

Internal Revenue Service

Number: **201043001**

Release Date: 10/29/2010

Index Number: 141.00-00, 141.01-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:B05

PLR-102461-10

Date:

July 19, 2010

Legend:

Association =

Catastrophe Insurance =

Category A Bonds =

Category B Bonds =

Category C Bonds =

Commissioner =

Date 1 =

Department =

Issuer =

State =

a =

b =

c =

d =

e =

f =

G =

h =

i =

j =

Dear :

This is in response to your request for a ruling that Issuer's proposed Category B Bonds and Category C Bonds will not be private activity bonds within the meaning of § 141 of the Internal Revenue Code (the "Code"). You have withdrawn your request for a ruling with respect to the Category A Bonds.

FACTS AND REPRESENTATIONS

Issuer is a public authority of State, created by an act of State's legislature. Among other things, Issuer is authorized to issue bonds for the purpose of paying claims for losses incurred by purchasers of Catastrophe Insurance policies from Association.

Association was established by an act of State's legislature for the purpose of providing Catastrophe Insurance to applicants who would otherwise be unable to obtain such insurance in the marketplace. As a condition of transacting business in State, every licensed property insurer in State must be a member of Association. Association is governed by a board of directors, comprised of a voting directors. Each of the directors is appointed by Commissioner. Commissioner is required to appoint b directors (which number is less than half of a) from a list of persons provided by Association's members. The directors serve terms of c years each and are limited to serving d full-length terms. The directors may be removed for cause by Commissioner.

At the end of each year, a portion of Association's net equity is transferred to State's catastrophe reserve trust fund. Additionally, Association must file with Department an annual statement summarizing Association's operations for the preceding year.

In accordance with State law, each year Association's members must contribute moneys to Association to participate in the costs of insured losses and operating expenses, to the extent that such losses and expenses exceed Association's premium receipts and other revenue. Each member's share of the contributions is in proportion

to that member's net direct premiums received during the preceding calendar year out of the aggregate net direct premiums of all members of Association during such year.

The members do not have rights to the moneys they pay to Association. Association may only spend its funds in furtherance of its purposes. Upon dissolution, all assets of Association revert to State.

Association sells Catastrophe Insurance to persons otherwise unable to obtain such insurance from a private insurer. Association sells both commercial policies (available only to persons engaged in a trade or business) and residential policies (available only to natural persons not engaged in a trade or business). There are differences between the residential and commercial policies because the policies provide different coverages to its policyholders on different types of property. As a result, the policies are rated separately.

Following the occurrence of a catastrophic event, as specified by State law, Issuer is authorized to issue bonds to pay insurance claims arising from both commercial and residential policies to the extent that such claims exceed the reserved moneys in Association's fund. In the event the moneys in the fund are insufficient to pay all claims, Issuer is authorized to issue up to \$e of Category A Bonds. The Category A Bonds will be repaid from future insurance premium revenues collected by Association. Association will also pledge these premium revenues for payment of the Category A Bonds.

In the event the Category A Bonds are insufficient to pay the claims, Issuer is authorized to issue up to \$f of Category B Bonds. G percent of the cost of the Category B Bonds will be paid from premium surcharges assessed on all policyholders who reside or have operations in, or whose insured property is located in a catastrophe area for each insurance policy issued for property located in the catastrophe area (the "Premium Surcharges"). The premium surcharges apply to all policies that provide coverage on any premises, locations, operations, or property located in the area for all property and casualty lines of insurance, other than federal flood insurance, workers' compensation insurance, accident and health insurance, and medical malpractice insurance.

State law does not limit or otherwise dictate the manner in which the Premium Surcharges are assessed (for example, whether or not they are to be generally applied at a uniform rate). Department's proposed rules indicate that the Premium Surcharge rate is a flat percentage applicable to all policies (i.e., a set percentage of premium or exposure). These rules are expected to be finalized and in effect no later than Date 1.

The remaining h percent of the cost of the Category B Bonds will be paid by assessments on all property insurers licensed to do business in State (the "Assessments").

In the event the Category B Bonds are insufficient to pay the claims, Issuer may issue up to \$i of Category C Bonds. The Category C Bonds will be paid from additional Assessments on all property insurers licensed to do business in State.

Under State law, the Assessments may not be refunded. Additionally, State law provides that each of the Category B Bonds and Category C Bonds (collectively, the "Bonds") may not be outstanding for more than j years.

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).

Thus, in order for the Bonds to be private activity bonds, both the private business use test and the private security or payment test, or the private loan financing test must be met.

Private Business Use Test

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.

Section 1.141-3(b)(7)(i) provides that any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to special legal entitlements such as ownership, leases or management contracts (or other arrangements not relevant for this purpose) results in private business use. For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.

