

INTERNAL REVENUE SERVICE

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October 5, 2004

This responds to your e-mail dated September 20, 2004, in which you requested information with respect to the tax-exempt status of lease-purchase arrangements of energy efficient equipment to municipalities and other political subdivisions (the "lessees"). Under such lease-purchase arrangements, lessor would lease energy efficient equipment to lessees. A component of the lease-purchase would be the payment of interest by lessees.

Lessees would make lease payments using a combination of income sources, including savings resulting from the decrease in utility costs and incentive payments from the utility company to encourage utility use.

You specifically requested information concerning the fact that the incentive payments (termed "rebates") from the utility company could exceed 10 percent of the total lease payments. You are concerned that interest paid under the lease-purchase arrangement could be taxable because the incentive payments would be payments from a private person that exceeds 10 percent of the proceeds.

During our telephone discussion regarding your hypothetical transaction, it became apparent that your concern was whether such a transaction would be treated as a private activity bond for failing the private security or payment test under section 141(b)(2) of the Internal Revenue Code. You stated, during the discussion, that the lessor would be the sole user of the energy efficient equipment in the hypothetical transaction.

The private security of payment test is part of the private activity bond test found in section 141(a)(1) of the Code. Under this test, a private activity bond is one that meets (1) the private business use test of section 141(b)(1), and (2) the security or payment test of section 141(b)(2).

Under the hypothetical transaction no private use is present. Thus, the lease arrangement would not constitute a private activity bond. In addition, there could be no private payment or security either. This private security test requires that payment of principal or interest on the bonds must be either (1) secured by the property used for private business use or (2) payments for such property. The private payment test requires the payment of principal or interest to be derived from the property used in a private business use.

Payment by a utility as an incentive would not meet either test, since under the hypothetical transaction there is no private use.

Although outside the scope of your request for information, the private activity bond test may be satisfied by meeting the private loan financing test. Nothing in the hypothetical transaction suggests the applicability of this test.

I hope that this information is helpful. If you have any question please contact me at . My identification number is . Also, you may contact , identification number , at .

Sincerely,

Lynn E. Kawecki