

Internal Revenue Service

Number: **200501004**

Release Date: 01/07/2005

Index Number: 141.00-00

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:TEGE:EOEG:TEB

PLR-116374-04

Date:

September 02, 2004

LEGEND

Utility 1

Utility 2

Utility 3

State 1

State 2

State 3

Service Provider

Bonds

Generators

Installed

Components

Spare Sets

Manufacturer

Organization

Project

Dear

This responds to your request for the following two rulings.

(1) Use by Utility 1 and Utility 2 of the Generator Components (defined below) pursuant to the Project will not be private business use of the proceeds of the Bonds.

(2) The Service Provider's use of the Generator Components pursuant to the Contracts (defined below) will not be private business use of the proceeds of the Bonds.

FACTS AND REPRESENTATIONS

Utility 1 is a political subdivision of State 1 and produces, distributes, and sells electric power. Utility 1 owns and operates four Generators in State 1. Utility 1 issued the Bonds and used the proceeds to finance a portion of the costs of constructing its Generators and acquiring spare sets of generator components (*i.e.*, the Spare Sets). Utility 1 financed the remaining portion of the costs of constructing its Generators and its Spare Sets with funds other than the proceeds of bonds issued pursuant to §§ 103 and 141 - 150 of the Internal Revenue Code (the "Code"). The cost of constructing the Generators includes the cost of four sets of Installed Components (one set for each of Utility 1's Generators).

Accordingly, for purposes of § 148, Utility 1 has allocated or will allocate a portion of the proceeds of its bonds to its Generators (including the four sets of Installed Components) and a portion to the Spare Sets. Utility 1's allocations will be consistent for purposes of §§ 141 and 148. Utility 1 expects that sales of the output of its Generators pursuant to output contracts that constitute private business use under § 141(b) will not exceed 20 percent.

Utility 2 is a political subdivision of State 2 and supplies power to various local municipal electric systems in State 2. Utility 2 owns and operates two Generators in State 2. Utility 2 financed the costs of its Generators with the proceeds of bonds issued

pursuant to §§ 103 and 141 - 150. The cost of constructing its Generators includes the cost of two sets of Installed Components (one set for each of Utility 2's Generators). Utility 2 has not purchased Spare Sets.

Accordingly, for purposes of § 148, Utility 2 has allocated or will allocate a portion of the proceeds of its bonds to its Generators (including the Installed Components). Utility 2's allocations will be consistent for purposes of §§ 141 and 148. Utility 2 expects that sales of the output of its Generators pursuant to output contracts that constitute private business use under § 141(b) will not exceed 10 percent.

Utility 3 is a political subdivision of State 3 and owns and manages an electric utility that serves State 3 customers. Utility 3 owns and operates four Generators in State 3. Utility 3 financed the costs of two of its Generators with the proceeds of bonds issued pursuant to §§ 103 and 141 - 150. The cost of constructing its Generators includes the cost of four sets of Installed Components (one set for each of Utility 3's Generators). Utility 3 financed the costs of the other two Generators and its Spare Sets with funds other than the proceeds of bonds issued pursuant to §§ 103 and 141 - 150.

Accordingly, for purposes of § 148, Utility 3 has allocated or will allocate a portion of the proceeds of the Bonds to its Generators (including the Installed Components). Utility 3's allocations will be consistent for purposes of §§ 141 and 148. Utility 3 expects that sales of the output of its Generators pursuant to output contracts that constitute private business use under § 141(b) will not exceed 10 percent.

Due to the need for Planned Maintenance and Unplanned Maintenance (defined below) for the Generators, Utility 1, Utility 2, and Utility 3 (collectively, "the Utilities") plan to share their respective sets of Installed Components and Spare Sets (collectively, the "Generator Components") by participating in the Project, described more fully below.

Generator Components and Maintenance

The Generator Components are certain integral component parts of the Generators. Each Generator requires a complete set of Generator Components to be installed in order to operate. Each item within a set of Generator Components is identified by serial number.

The Manufacturer specifies a useful life for each set of Generator Components. The useful life of a set of Generator Components is described as the total number of hours of operation or "starts" that the set may have in order to properly function when it is installed in an operating Generator. This total number of hours/starts is subdivided into specific periods that are referred to as "turns". Hence, the useful life of a set of Generator Components is described as a total number of turns, *e.g.*, four turns, with each turn representing the number of hours of operation or starts that the Manufacturer specifies a set of Generator Components may have in order to properly function when installed in an operating Generator.

The Manufacturer also specifies that each set of Generator Components must be removed after one turn and refurbished in order to continue to operate properly for the remaining number of turns, if any ("Planned Maintenance"). Once refurbished, that set of Generator Components can be reinstalled in a Generator for an additional turn after which the Generator Components are again removed and refurbished. Removal, refurbishment, and reinstallation continue until the total number of turns has been exhausted. If a set of Generator Components malfunctions or fails unexpectedly, that set is also removed and replaced ("Unplanned Maintenance").

The Project

Utility 1, Utility 2, and Utility 3, and a fourth utility are members of the Organization, a nonprofit corporation formed under provisions of the State 2 nonprofit corporation law to facilitate cost savings and to enhance revenues in the operation and maintenance of each Organization member's respective utility business. The Project is one of the Organization's cooperative projects and each of the Utilities has elected to participate. The fourth utility is not material to this ruling request because it will not participate in the Project.

Based on feasibility studies, the Organization and the Utilities concluded that, because the Utilities each own Generators that are the same model from the Manufacturer, the Utilities could reduce their costs for Planned Maintenance and Unplanned Maintenance if the Utilities (1) shared their respective Generator Components and (2) acted together to arrange for the Service Provider to provide Planned Maintenance and Unplanned Maintenance based on the Utilities' total number of ten Generators and the Spare Sets. The Project is the initiative designed to implement these measures. As a result of its participation in the Project, Utility 3 reasonably expects that: (1) the Generator Components which it has purchased with a portion of the Bonds will be installed in the Generators that Utility 1, Utility 2, and Utility 3 own; and (2) the Service Provider will take title to and exercise ownership rights over at least some of the Generator Components to be shared by the Utilities.

The Generator Components Pool

The Utilities plan to share their Generator Components as a pool. We subsequently refer to all of the Generator Components that the Utilities own collectively as the "Pool". The Utilities' use of the Pool will be measured by the number of turns with respect to any Generator Components in the Pool. Based on turns, the Utilities expect that Utility 1 and Utility 3 will each use 40 percent of the Pool and Utility 2 will use 20 percent of the Pool. The total number and value of the Generator Components each Utility will contribute to the Pool will differ. More importantly, the relative value each Utility will contribute will not be in exact proportion to its expected use of the Pool. As a result, the Organization will coordinate a settlement among the Utilities that will

equitably apportion each Utility's contribution to the Pool.¹ Based on the value of their respective contributions as adjusted by the settlement, Utility 1 and Utility 3 will each initially hold a 40 percent interest in the Pool and Utility 2 will hold a 20 percent interest.

To ensure that Generator Components are available to each of the Utilities for Planned Maintenance, the Organization will develop one Planned Maintenance schedule for all ten of the Utilities' Generators (the "Master Schedule") based on schedules submitted by each of the Utilities. When the Service Provider performs Planned Maintenance on each of the ten Generators according to the Master Schedule, the Service Provider will refurbish the set of Generator Components that has been removed and ship it to the site of the next Generator that is scheduled for Planned Maintenance and that does not have a spare set of Generator Components on hand. The Master Schedule reflects each of the Utilities' interests in the Pool. The Master Schedule permits each of the Utilities to use Generator Components from the Pool according to that particular Utility's respective interest in the Pool without regard to which of the Utilities originally owned the specific Generator Components.

The Project operating procedures provide that each of the Utilities will be entitled to use Generator Components from the Pool for Unplanned Maintenance only if those Generator Components are not needed for a Planned Maintenance event according to the Master Schedule. If a Utility requires Generator Components for Unplanned Maintenance and none from the Pool are available, the Project operating procedures require that Utility to purchase an additional set of Generator Components (the "Additional Components"), which will then be added to the Pool for use by any of the Utilities for subsequent Planned or Unplanned Maintenance events. The Utility that purchases the set of Additional Components will take title to that set and the Utilities will share the cost according to their respective interests in the Pool.

The Organization will compile and maintain relevant data regarding the use of the Pool and each item within the Pool according to the serial numbers for each item. The Organization will review the Utilities' rates of use and operational history at quarterly meetings and will use this data to recommend any adjustments provided for under the settlement procedures.

The contributing Utility will retain title to any Generator Components that it has contributed. However, the Project operating procedures provide that: (1) the contributing Utility cannot sell or otherwise exercise ownership rights over the contributed Generator Components for the duration of the Project; (2) if one Utility terminates its participation in the Project, the terminating Utility's contributed Generator Components (other than any that may then be installed in its Generators) will remain in the Pool for continued use by the other two Utilities, and the terminating Utility will receive a settlement based on the value of the terminating Utility's interest in the Pool compared to the total value of the Generator Components installed in that Utility's

¹ Utility 3 expects that this settlement will result in a payment to it. Utility 3 has not requested a ruling and, therefore, we express no opinion, as to the treatment or consequences of this settlement payment.