Section 141 was enacted by the Tax Reform Act of 1986. 1986-3 (Vol. 1) C.B. 1. With respect to the private business use test, the House Report to this act states:

The determination of who used bond proceeds or bond-financed property generally is made by reference to the ultimate user of the proceeds or property. As under present law, however, the proceeds of an issue generally are not treated as used in any trade or business of a nongovernmental person when the proceeds are used to pay for services rendered to the government or to defray other liabilities of a governmental unit arising from general government operations. For example, bond proceeds used to purchase a computer to be owned and used by the purchasing governmental unit are not treated as used in the computer company's business. Likewise, bond proceeds used to satisfy contractual obligations undertaken in connection with general governmental operations, such as payment of government employees' salaries, or to pay legal judgment against a governmental unit, are not treated as

used in the business of the payee. This is to be contrasted with the indirect nongovernmental use of bond proceeds that occurs when a government contracts with a nongovernmental person to supply that person's business with a service (e.g., electric energy) on a basis different from that on which the service is provided to the public generally or to finance property used in that person's business (e.g., a manufacturing plant). In both of these instances a nongovernmental person is considered to use the bond proceeds other than as a member of the general public.

H. R. Rep. No. 426, 99th Cong. 1st Sess. 522-23 (1985), 1986-3 (Vol. 2) C.B. 522-23. (House of Representatives Report).

The proceeds of the Bonds will be used to make payments in respect of claims received by Association from various residential and commercial policyholders who have suffered damage as a result of a catastrophic event. Once the proceeds are paid to the policyholders, the policyholders are not restricted in any way as to their use of the proceeds. Thus, the policyholders will own them outright.

In contrast with the examples in the legislative history of § 141, the Bonds are not being used to finance working capital expenditures (such as employee salaries and other expenditures arising from general governmental operations) because they are reimbursing policyholders for losses. The Bond proceeds are not being paid in respect of services rendered to Association; rather, they are paid in respect of a contractually purchased right by policyholders, similar to the purchase of electricity from a municipal utility. Therefore, the use of the Bond proceeds must be tracked following the transfer of the proceeds to the policyholders. Just as electricity provided by a municipal utility from a tax-exempt bond financed generation facility is tracked following the construction of such generation facility, so must the use (including ownership) be tracked in this case following the payment of claims by Association.

Here, the proceeds of the Bonds will be used to pay claims of Association's policyholders, made pursuant to each policyholder's respective insurance contract with Association, upon a catastrophic event resulting in damage to a policyholder's property. While the policyholders are able to use the proceeds they receive to rebuild their respective properties, they are not required to use them in any particular manner.

Commercial policyholders who receive Bond proceeds in satisfaction of their claims are private business users who own the proceeds. The amounts of proceeds owned by such persons must be aggregated in order to determine whether the private business use test is met. Issuer has made no assertion that use by nongovernmental persons will not exceed the percentage limits set forth in § 141(b) or any other basis on which to establish the private business use test will not be met.

Additionally, Issuer is unable to avail itself of the public use exception here. There are enough differences between residential and commercial insurance policies, with each policy type providing different coverages to its respective category of policyholders, so that each policy type must be rated separately. Regardless, even if the residential policyholders and commercial policyholders have a right to payment of claims on the same basis, all policyholders (including the commercial policyholders) will own the proceeds, meaning that they will have a “special entitlement” to the proceeds for as long as the Bonds remain outstanding (a period greater than 200 days). As a result, the public use exception is unavailable. Thus, the use of Bond proceeds by the commercial policyholders must be counted as private business use. Furthermore, no other exception under § 1.141-3(d) applies here.

Therefore, the Bonds meet the private business use test. In order for the Bonds not to be private activity bonds, they cannot meet the private security or payment test or the private loan financing test.

Private Security or Payment Test

An issue meets the private security test of § 141(b)(2)(A) if the payment of the principal of, or interest on, more than 10 percent of the proceeds of an issue is (under the terms of the issue or any underlying arrangement) directly or indirectly secured by any interest in property used or to be used for a private business use (or by any interest in payments in respect of such property).

An issue meets the private payment test of § 141(b)(2)(B) if the payment of the principal of, or interest on, more than 10 percent of the proceeds of an issue is (under the terms of the issue or any underlying arrangement) directly or indirectly 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 1.141-4(a)(1) provides that the private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test takes into account the payment of 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, or borrowed money, used or to be used for a private 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.

Section 1.141-4(a)(3) provides that the security for, and payment of debt service on, an issue is determined from both the terms of the bond documents and on the basis of any underlying arrangement. An underlying arrangement may result from separate

agreements between the parties or may be determined on the basis of all of the facts and circumstances surrounding the issuance of the bonds. For example, if the payment of debt service on an issue is secured by both a pledge of the full faith and credit of a state or local governmental unit and any interest in property used or to be used in a private business use, the issue meets the private security or payment test.

Section 1.141-4(c)(2)(i) provides, in part, that 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 are taken into account as private payments only to the extent that they are made for the period of time that proceeds are used for a private business use. Payment for 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.

Section 1.141-4(d)(2) provides that the property that is the security for, or source of, the payment of debt service on an issue need not be property financed with proceeds. For example, unimproved land or investment securities used, directly or indirectly, in a private business use that secures an issue provides private security. Private security (other than financed property and private payments) for an issue is taken into account under § 141(b), however, only to the extent it is provided, directly or indirectly, by a user of proceeds of the issue.

