

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EOEG:TEB-PLR-128026-02

Date:

September 10, 2002

Legend:

Authority =

Lease =

System =

City =

Operator =

Bonds =

State =

Agency =

Act =

Agreement =

Prior Bonds =

a =
Date 1 =
Date 2 =
Date 3 =
Date 4 =

Dear

This is in response to your request on behalf of the Authority for a ruling that the Lease of the System between the City and the Operator will not adversely affect the tax-exempt status of the Bonds.

FACTS AND REPRESENTATIONS

The Authority represents the following facts. The City is a municipal corporation duly organized and existing under the laws of State. The Agency is a public body, corporate and politic, duly organized and existing under the laws of State. The Authority is a joint powers agency formed pursuant to the Act by the City and the Agency. In accordance with the Act and the Agreement between the City and the Agency, the Authority has the power to issue bonds on behalf of the City to finance and refinance public improvements.

The Authority issued the Bonds on behalf of the City to provide financing for the System, a municipal utility system that serves residents and businesses within the City's limits. The System is owned by the City and is currently leased to the Authority and subleased back to the City. The System is operated by Operator, a nongovernmental person, pursuant to an arrangement meeting the requirements set forth in Rev. Proc. 97-13, 1997-1 C.B. 632.

On Date 1, the Prior Bonds were issued on behalf of the City and the proceeds were used to acquire, improve, and replace parts of the System. On Date 2, the Prior Bonds were currently refunded in their entirety by the Bonds. As of the date of this ruling request, \$a of the Bonds are still outstanding. Except for amounts deposited in reasonably required reserve or replacement funds, all of the proceeds of the Bonds have been expended.

The Bonds have been outstanding at least five years since the later of the issue date or the date the System was placed in service. As of the issue date of the Bonds, the City and the Authority reasonably expected to use the Bond proceeds for a qualified use throughout the term of the Bonds. The Bonds are scheduled for a final maturity on Date 4, more than 10.5 years from the issue date, and, by their terms, are not subject to any early call and, therefore, cannot be retired prior to their final maturity date. The issue date of the Bonds predates May 16, 1997, and the Authority has not chosen to apply § 1.141-12 of the Income Tax Regulations to the Bonds.

For a variety of reasons, including to ease the City's administrative burden of operating the System, to reduce existing and future costs of operating the System, to ensure stable utility rates, to improve the System's condition and the level of service and ensure that it meets the City's current and future needs, and to significantly reduce the City's and the Authority's legal liabilities of owning and operating the System, the City wishes to lease all of its interest in the System to the Operator.

The City issued a "Request for Proposal to Lease the System" (the "RFP") to four private companies that were selected during a pre-qualification process. All four private companies submitted a proposal in response to the RFP. The City received a report prepared by an independent appraiser evaluating the proposals and the companies that participated in the bidding process. After holding a public hearing, the City accepted the appraiser's recommendation and selected the Operator as the most qualified bidder with the best financial proposal. The proposed terms of the Lease were approved by the City on Date 3. Execution of the Lease is pending on the outcome of this ruling.

Within 90 days after the execution of the Lease, the Authority will defease all of the outstanding Bonds to maturity. In order to defease the Bonds to maturity, the Authority will establish an irrevocable escrow funded with general revenues of the City that, together with the investment earnings thereon, will be sufficient to pay all principal and interest on the Bonds to the maturity date. The escrow will be invested at a restricted yield not in excess of the yield on the Bonds. Amounts in the escrow will not be invested in any investment under which the obligor (or a related party) is a user of the proceeds of the nonqualified Bonds.

The Authority seeks a ruling that the execution of the Lease will not cause the interest on the Bonds to fail to be excluded from gross income under § 103(a) of the Internal Revenue Code (the "Code"), provided that the Authority takes the remedial action as described herein.

LAW AND ANALYSIS

Under § 103(a) of the Code, gross income does not include interest on any state or local bond. Section 103(b), however, provides 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 a part of an issue (1) which meets the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2), or (2) which meets the private loan financing test of § 141(c). Section 141(b)(1) provides, in general, 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.

Section 141(b)(2) provides in general that 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 the issue is (under the terms of the issue or any underlying arrangement) directly or indirectly (A) secured by any interest in property used or to be used for a private business use, or 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(b)(6) provides that the term "private business use" for purposes of § 141(b) means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business.

Section 1.141-2(d) generally provides that a deliberate action is any action taken by the issuer that is within its control. Section 1.141-12 provides rules under which a deliberate action that would cause bonds to meet the private business tests will not cause the bonds to be private activity bonds if certain conditions are met and a permitted remedial action is taken. Section 1.141-15(b) provides that §§ 1.141-2 and 1.141-12 are effective for bonds issued after May 15, 1997, that are subject to § 1301 of the Tax Reform Act of 1986 (the "1986 Act"). Section 1.141-15(e) permits § 1.141-12 to be applied to any bonds issued before May 16, 1997. The Authority has not chosen to apply § 1.141-12.

