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Legend

Issuer =

Bonds =

State =

Authority =

Canal A =

Canal B =

Canal C =

Lake S =

Lake T =

River U =

River V =

Supply X =

Supply Y =

a =

b =

c =

d =

e =

f =

Dear :

This is in response to the request for a ruling submitted on behalf of Issuer pertaining to the proposed issuance of the Bonds in part as governmental bonds (as defined in § 1.150-1(b) of the Income Tax Regulations) and in part as exempt facility bonds under § 142 of the Internal Revenue Code (Code).

#### FACTS AND REPRESENTATIONS

Issuer makes the following representations. Issuer was formed by State as a political subdivision and governmental agency of State to develop, conserve, and protect the water resources of River U watershed. Issuer owns and operates various facilities for collecting, storing, and distributing raw water for industrial, municipal, and irrigation purposes.

Issuer collects, stores, and distributes raw water from Supply X and Supply Y primarily on the basis of gravity. The delivery points for Supply Y are approximately a miles downstream from Supply X. Supply X consists solely of stored water rights in the amount of b acre-feet per year (afpy), while Supply Y, totaling c afpy, consists primarily of run-of-river water rights from River U and River V and some stored and developed water rights.

Supply X is collected and stored at Lake S and delivered or expected to be delivered to Issuer's customers with contracts for the delivery of Supply X water (Supply X customers). Supply X facilities are owned and operated by Issuer and include a dam and reservoir at Lake S, diversion channels, a service outlet pond, flood gates, and

other property such as a maintenance shop, warehouse, and a communications tower (Supply X Facilities).

Supply Y facilities consist of a pump station at Lake T, Canal A into which the pump station transfers Issuer's run-of-river water supply from River U (and certain available stored and developed water rights) flowing through Lake T, a reservoir (Reservoir), Canal B, Canal C, and a pump station on Canal C (Canal C pump station) (collectively referred to as Supply Y Facilities). Issuer's run-of-river water supply from River V runs through a canal owned, operated, and maintained by Authority, a governmental unit, that traverses both Canal B and Canal C (Authority Canal). Canal C pump station transfers Issuer's run-of-river water supply from Authority Canal into Canal C. Issuer's customers with contracts for the delivery of Supply Y water (Supply Y customers) receive raw water at various delivery points on Canal A, Canal B, and Canal C.

Other than Canal C pump station, which is owned and operated by Authority, Supply Y Facilities are owned and operated by Issuer. Issuer and Authority have entered into an agreement whereby Authority operates Canal C pump station to transfer, upon request by Issuer, Issuer's River V run-of-river water supply from Authority Canal into Canal C for delivery to Issuer's customers that receive water from Canal C. Authority's customers have no rights to the use of, and receive no benefit from, Canal C pump station.

The contracts entered into between Issuer and its Supply X customers and Supply Y customers are take or pay contracts (within the meaning of § 1.141-7(c)(4)) that require the customer to purchase raw water in accordance with generally applicable schedules or rates. Issuer has the right to adjust the water rates from time to time to cover the cost of the administration of, and capital improvements to, the water supplies, including principal and interest on outstanding bonds that were used to finance the water supply and its improvements. Water rate increases are applicable to both Supply X customers and Supply Y customers.

Supply X customers consist of an industrial user and municipal water districts. Issuer has entered into a take or pay contract with an industrial customer, and expects to enter into take or pay contracts with municipal water districts, for the delivery of all of the raw water from Supply X. Based on such agreements, Issuer expects that less than 10 percent of Supply X will be used by the industrial customer, while the remainder will be used by municipal water districts.

Supply Y customers consist of industrial and irrigation users and municipal water districts. Issuer has entered into take or pay contracts for the delivery of d percent of Supply Y. Its contracts with industrial and irrigation customers account for e percent (over 10 percent) of Supply Y.

Issuer represents that it will make the remaining unallocated f percent of Supply Y available to members of the general public, including making reasonable accommodation for any additional infrastructure necessary to deliver the requested amounts to the delivery point for such customers, and will not deny access to such portion of Supply Y upon request. Issuer represents that it will make available at least 25 percent of Supply Y to residential users and municipal water districts throughout the term of the Bonds.

Although Issuer has the right to move excess supply from Supply X, if any, downstream for delivery to Supply Y customers, Issuer has not exercised its right to release such excess water downstream in recent history and does not expect that it will need to do so in any significant amount in the future. Supply Y customers do not have rights to stored water from Supply X, and Supply X customers do not, or will not, have rights to water deliveries from Supply Y. In addition, Supply X customers have no physical ability to receive water from Supply Y, because Supply Y is downstream from Supply X and no portion of Supply Y is being moved upstream.

Issuer proposes to issue the Bonds in part as governmental bonds to finance capital improvements to Supply X Facilities (Supply X Improvements) and in part as exempt facility bonds to finance improvements to Supply Y Facilities (Supply Y Improvements).

