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Date:
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This letter responds to Issuer's request for a ruling that the management contract described below (the "Contract") will not cause bonds (the "Bonds") to be issued by Issuer to finance the Facilities (as defined below), to meet the private business use test of § 141(b)(1) of the Internal Revenue Code (the “Code”). For this purpose, the Issuer requests a ruling that the Contract meets the requirements of Rev. Proc. 97-13, 1997-1 C.B. 692 or, in the alternative, that the Contract will not cause the Bonds to meet the private business use test under § 141(b)(1) based on all of the facts and circumstances.

Facts and Representations:

Issuer is a nonprofit corporation, organized under the laws of State to assist the City in acquiring and financing municipal property and equipment, including a proposed new water treatment plant, a raw water intake and pumping station, and a raw water transmission line (the “Facilities”).

Issuer represents that the Facilities will be a “public utility” within the meaning of Rev. Proc. 97-13 and § 168(i)(10). Issuer also represents that the reasonably expected useful life of the Facilities will be greater than Y years based on the 50 year safe harbor economic life for water utilities under Rev. Proc. 62-21, 1962-2 C.B. 418, 428.

Pursuant to a resolution adopted on Date 1, Issuer intends to issue the Bonds in separate issues in the aggregate amount of approximately $ X on behalf of City and will loan the proceeds to the City. City will use the proceeds of the Bonds to finance the costs of the Facilities. The City will own the Facilities.

The City intends to enter into the Contract with a private entity to design and construct the Facilities as well as to operate and maintain the Facilities. The City has qualified three private entities and proposes to enter into the Contract with one of the three private entities (the “Manager”) on Date 2.

According to the Contract, subsequent to the development and construction periods (the "Construction Periods"), the Manager will operate the Facilities for a period equal to the first partial year and 15 full years after the provisional acceptance date (the "Management Period"). The provisional acceptance date is the date on which the Facilities are accepted by the City after construction. The City has the sole option to renew the Contract for an additional five-year period. Issuer represents that the initial term of the Contract, which includes the Construction Period and the Management Period, will not exceed 20 years.

Payments to the Manager under the Contract during the Management Period include: (1) the "base operating charge"; (2) the "reimbursable costs charge"; and (3) the "extraordinary items" charge or credit.

(1) The base operating charge

The base operating charge includes components called a "fixed component” and a "variable component".

The fixed component of the base operating charge is structured as a three-tiered payment arrangement described in the Contract (the "“fixed fee groups”). For each annual period during the Management Period, the Manager will be paid the amount stated in one of the three fixed fee groups. Each fixed fee group represents a stated dollar amount for management services required to meet the reasonably expected water demand for the coming annual period under the Contract. Each fixed fee group corresponds to an entitlement by City of a specified average annual volume amount of finished water.

Once the City chooses a fixed fee group, the City cannot choose a different fixed fee group unless it gives written notice to the Manager 60 days before the start of the coming annual period under the Contract. The amount to be paid the Manager under the selected fixed fee group will increase each year by a fixed percentage of the annual change of the Consumer Price Index (the "CPI"). Issuer represents that the fixed fee group payments will constitute at least 80% of the Manager's compensation for each annual period during the Management Period of the Contract.

The variable component of the base operating charge will consist of the following: (1) the excess demand element, (2) the electricity savings element, and (3) the extra chlorine element. The excess demand element will be an amount paid to the Manager based on the amount of water required by the City in excess of the amount specified in the fixed fee group chosen for that year. The electricity savings element will be an incentive paid to the Manager for reducing electricity consumption, the cost of which is paid by the City. The extra chlorine element will be an amount that compensates the Manager for providing residual chlorine in excess of the amount of Z in the finished water.

The Manager's variable compensation (not including reimbursable costs) will be capped at 20% of the total compensation in each annual period and any portion of potential variable compensation that is constrained by the 20% cap may be carried forward for potential payment to Manager in a future year, if any, during which payment will be within the 20% cap.

(2) The reimbursable costs

The reimbursable costs charge covers direct, actual expenses paid by the Manager to third parties (without markup for profit, administration, or otherwise) for providing security for the Facilities and for residual chlorine in amounts greater than ZZ in the finished water.

(3) The extraordinary items

The extraordinary items component includes, among other specified items, payments to the Manager as a result of (1) increased costs of Manager due to "uncontrollable circumstances"; and (2) "capital modifications" necessitated by uncontrollable circumstances. Some examples of uncontrollable circumstances are: change in law; contamination of the site by hazardous waste; naturally occurring events such as an earthquake or landslide; war, terrorism, or sabotage; shortfalls in delivery of raw water; government preemption or condemnation of the Facilities; labor disputes; subcontractor failures; maintenance failures by other utility providers; City failures to finish certain related facilities; and City requested change orders not due to Manager fault. Issuer expects that payment under the extraordinary items component related to uncontrollable circumstances will only occur under extraordinary, remote and rare circumstances.