Rev. Proc. 93-17, 1993-1 C.B. 507, contains certain conditions under which changes in the use of proceeds of an issue of state or local bonds would not result in those bonds being treated as violating certain requirements of §§ 141 through 150 of the Code. Rev. Proc. 93-17 is obsolete for actions that occur on or after May 16, 1997. See T.D. 8712, 1997-1 C.B. 23. Thus, neither § 1.141-12 nor Rev. Proc. 93-13 will apply to the City's entering into the Lease. Under these circumstances, in considering whether to issue an advance ruling as to whether a change from a qualified to a nonqualified use will not cause bonds to meet the private business use tests of § 141(b) of the Code, the Internal Revenue Service may apply the principles underlying Rev. Proc. 93-17.

Section 4.01(1) of Rev. Proc. 93-17 provided that a "change of use" is a change in the use of the proceeds of an issue from the actual or expected use to a different

use. Section 4.01(6) provided that a "qualified use" is any use of the proceeds of an issue in a manner that satisfies all of the applicable requirements for tax-exempt bonds under §§ 103 and 141 through 150. Section 4.01(5) provided that a "nonqualified use" means any use of the proceeds of an issue in a manner that fails to satisfy the applicable requirements for tax-exempt bonds under certain specified sections of the Code, including § 141(b).

Section 4.01(4) of Rev. Proc. 93-17 provided that "nonqualified bonds" means, for purposes of the revenue procedure, the portion of the bonds that is properly allocable to proceeds with respect to which there occurs a change of use that results in a change from a qualified use to a nonqualified use.

Under Rev. Proc. 93-17, if certain conditions were met, a change of use resulting in a nonqualified use would not be treated as causing interest on the bonds to fail to be excluded from gross income under § 103(a) because of a failure to satisfy the requirements of the Code specified in this revenue procedure. Specifically, under Rev. Proc. 93-17, to maintain tax-exempt status following a change of use to a nonqualified use, it was necessary that the following conditions be met:

(1) The issuer and all conduit borrowers must reasonably expect on the issue date to use the bond proceeds for a qualified use for the entire term of the issue.

(2) The bond proceeds must have been used for a qualified use for a substantial time period of at least 5 years after the later of the issue date or the date on which the financed facilities were placed in service.

(3) Any agreements between the new user and the original user are bona fide and arm's length, and the new user must pay fair market value for the facilities.

(4) No circumstances can be present that suggest an attempt to avoid the requirements of §§ 103 and 141 through 150.

(5) The issuer must take one of the three remedial actions set forth in § 4 of this revenue procedure, one of which is relevant in this case.

Section 4.02(5)(a) provides that a valid remedial action is the redemption of all of the nonqualified bonds at the earliest call date after the change of use. If the nonqualified bonds are not redeemable within 90 days of the change of use, an irrevocable escrow must be established within this 90-day period and used to redeem the bonds at their earliest call date. The escrow may not be invested in higher yielding investments. The escrow must be established in an amount that, together with investment earnings thereon, is sufficient to pay all principal, interest, and call premium on the nonqualified bonds from the date the escrow is established to, and including, the earliest call date. The amounts in the escrow may not be invested in any investment

under which the obligor is a user of the proceeds of the nonqualified bonds or any related party to that user.

Although Rev. Proc. 93-17, by its terms, does not apply to this case, the principles underlying the revenue procedure present guidelines for the Internal Revenue Service to issue a private letter ruling as to whether a change in use will cause bonds to be treated as not meeting the private business use test of § 141(b). Under these principles, the Lease of the System to the Operator would have resulted in a change of use of the Bond proceeds from a qualified use to a nonqualified use. The Bonds, however, would have qualified for the safe harbors provided in the revenue procedure. Specifically, the Authority had reasonable expectations on the date of issuance of the Bonds that the facilities financed by the Bonds would be used for a qualified use throughout the term of the Bonds, the Bond proceeds were used for a qualified use for a substantial time period of at least 5 years after the later of the date of issue or the date on which the System was placed in service, the Lease of the System will be for fair market value and the Lease terms were determined in a bona fide arm's-length transaction, and there appear to be no circumstances indicating an attempt to pass the benefit of the tax-exemption to a private business or to avoid the requirements of §§ 103 and 141 through 150 of the Code. Finally, the Authority represents that it will establish an irrevocable and restricted escrow sufficient to defease all of the outstanding bonds to maturity subject to the requirements of § 4.02(5)(a).

CONCLUSION

Based solely upon your representations and the facts presented, we conclude that the Lease of the System to the Operator will not cause the Bonds to meet the private business use test of § 141(b) of the Code, provided that the Authority takes the actions described in this letter.

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, including whether interest on the Bonds is excluded from gross income under § 103 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 the taxpayer.

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: _____
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