

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **201830006**  
Release Date: 7/27/2018

Third Party Communication: None  
Date of Communication: Not Applicable

Index Number: 103.02-00, 141.01-01,  
141.01-02, 141.01-04

Person To Contact:  
, ID No.

Telephone Number:

Refer Reply To:  
CC:FIP: Branch 5  
PLR-130919-17

Date:  
April 11, 2018

LEGEND

Issuer =

Energy Station =

Project One =

Project Two =

River =

State =

City =

Company =

Date 1 =

Date 2 =

a =

b =

c =

Dear \_\_\_\_\_ :

This letter is in response to your request for a ruling that Agreement Two, described below, will not cause Project Two Bonds, also described below, to meet the private business tests under § 141(b) of the Internal Revenue Code of 1986, as amended.

## FACTS AND REPRESENTATIONS

Issuer is a governmental entity and a provider of electrical power. Its Energy Station is coal-fired and requires a source of water for process and cooling purposes. To meet these needs, Issuer participated in Project One constructed by the Issuer and several municipalities to divert water from the River ("Project Water") for their use. Water yields from Project One fluctuate significantly from year to year due to the junior nature of its water rights and inadequate infrastructure and storage.

On Date 1, Issuer entered into Agreement One with City. Under Agreement One, the Issuer will annually provide, when available, a acre-feet (AF) of Project Water to the City on the upstream side of its municipal water system in exchange for a AF of treated effluent at the tail end of the water system, plus the return flow of Project Water after use by City. About a AF of the treated effluent is then pumped to the Issuer's Energy Station to meet its need for cooling water. Under Agreement One, neither Issuer nor City pays additional compensation for the water to be delivered to the other under the Agreement.

To provide for more consistent water yields from Project One, Issuer intends to finance the acquisition and construction of an undivided portion of a new reservoir, Project Two, using tax-exempt bonds ("Project Two Bonds"). Project Water will be stored for release when Project Water directly from Project One is unavailable. Project Two will significantly change the reliable annual yield of Project Water from zero AF to b AF.

Company, subsequent to Date 1, located a plant near City. Company requires c AF of consumable water to meet its needs. On Date 2, Issuer, City, and Company entered into Agreement Two that obligates City to deliver c AF of consumable water to Company. Under Agreement Two, Issuer also agreed that the a AF of Project Water to be delivered to City by Issuer under Agreement One may instead be designated by City for delivery to Company to meet most of Company's water needs. Under a separate agreement, Company pays for water acquired from City, including Project water, in the same manner as any other customer of City water. Because Agreement One remains in effect during the term of Agreement Two, Issuer continues to be entitled to effluent from City directly proportional to the amount of Project Water delivered to Company plus the return flow of Project Water after the use of such water by Company.

Under Agreement Two, to the extent that Project Water is unavailable, City must divert other amounts of its consumable water for use by Company. If this results in insufficient effluent from City (including the return flow of Project Water after use by Company) to meet Issuer's cooling water needs, Company must reimburse Issuer for the costs of obtaining alternative water. Project Two enhances the probability that the water delivered to Company will be Project Water.

Although Issuer will be entitled to the return flow produced by Company from Project Water, the amount will be significantly less than that produced by City from its previous use of the same amount of Project Water and will reduce the amount of water available to Issuer for cooling purposes. To compensate Issuer for this reduction, Company further agrees in Agreement Two to pay the costs incurred by Issuer for the operation and maintenance of the pipes, canals and other facilities (variable costs) utilized by Issuer in the delivery, via Project Two or otherwise, of the Project Water to City for use by Company. The payment of these variable costs will be proportionally reduced if less than a AF of Project Water is delivered to Company.

## LAW

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) provides, in part, 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 part of an issue (1) which meets (A) the private business use test, and (B) the private security or payment test, or (2) which meets the private loan financing test.

Section 141(b)(1) provides that except as otherwise provided in § 141(b), 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 except as otherwise provided in § 141(b), 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 such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly (A) secured by any 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) provides that private business use is use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit.

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 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 financed property as a result of ownership, lease, management contract or certain other arrangements such as a take of pay contract 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 financed property that are comparable to the special legal entitlements applicable to ownership, leases, management agreements, research agreements or output contracts generally results in private business use.

Section 1.141-3(b)(7)(ii) provides that private use of financed facilities not available for use by the general public, as defined in 1.141-3(c), may be established solely on the basis of a special economic benefit to one or more nongovernmental persons even if those nongovernmental persons have no special legal entitlement to the use of the property. All of the facts and circumstances must be considered in determining whether a special economic benefit causes private business use of the financed property.

Section 1.141-4(a)(1) provides that the private security of 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 the debt service on the issue that is directly or indirectly derived from payments (whether or not to the issuer or to any related party) in respect of property used or to be used by a private business use.