For most situations defined as uncontrollable circumstances under the Contract, the City and the Manager will negotiate a lump sum payment before the Manager begins any work or repair necessitated by the uncontrollable circumstance. For uncontrollable circumstances that are emergency situations requiring the Manager to begin work or repair immediately, with no time to negotiate payment, the Manager will be reimbursed for its costs plus reasonable overhead.

For payments resulting from uncontrollable circumstances, the City and the Manager will be required to designate and treat payments under the extraordinary items component as one of the following: 1) an ongoing adjustment or one-time payment under the fixed component; 2) as part of the variable component; or 3) as reimbursement of direct, actual expenses payable to third parties; or (4) as otherwise described hereafter. Payments with respect to "capital modifications" that are in the nature of capital expenditures for the Facilities, will be treated as capital expenditures rather than compensation for management services. Payments for breach, non-performance, or default of the City will be characterized as liquidated damages.

Under the Contract, the City will have the sole right to terminate the Contract for convenience and without cause upon 60 days notice during the Management Period, but if it does so it must pay the Manager a termination payment. The termination payment will be a fee equal to $ R less S of that amount for each month that has elapsed following the start of the Management Period including the month in which termination occurs. The City may also terminate the Contract for convenience and without cause during the Management Period, without paying the termination payment, upon the occurrence of certain uncontrollable circumstances.

Issuer represents that the Manager will not have any role or relationship that will substantially limit the City's ability to exercise any rights, including cancellation rights, under the Contract. Issuer also represents that not more than 20 percent of the voting power of the governing body of the City in the aggregate will be vested in the Manager and its directors, officers, shareholders, and employees. Also, there will be no overlapping board members of the City and the Manager. Issuer represents that the City and the Manager will not be related parties as defined in § 1.150-1(b) of the Income Tax Regulations.

Law

Section 103(a) 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 that is not a qualified bond (within the meaning of § 141).

Section 141(a)(1) defines a private activity bond as any bond issued as part of an issue that meets both the private business use test of § 141(b)(1) and the private security payment test of § 141(b)(2); or is part of an issue that meets the private loan financing test of § 141(c).

Under §§ 141(b)(1) and 141(b)(6)(A), private business use occurs if more than10 percent of the proceeds of the bonds are to be used (directly or indirectly) in a trade or business carried on by a person other than a governmental unit. Any activity carried on by a person other than a natural person is treated as trade or business use. Under § 1.141-3(b)(1), generally private business use can arise 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)(i) provides that a management contract with respect to financed property may result in private business use of that property based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

Under § 1.141-3(b)(4)(ii), a management contract is defined 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 a function of, a facility.

Under § 1.141-3(b)(4)(iii)(C), a contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property is generally not treated as a management contract that gives rise to private business use if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

Under § 1.141-3(b)(4)(iii)(D), a contract to provide for services is generally not treated as a management contract that gives rise to private business use if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

Revenue Procedure 97-13 sets forth conditions under which a management contract does not result in private business use under § 141(b). Under § 5.02, the management contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facilities. Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation. In addition, § 5.02(3) provides that for purposes of § 1.141-3(b)(4)(i) and Rev. Proc. 97-13, a productivity award equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues or adjusted gross revenues and reductions in total expenses) in any annual period during the term of the contract generally does not cause the compensation to be based on a net share of profits.

There are six specific arrangements that satisfy § 5 of Rev. Proc. 97-13. Under § 5.03(2), at least 80 percent of the compensation for services for each annual period during the term of the contract must be based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 10 years. For the purposes of this section, a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

Section 5.03(3) of Rev. Proc. 97-13 provides that if all of the financed property subject to the contract is a facility consisting of predominantly public utility property (as defined under § 168(i)(1)), then 20 years is substituted for 10 years in § 5.03(2).

The term “public utility property” is defined in general, under § 168(i)(10), as property predominantly used in the trade or business of furnishing or sale of electric energy, water, or sewage disposal services if the rates from such furnishing or sale, as the case may be, have been established or approved by a state or political subdivision thereof.

Section 3.05 of Rev. Proc. 97-13 defines a “periodic fixed fee” to mean a stated dollar amount for services rendered for a specified period of time. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to output or production of a facility.

Section 3.06 of Rev. Proc. 97-13 defines a “per-unit fee” to mean a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party.