As part of Supply Y Improvements, Issuer plans to construct a new pump station at or near the point where Authority Canal traverses Canal B (Canal B pump station). Issuer will own and operate Canal B pump station to transfer Issuer's River V run-of-river supply from Authority Canal into Canal B for delivery to Issuer's customers connected to Canal B. Neither Authority nor its customers will have rights to the use of, or benefit from, Canal B pump station.

In addition, Issuer proposes to use proceeds of the Bonds to finance certain services and equipment. The services consist of construction management, inspection, and testing relating to the construction of Supply X Improvements and Supply Y Improvements. To the extent that the services pertain solely to Supply X Improvements or to Supply Y Improvements, Issuer will allocate the costs of these services to the construction of Supply X Improvements and the Supply Y Improvements, respectively. Issuer will allocate services that relate to the construction of both Supply X Improvements and Supply Y Improvements based on the relative costs of Supply X Improvements and Supply Y Improvements. Issuer proposes to use proceeds of governmental bonds for the costs of the services allocable to Supply X Improvements and proceeds of exempt facility bonds for the costs of the services allocable to Supply Y Improvements.

The equipment consists of supervisory control and data acquisition equipment that will permit Issuer to measure water flow levels in the canals and to capture customer flow data on a real-time basis for Supply X and Supply Y. Some of the equipment will relate

solely to the monitoring of Supply X or to the monitoring of Supply Y and will be allocated respectively. To the extent that the equipment relates to monitoring both Supply X and Supply Y, Issuer will allocate the costs of such equipment between Supply X and Y based on the relative water supply. Issuer proposes to use proceeds of governmental bonds for the costs of the equipment serving, or allocable to, Supply X. Issuer proposes to use proceeds of exempt facility bonds for the costs of the services allocable to the costs of equipment serving, or allocable to, Supply Y. (We refer to Supply X Facilities, Supply X Improvements, and the equipment allocable to Supply X, collectively, as Improved Supply X Facilities. We refer to Supply Y Facilities, Supply Y Improvements, and the equipment allocable to Supply Y, collectively, as Improved Supply Y Facilities.)

## LAW AND ANALYSIS

Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply in the case of any private activity bond which is not a qualified bond (within the meaning of § 141).

### **I. Private Business Use**

Section 141(a) provides that the term “private activity bond” means any bond issued as part of an issue which meets the private business use test and the private security or payment test, or which meets the private loan financing test. Section 141(b)(1) provides 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 that an issue meets the private security or payment test if the payment of the principal of, or interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly (A) secured by an interest in (i) property used or to be used for a private business use, or (ii) 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)(A) provides that for purposes of the private business use tests, 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. For this purpose, use as member of the general public shall not be taken into account. Section 141(b)(7) provide that the term “government use” means any use other than a private business use.

Section 1.141-7 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. For this purpose, unless otherwise stated, water facilities are treated as output facilities. Section 1.141-1(b) defines output facilities as electric and gas

generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.

Section 1.141-7(c)(1) provides that the purchase pursuant to a contract by a nongovernmental person of available output of an output facility (output contract) financed with proceeds of an issue is taken into account under the private business test if the purchase has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on bonds used (directly or indirectly) to finance the facility (the benefits and burdens test). Section 1.141-7(c)(2) provides that the benefits and burdens test is met if a non-governmental person agrees pursuant to a take contract or a take or pay contract to purchase available output of a facility. Section 1.141-7(b)(4) provides in part that 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. Section 1.141-7(d) provides that if an output contract results in private business use under § 1.141-7, the amount of private business use generally is the amount of output purchased under the contract.

Section 1.141-7(h)(1) provides that whether output sold under an output contract is allocated to a particular facility (for example, a generating unit), to the entire system of the seller of that output (net of any uses of that system output allocated to a particular facility), or to a portion of a facility is based on all the facts and circumstances. Significant factors to be considered in determining the allocation of an output contract to a financed property are the following:

- i. The extent to which it is physically possible to deliver output to or from a particular facility or system.
- ii. The terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources).
- iii. Whether a contract is entered into as part of a common plan of financing for a facility.
- iv. The method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

Section 1.150-1(b) defines governmental bonds as any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds.

Issuer proposes to use proceeds of the governmental bond portion of the Bonds to finance Supply X Improvements, the services allocable to Supply X Improvements, and the equipment allocable to Supply X. Given the nature of these expenditures and Issuer's operation of its facilities, the use of these proceeds will be the same as the use of Supply X Facilities. Thus, private business use of the proceeds is determined by analyzing the contracts for water from Supply X. We first determine the allocation of contracts as between Supply X and Supply Y and the respective facilities.

Issuer represents that it has entered into, or expects to enter into, take or pay contracts for all of Supply X. It has entered into take or pay contracts for d percent of Supply Y. The delivery points for Supply Y are approximately a miles downstream of Supply X. While Issuer has the legal right and physical ability to deliver excess water, if any, from Supply X downstream to Supply Y customers, Supply Y customers have no rights to Supply X. Issuer has not exercised its right to release such excess water downstream in recent history and does not expect that it will need to do so in any significant amount in the future. Supply X customers do not have any rights or ability to receive water from Supply Y. Accordingly, we conclude that the contracts between Issuer and Supply X customers are allocable to Improved Supply X Facilities and the contracts between Issuer and Supply Y customers are allocable to Improved Supply Y Facilities.

Based on its actual and expected contracts, Issuer expects less than 10 percent private business use of Supply X. Accordingly, the contracts for water from Supply X will result in less than 10 percent private business use of the proceeds of the Bonds Issuer proposes to spend for the costs of Supply X Improvements, the services allocable to Supply X Improvements, and the equipment allocable to Supply X.

## **II. Facilities for the Furnishing of Water**

Section 141(e)(1) provides, in part, that the term “qualified bond” includes an exempt facility bond. Section 142(a)(4) provides that the term “exempt facility bond” includes any bond issued as part of an issue 95 percent or more of the proceeds of which are to be used to provide facilities for the furnishing of water. Section 142(e) provides that, for purposes of § 142(a)(4), the term “facilities for the furnishing of water” means any facility for the furnishing of water if (a) the water is or will be made available to members of the general public (including electric utility, industrial, agricultural, or commercial users), and (b) either the facility is operated by a governmental unit or the rates for the furnishing or sale of the water have been established or approved by a state or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any state or political subdivision thereof.

Issuer proposes to spend proceeds of the exempt facility bond portion of the Bonds for the costs of Supply Y Improvements, the services allocable to the Supply Y Improvements, and the equipment allocable to Supply Y. Thus, we consider whether Supply Y Improvements and equipment allocable to Supply Y are facilities for the furnishing of water under § 142(e). Supply Y Improvements and the equipment allocable to Supply Y will be used in conjunction with the Supply Y Facilities. Accordingly, we must determine whether Improved Supply Y Facilities are facilities for the furnishing of water. See H.R. Conf. Rep. No. 95-1800, at 237 (1978), 1978-3 (Vol. 1) C.B. 521, at 571 (“[T]o ... be a facility for the furnishing of water, the facility must be a component of a system or project which furnishes water.”).

First, we determine the nature of Improved Supply Y Facilities. Improved Supply Y Facilities consist of pump stations, canals, a reservoir, and functionally related and subordinate property, used by Issuer to collect, store, and distribute raw water to Supply Y customers. Accordingly, we conclude that Improved Supply Y Facilities are facilities for the furnishing of water.

Next, we determine whether Improved Supply Y Facilities are or will be used by Issuer to make water available to members of the general public (including electric utility, industrial, agricultural, or commercial users). Issuer represents that it will make the remaining unallocated f percent of Supply Y available to members of the general public and will not deny access to such portion of Supply Y upon request. Issuer represents that it will make at least 25 percent of Supply Y available to residential users and municipal water districts throughout the term of the Bonds. We conclude that water from Supply Y is or will be available to members of the general public because a substantial portion of Supply Y will be made available to residential users or municipal water districts. See S. Rep. No.95-1263, at 142-43 (1978), 1978-3 (Vol. 1) C. B. 315, at 440-41.

Finally, we determine whether Improved Supply Y Facilities are operated by a governmental unit or the rates for the furnishing or sale of Supply Y have been established or approved by the appropriate government body. Issuer represents that it is a political subdivision and government agency of State. It is, therefore, a governmental unit for purposes of § 142(e). Issuer operates all of Supply Y Facilities, except Canal C pump station. Canal C pump station is operated by Authority, a governmental unit. Accordingly, we conclude that Improved Supply Y Facilities are operated by a governmental unit.

As Improved Supply Y Facilities meet all of the requirements of § 142(e), Improved Supply Y Facilities are facilities for the furnishing of water for purposes of § 142(a)(4). Therefore, Supply Y Improvements, including the services allocable to Supply Y Improvements, and the equipment allocable to Supply Y are facilities for the furnishing of water for purposes of § 142(a)(4).

## CONCLUSIONS

Accordingly, we conclude:

1. That the private business use of the proceeds to be used for Supply X Improvements, the services allocable to Supply X Improvements, and the equipment allocable to Supply X does not exceed 10 percent; and
2. That Supply Y Improvements, including the services allocable to Supply Y Improvements, and the equipment allocable to Supply Y constitute facilities for the furnishing of water under § 142(e).



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 the interest on the Bonds will be excludable from gross income under § 103(a).

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.

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)

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By: \_\_\_\_\_  
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Branch 5