Section 1.141-4(c)(2)(i)(A) provides that both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of an issue are taken into account as private payments to the extent allocable to the proceeds used by that person. 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 the fair market value compensation for that other use.

Section 1.141-4(c)(2)(i)(C) provides that payments by a person for use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses directly attributable to the operation and maintenance of the financed property used by that person.

Section 1.141-7(a) provides special rules to determine whether arrangements for the purchase of output from an output facility cause an issue of tax-exempt bonds to meet the private business tests. For this purpose, unless otherwise stated, water facilities are treated as output facilities.

Section 1.141-7(c) provides that the purchase pursuant to a contract by a nongovernmental person of available output of an output facility (an output contract) financed with the proceeds of a tax-exempt bond issue is taken into account if the purchase has the effect of transferring the benefits of owning the facility and burdens of paying the debt service on the bonds used (directly or indirectly) to finance the facility.

## ANALYSIS

We first have to determine whether Project Two Bonds meet the private use tests based on the special rules for output facilities under § 1.141-7. Company's right to the delivery of an amount of consumable water, specifically Project Water, necessary to meet its water requirements is derived from Agreement Two. The first step in the analysis of whether Agreement Two falls under § 1.141-7(c) turns on the question of whether Company, either directly or indirectly, purchases Project Water from Issuer.

Although Company makes payments to City for the Project Water it receives, we conclude that § 1.141-7 is inapplicable in this case because Company does not purchase Project Water from Issuer. Issuer receives two payments from Company under Agreement Two neither of which are payments for Project Water. The first payment occurs as a reimbursement to Issuer for its costs to find replacement water if City's diversion to Company of consumable water other than Project Water causes a shortage of cooling water for Energy Station. The second payment occurs because the use by Company of Project Water results in significantly less return flow to Issuer than the use of the same amount of Project Water by City. Company's payment of Issuer's variable costs compensates Issuer for this loss.

Although we conclude that Agreement Two is not an output contract to be analyzed under § 1-141-7 for purpose of the private business tests, we still must determine if these tests are met by Company under §§ 1.141-3 and 1.141-4. Although Company has a need for consumable water such as Project Water, it has no specific legal entitlement to Project Water. In fact, to the extent that Project Water is unavailable, City must deliver other consumable water to Company.

However, based on all of the facts and circumstances, we conclude that Project Two will provide a special economic benefit to Company that is not available to the general public. Project Two will increase the reliable annual yield of Project Water by b AF. A reliable source of consumable water is critical for Company's trade or business. Project Two will decrease Company's reliance on City to find other consumable water for its use in years when the current supply of Project Water is unavailable (an important, non-monetary benefit in State). Project Two will also mean that Company will have a significantly reduced contingent (and unknown) liability to pay for water needed by Issuer for cooling purposes. Thus, even though Company has no legal entitlement to Project Water, this special economic benefit results in private business use of Project Two by Company under § 141(b)(1).

For purposes of determining whether Project Two bonds meet the private business tests of § 141(b), we have to determine whether Company also meets the private payment or security test of § 141(b)(2). 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 an issue are taken into account as private payments to the extent allocable to the proceeds used by that person.

Company has two payment obligations to Issuer. The first is the obligation to compensate Issuer for costs it incurs for alternative cooling water if City's obligation to deliver c AF of consumable water to Company causes a reduction in the effluent available for City to meet Issuer's cooling needs. This contingent obligation virtually disappears after Project Two comes on-line and, while its disappearance enhances the special economic benefit of Project Two to Company, the obligation cannot be considered a payment in respect of Project Two by Company.

Company's second payment obligation is for the variable costs related to the delivery of Project Water for use by Company. These expenses include the costs of maintaining and operating the canals, ditches and other facilities that are to be used to deliver Project Water for use by Company via Project Two after it comes on line or otherwise. Although not directly related to the operation of Project Two, without these supporting facilities to deliver the water from Project One to Project Two, there would be no Project Two. Thus, these payments are in respect of Company's private use of Project Two. Nevertheless, they are disregarded under § 1.141-4(c)(2)(i)(C) and are not taken into account as payments for purposes of § 141(b)(2)

Accordingly, we conclude that Agreement Two is not an output contract under § 1.141-7(c). Further, even though Company will receive a special economic benefit from Project Two it will not be making private payments in respect of Project Two that are taken into account for purposes of the private security or payment test under § 141(b)(2).

## CONCLUSION

Based on the above Issuer's representations, we conclude that Agreement Two will not cause Project Two Bonds to meet the private business tests of § 141(b).

This ruling is directed 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 is based upon information and representations submitted by the Issuer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the materials submitted in support of the request for a ruling, such materials are subject to verification upon examination.

Sincerely,

Associate Chief Counsel  
(Financial Institutions and Products)

/S/

By: \_\_\_\_\_  
Timothy L. Jones  
Senior Counsel  
Branch 5