Section 1.141-4(d)(4) provides that property 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 purposes of the previous sentence, 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. Payments made 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 to the extent that they are made for the period of time that property is used by a private business user.

Section 1.141-4(e) provides that for purposes of the private security or payment test, generally applicable taxes are not taken into account (that is, are not payments from a nongovernmental person and are not payments in respect of property used for a private business use). A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenues to be used for governmental purposes. A generally applicable tax must have a uniform rate that is applied to all persons of the same

classification in the appropriate jurisdiction and a generally applicable manner of determination and collection. A special charge is not a generally applicable tax. For this purpose, a special charge means a payment for a special privilege granted or regulatory function, a service rendered, a use of property, or a payment in the nature of a special assessment to finance capital improvements that is imposed on a limited class of persons based on benefits received from the capital improvements financed with the assessment. Thus, a special assessment to finance infrastructure improvements in a new industrial park (such as sidewalks, streets, streetlights, and utility infrastructure improvements) that is imposed on a limited class of persons composed of property owners within the industrial park who benefit from those improvements is a special charge. By contrast, an otherwise qualified generally applicable tax (such as a generally applicable ad valorem tax on all real property within a governmental taxing jurisdiction) is not treated as a special charge merely because the taxes received are used for governmental or public purposes in a manner which benefits particular property owners.

Category B Bonds

The debt service on the Category B Bonds will be paid from the Premium Surcharges and the Assessments.

The Premium Surcharges are assessed on all policyholders who reside or have operations in, or whose insured property is located in a catastrophe area for each insurance policy, other than federal flood insurance, workers' compensation insurance, accident and health insurance, and medical malpractice insurance. Thus, the Premium Surcharges are assessed on a broad base of persons. Furthermore, the Premium Surcharges are levied solely for the purpose of raising revenue for a governmental purpose. Provided that the Premium Surcharges are assessed by the Commissioner as described in the proposed rules, the Premium Surcharges qualify as taxes of general application for purposes of § 141.

The Assessments charged to all licensed property insurers in State are taxes of general application for purposes of § 141. The Assessments are not a payment of special privileges granted or services rendered because the Assessments are paid by all insurers writing insurance policies in State (an entire class of persons). The Assessments are levied solely for the purpose of raising revenue for a governmental purpose and are applied at a uniform rate to all entities of the same classification in State (i.e., all licensed insurance companies doing business in State).

Because the Premium Surcharges and the Assessments are taxes of general application, they do not constitute private payments or security. As a result, the Category B Bonds fail the private security or payment test.

Therefore, the Category B Bonds will not constitute private activity bonds unless they meet the private loan financing test.

Category C Bonds

The debt service on the Category C Bonds will be paid from additional Assessments. As discussed above, the Assessments charged to all licensed property insurers in State are taxes of general application for purposes of § 141.

Because the Assessments are taxes of general application, they do not constitute private payments or security. As a result, the Category C Bonds fail the private security or payment test.

Therefore, the Category C Bonds will not constitute private activity bonds unless they meet the private loan financing test.

Private Loan Financing Test

An issue generally meets the private loan financing test of § 141(c) if the amount of the proceeds of the issue which is to be used (directly or indirectly) to make loans to persons other than governmental units exceeds the lesser of 5 percent of the proceeds or \$5,000,000.

Section 1.141-5(a) provides that bonds of an issue are private activity bonds if more than the lesser of 5 percent or \$5,000,000 of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons.

Section 1.141-5(c)(1) provides that any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of § 1.141-5. For federal tax purposes, a loan denotes "an advance of money with an absolute promise to repay." Bankers Mortgage Co. v. Commissioner, 142 F.2d 130, 131 (5th Cir. 1944). In addition, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction rather than its form.

Neither the Category B Bonds nor the Category C Bonds meet the private loan financing test of § 141(c). Persons paying the Assessments and the Premium Surcharges are required to do so by State law. Those persons who receive payment of their insurance claims from proceeds of the Bonds receive such payment as a result of a previously obtained contractual right (under an insurance contract with Association). A claimant receiving Bond proceeds is not under any obligation to repay any amounts it receives in satisfaction of its claim. Furthermore, there is no assurance that any

claimant who receives Bond proceeds in satisfaction of its claim will continue to contract with Association for any future insurance coverage. Thus, there is no assurance that Association will receive any future moneys from any claimant whatsoever.

CONCLUSION

Based on the foregoing, we conclude that Issuer's Category B Bonds and Category C Bonds will not be private activity bonds within the meaning of § 141 of the Internal Revenue Code.

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 concerning whether the interest on the Bonds is excludable from gross income under § 103(a).

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. This office has not verified any of the material submitted in support of the request for rulings; however, such material is subject to verification on examination. This letter is based upon the assumption that the proposed rules described herein will be finalized as set forth herein, and the application of this letter is conditional on such finalization.

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 representative.

Sincerely,

Associate Chief Counsel
(Financial Institutions & Products)

By: _____
Timothy L. Jones
Senior Counsel