Generators; (3) if the Project is terminated, there will be a settlement among the Utilities based on the value of their respective interests as compared to the total value of the Generator Components installed in each Utility's Generators; and (4) each Utility must insure and replace lost or damaged Generator Components that are in that Utility's possession.

The Maintenance Contracts

The Utilities have each entered into substantially identical maintenance contracts with the Service Provider (the "Contracts"). The term of each Contract is 25 years or, if earlier, the date that the Service Provider completes a stated number of Planned Maintenance events.

The Contracts provide that, for Planned Maintenance, the Service Provider will remove a set of Generator Components and immediately replace those Generator Components with Generator Components from the Pool. The Contracts also provide that the Service Provider will refurbish the removed set of Generator Components at the Service Provider's facility and return the refurbished set of Generator Components to the Pool within a specified period by shipping the Generator Components to the next Utility that has been scheduled for Planned Maintenance and that does not have spare Generator Components on hand.

For Planned Maintenance, the Contracts further provide that the Service Provider may replace a set of Generator Components with new generator components from the Service Provider's inventory (the "New Components"), instead of using Generator Components from the Pool, in two circumstances: (1) the Service Provider concludes that the removed Generator Components cannot be refurbished because, for example, the useful life is exhausted; or (2) New Components would enhance Generator performance or reduce future maintenance. In either of these two circumstances, the Service Provider will take title to the set of Generator Components that has been removed and will exercise all ownership rights over those removed Generator Components. The Utility that held title to the removed Generator Components will take title to the New Components, but at no additional cost, and those New Components will be included in the Pool. Utility 3 expects that any New Components will be of greater value than the removed Generator Components because the New Components will have a longer useful life or will be more technologically advanced than the removed Generator Components.

The Contracts also provide that if a Generator requires Unplanned Maintenance and no Generator Components from the Pool are available, the Additional Components to be purchased from the Service Provider may be either a refurbished set of generator components from the Service Provider's inventory (if the Utility consents) or new components. The Service Provider will not take title to the set of Generator Components that has been removed. Instead, the Utility that holds title to the removed set of Generator Components will retain title to those Generator Components. The

Utility that owns the Generator in which the Additional Components are installed will take title to the Additional Components. The Additional Components will be added to the Pool and the Utilities will share the cost of the Additional Components according to their respective interests in the Pool.

LAW AND ANALYSIS

Generally, § 103(a) provides that gross income does not include interest on any state or local bond. Section 103(b)(1) provides that this exclusion does not apply to any private activity bond unless it is a qualified bond under § 141. Section 141(a) provides that a bond is a private activity bond if the bond satisfies the private business use test and the private security or payment test under § 141(b) or the private loan financing test under § 141(c).

Under §§ 141(b)(1) and (6)(A), 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 (*i.e.*, use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit). Under §§ 1.141-1(b) and 1.103-1(a) of the Income Tax Regulations, a governmental person is any state or local governmental unit (*i.e.*, a State, territory, or possession of the United States, the District of Columbia, or any political subdivision or an instrumentality thereof).

Under § 1.141-3(a)(1), the private business use test relates to the use of the proceeds of an issue. Section § 1.141-3(a)(1) further provides that use of financed property is treated as the direct use of proceeds. Under § 1.141-3(a)(2), it is necessary to look to both the indirect and direct uses of proceeds in determining whether an issue meets the private business use test.

Under § 1.141-3(b)(1), both actual and beneficial use by a nongovernmental person may be treated as private business use. Section 1.141-3(b)(1) further provides as follows. 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)(4) provides that, in general, a management contract (within the meaning of § 1.141-3(b)(4)(ii)) with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. Section 1.141-3(b)(4)(ii) defines a management contract as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. Section 1.141-3(b)(4)(iii)(A) provides that contracts for services that are solely

incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services) generally are not treated as management contracts that give rise to private business use. Section 1.141-3(b)(4)(iv) provides, in part, that a management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes.

Section 1.141-2(d)(1) provides, in part, that an issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet the private business tests. Section 1.141-2(d)(1) further provides, in part, that an issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date that causes the conditions of the private business tests to be met. Under § 1.141-2(d)(3), in general, a deliberate action is any action taken by the issuer that is within its control; an intent to violate the requirements of § 141 is not necessary for an action to be deliberate. Under § 1.141-2(e), a deliberate action occurs on the date the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies.