Section 3.08 of Rev. Proc. 97-13 provides that a renewal option means a provision under which the service provider has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for one year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

Section 5.04(1) of Rev. Proc. 97-13 provides in general that a service provider must not have any role or relationship with the qualified user (the state or local government or instrumentality that is a party to the management contract) that substantially limits the qualified user’s ability to exercise its rights, including cancellation rights, based on all the facts and circumstances. Under § 5.04(2), the qualified user’s rights are not substantially limited if the following requirements are satisfied: (1) not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees; (2) overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and (3) the qualified user and the service provider under the contract are not related parties, as defined in § 1.150-1(b).

Analysis:

The Manager's compensation under the Contract does not meet the requirements of Rev. Proc. 97-13 for the reasons stated below. Therefore, whether the Contract results in private business use under § 141(b)(1) and § 1.141-3(b)(4) depends on all of the facts and circumstances. In determining whether the facts and circumstances indicate private business use, the principles set forth in Rev. Proc. 97-13 are useful reference points.

A permissible fee arrangement for the purposes of § 5.03(2) of Rev. Proc. 97-13 requires that at least 80 percent of the Manager's payment during any annual period during the Management Period of the Contract be a periodic fixed fee. Although City can choose one of three fixed fee groups for any year, the fixed component to be paid to Manager for any given year of the Management Period of the Contract is fixed subject only to a changes based on changes of the CPI and changes caused by certain uncontrollable circumstances and extraordinary items. Moreover, the fixed component of the base operating charge will be at least 80 percent of the payment to the Manager's compensation for each annual period during the Management Period of the Contract.

Nevertheless, we do not believe that the fixed component of the base operating charge meets the requirements of Rev. Proc. 97-13 because of the adjustments to this component permitted for certain uncontrollable circumstances and extraordinary items. Although these circumstance are represented to be remote, and separately may be remote, the totality of circumstances described as uncontrollable strongly suggests that one or more may happen during the term of the Contract. This possibility is significantly increased because of the length of the Management Period of the Contract.

Although we do not believe that the fixed component meets the requirements of § 5.03(2) of Rev. Proc. 97-13, we nevertheless conclude that payments under the fixed component of the Contract do not result in private business use of the Facilities for purposes of § 141. These payments, including those for certain uncontrollable circumstances and extraordinary items, are based on services to be provided by the Manager rather than revenues from the Facilities. Furthermore, payments of the fixed component will constitute at least 80 percent the total compensation to the Manager for each annual period during the Management Period of the Contract. Thus, these payments are not based on a share of net profit of the Facilities.

The variable component of the base operating charge also does not result in private business use of the Facilities. The extra chlorine and the excess demand charges are fees which are not based on net profit because each is based on an expense to the Manager and not on a share of the City's revenue from the Facilities. The electricity savings element is also not based on net profits because it is derived from a decrease of a limited expense element and is not associated with an increase in

gross or adjusted revenues of City from the Facilities.

The reimbursable costs charges will not be compensation to the Manager because, under § 1.141-3(b)(4)(iii)(D) and Rev. Proc. 97-13, a payment to the Manager of actual and direct expenses paid by the Manager to third parties is not compensation to the Manager.

The extraordinary items component of the service fee under the Contract requires the City and the Manager to treat the payments made under that provision, among other specified items, as a one time or ongoing adjustment to the fixed component, reimbursement of costs paid to third parties, part of the Manager's variable compensation, or as an amount paid for a capital modification. Although the ability to adjust the fixed component causes the Contract to not meet Rev. Proc. 97-13, payments made for extraordinary items do not result in private business use under § 141. These payments are based on services provided by Manager rather than net profits from the Facilities. Also, § 1.141-3(b)(4)(iii)(C) allows reimbursement of the actual and direct expenses and reasonable administrative overhead expenses of the service provider in public utility management contracts.

Payments with respect to capital modifications that are in the nature of capital expenditures for the Facilities represent payment for work separate from the Manager’s management services and are not considered management compensation under the Contract. As a result, we disregard these payments for purposes of analyzing Manager’s compensation.

Finally, neither the length of the Contact nor any relationship between Manager and City will cause there to be private business use of the Facilities. The initial term of the Contract (including the Construction Periods and the Management Period) will not exceed the 20 year term allowable for public utilities under Rev. Proc. 97-13. Also, the Manager will have no role or relationship with the City that will substantially limit the City’s ability to exercise any rights under the Contract, including cancellation rights. There will be no overlapping board members of the City and the Manager and the City and the Manager will not be related parties as defined in § 1.150- 1(b).

Conclusion:

Based on all of the facts and circumstances, we conclude that the Contract does not result in private business use of the Facilities under § 141(b) and § 1.141-3(b)(4)(i).

The ruling contained in this letter is 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 a ruling, it is subject to verification upon examination.

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(s) 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 the taxpayer.

Sincerely,

Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)

By: _____
Timothy L. Jones

cc: