, the utility lines are privately used. The undergrounding project is governmental property that is not privately used. The relocation does not result in any additional benefit to the utility company

because electricity is already being transported through the overhead lines. Also, the utility company has no reserved rights in the undergrounding project.

In contrast to Example 4, the Bond-financed City Project is only one property, which is privately used by Company. The City Project transports wastewater from the City's sewage treatment plant to the geyser field pursuant to the Contract with Company.³ Unlike Example 4, there is no separate governmental property being financed to which the sewer fees can be allocated. The fact that City Project may provide public benefits while it is privately used by Company does not mean that City Project consists of two properties. A public benefit is not a separate property. In addition, Example 4 does not illustrate that the § 141 regulations permit bond proceeds to be allocated among those benefitting from a discrete facility.

Conclusions

Based on the above, we conclude that the Bonds will meet the private business tests of § 141(b). The City Project will be privately used by Company and the sewer fees paid by the City's ratepayers for debt service on the Bonds will be private payments because they are being made in respect of a privately used property financed with the Bonds.

This ruling is addressed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The ruling 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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,
Assistant Chief Counsel
(Financial Institutions and Products)
By : Rebecca L. Harrigal
Branch Chief, Branch 5

Enclosure (1)

³ It will also be used to transport wastewater to the irrigators when there are contracts with the irrigators.