Section 1.141-6(a) provides as follows. For purposes of §§ 1.141-1 through 1.141-15, the provisions of § 1.148-6(d) apply for purposes of allocating proceeds to expenditures. Thus, allocations generally may be made using any reasonable, consistently applied accounting method and allocations under §§ 141 and 148 must be consistent with each other.

Section 1.141-1(b) defines output facility as electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.

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 bonds to meet the private business tests. Section 1.141-7(i), Example 1 provides as follows. Z, an investor-owned electric utility, and City H agree to construct an electric generating facility of a size sufficient to take advantage of the economies of scale. H will issue \$ 50 million of its 24-year bonds, and Z will use \$ 100 million of its funds for construction of a facility they will jointly own as tenants in common. Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. H's bonds will be secured by H's ownership interest in the facility and by revenues to be derived from its share of the annual output of the facility. H will need only 50 percent of its share of the annual output of the facility during the first 20 years of operations. It agrees to sell 10 percent of its share of the annual output to Z for a period of 20 years pursuant to a contract under which Z agrees to take that power if available. The facility will begin operation, and Z will begin to receive power, 4 years after the H bonds are issued. The measurement period for the property financed by the issue is 20 years. H

also will sell the remaining 40 percent of its share of the annual output to numerous other private utilities under contracts of three years or less that satisfy the exception under paragraph (f)(3) of this section. No other contracts will be executed obligating any person to purchase any specified amount of the power for any specified period of time. No person (other than Z) will make payments that will result in a transfer of the burdens of paying debt service on bonds used directly or indirectly to provide H's share of the facilities. The bonds are not private activity bonds, because H's one-third interest in the facility is not treated as used by the other owners of the facility. Although 10 percent of H's share of the annual output of the facility will be used in the trade or business of Z, a nongovernmental person, under this section, that portion constitutes not more than 10 percent of the available output of H's ownership interest in the facility.

Use by Utility 1 and Utility 2

For purposes of § 148, Utility 3 has allocated or will allocate a portion of the proceeds of the Bonds to its four sets of serial-numbered Installed Components. Pursuant to the Project, the Installed Components that Utility 3 contributes to the Pool will also be used in Generators that Utility 1 and Utility 2 own. If, after Utility 3's contribution of the Installed Components to the Pool, the proceeds of Utility 3's Bonds were to remain allocable for purposes of § 141 to the specific serial-numbered Installed Components that it contributes to the Pool, Utility 3 would be required to take into account use of the Installed Components by Utility 1 and Utility 2. Utility 3 argues that it is appropriate on the facts presented here (1) to reallocate proceeds of the Bonds from the Installed Components that it will contribute to the Pool to its 40 percent interest in the Pool, and (2) to determine private business use of those proceeds of the Bonds based solely on its use of the Pool, thus disregarding use of the Pool by Utility 1 and Utility 2.

Reallocation of Proceeds of the Bonds

Based on the facts, we conclude that Utility 3 will divest itself of all meaningful ownership rights to its contributed Installed Components and, in exchange, Utility 3 will receive a 40 percent undivided ownership interest in all of the Generator Components in the Pool. No Utility may select its contributed Generator Components for use in a Planned or Unplanned Maintenance event but is required to use the set that has been shipped to its Generator site. Each Utility will bear the risk of loss for Generator Components from the Pool that are in its possession, regardless of whether it holds title to those Generator Components. If a Utility obtains a set of New Components because, for example, the Service Provider cannot refurbish a set that has been removed from that Utility's Generators, the New Components will also be included in the Pool. Further, if a Utility terminates its participation in the Project, it will be entitled only to a settlement amount based on the value of its interest in the Pool and it will not recover its specific serial-numbered Generator Components. Instead, the terminating Utility's contributed Generator Components will remain in the Pool for continued use by the remaining Utilities (unless already installed in the terminating Utility's Generator).

Utility 3's contribution of its Installed Components to the Pool is a transfer of its bond-financed property. This is a deliberate action under § 1.141-2(d)(3)(i) because it is an action within its control. Here, Utility 3 will exchange its Installed Components for an undivided interest in all of the Generator Components in the Pool. The Generator Components are fungible parts and Utility 3's interest in the Pool represents a share of these fungible Generator Components. Utility 3's undivided interest in the Pool is merely a substitute for and replacement of Utility 3's originally financed Installed Components. On these facts, we conclude that it is appropriate for Utility 3 to reallocate the proceeds of the Bonds from its Installed Components to its 40-percent undivided ownership interest in the Pool.²

Use of Utility 3's interest in the Pool

The Pool consists of Generator Components that are integral to and required for Generator operation. Absent one set of Generator Components installed in a Generator, the Generator cannot operate and stands idle. Hence, at any given time, ten sets of Generator Components that are included in the Pool will be installed in the Generators. Moreover, the remaining Generator Components are interchangeable with the installed sets of Generator Components, which the Manufacturer specifies must be periodically removed and refurbished for the Generators to continue to operate. The immediate availability of these spare Generator Components enables the Utilities to provide uninterrupted Generator operation to the greatest extent possible. Hence, the spare Generator Components are functionally related to the Generators and are integral to such uninterrupted Generator operation. Therefore, we conclude that the definition of output facility found in § 1.141-1(b) applies to the Pool.

For purposes of applying the private business tests when multiple entities own an undivided ownership interest in an output facility, Example 1 of § 1.141-7(i) conceptually divides the facility according to the joint owners' proportionate interests in the facility. In Example 1, City H owns a one-third interest in the facility and Z owns a two-thirds interest based on their respective contributions to the total cost of the facility. They share in the output of the facility in the same proportions. As a result, Example 1 applies the private business tests only to City H's one-third interest. City H's interest is not treated as used by the other owner. However, the output that Z will purchase from City H is treated as use of the City H's interest.

Here, each of the Utilities will acquire an undivided ownership interest in the Pool that will correspond to the value that each Utility contributes, *i.e.*, Utility 1 and Utility 3 will each contribute 40 percent of the value of the Pool and Utility 2 will contribute 20 percent. Each Utility will be entitled to use the Pool only to the extent of that Utility's interest. Accordingly, to the extent that Utility 1 and Utility 2's use of the Pool does not exceed their collective interests, for purposes of applying the private business tests, we

² These proceeds do not include proceeds attributable to the value of the contributed parts in excess of its interest for which it will receive a settlement payment.

conclude that only Utility 3, not Utility 1 or 2, should be treated as using its ownership interest in the Pool.

Use by the Service Provider

Under § 141(b)(6), the Service Provider is a nongovernmental person engaged in a trade or business. Its use of the Pool is pursuant to the Contract, which entitles the Service Provider to: (1) refurbish Generator Components that make up the Pool; and (2) take title to and exercise ownership rights over any Generator Components in the Pool when the Service Provider removes those Generator Components from one of the Utilities' Generators and replaces them with New Components.

As to refurbishing, under § 1.141-3(b)(4)(iii), we conclude that the Service Provider's Contract is a contract for services that are solely incidental to Utility 3's primary functions of managing an electric utility that serves State 3 customers and operating the Generators. Therefore, the Service Provider's refurbishing is analogous to office equipment repair and, accordingly, the Contract is not treated as a management contract that gives rise to private business use.

As to taking title to and exercising ownership rights over the removed Generator Components, the Service Provider's ownership would result in private business use of the removed Generator Components under § 1.141-3(b)(4)(iv). However, the Contract limits the Service Provider's ownership of removed Generator Components to two circumstances where the Service Provider installs New Components to replace the removed Generator Components: (1) the Service Provider cannot refurbish the Generator Components because, for example, the useful life has been exhausted; or (2) the New Components will improve the Generator's performance or reduce future Generator maintenance. In each of these circumstances, the Utility that held title to the removed Generator Components will take title to the New Components and the New Components will be included in the Pool. Moreover, the Service Provider will receive no additional payment for these New Components and Utility 3 expects that any New Components will be of greater value than the removed Generator Components.

Thus, the Contract only permits the substitution of one set of Generator Components of lesser value for a substantially identical and interchangeable set of New Components of greater value and at no additional cost to the Utilities. As a result, when the Pool acquires New Components, the Pool will continue to consist of the same number of fungible generator components but with greater value. Accordingly, we conclude that the Service Provider's subsequent ownership of removed Generator Components will not be private business use of the proceeds of the Bonds.

CONCLUSIONS

(1) To the extent that use by Utility 1 and Utility 2 of the Pool does not exceed their collective interests in the Pool, their use will not be use of the proceeds of the Bonds.

(2) The Service Provider's use of the Pool will not be private business use of the proceeds of the Bonds.

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.

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.

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: _____
Johanna Som de Cerff
Assistant Branch Chief
Tax Exempt Bond Branch

Enclosure (1)