

Guidance Regarding Mixed Use Output Facilities

Announcement 2002-91

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: This document describes and illustrates rules the IRS and Treasury Department expect to propose in a notice of proposed rulemaking with respect to the issuance of tax-exempt bonds for the government use portion of an output facility that is used for both a government use and a private business use. This document also invites comments from the public regarding these rules. Issuers may rely on this advance notice of proposed rulemaking for issues sold before the notice of proposed rulemaking is issued.

DATES: Written and electronic comments must be submitted by December 23, 2002.

ADDRESSES:

Send submissions to: CC:ITA:RU (REG-142599-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG-142599-02), courier's desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, submissions may be made

electronically to the IRS Internet site at <http://www.irs.gov/regis>.

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Guy Traynor, (202) 622-7180; concerning the proposals, Rose M. Weber, (202) 622-3980 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In general, under section 103 of the Internal Revenue Code, gross income does not include the interest on any State or local bond. However, this exclusion generally does not apply to private activity bonds. Section 141(a)(1) defines a private activity bond as any bond issued as part of an issue that meets either (1) the private business use test in section 141(b)(1) and the private security or payment test in section 141(b)(2) (the private business tests) or (2) the private loan financing test in section 141(c).

The private business use test is met if more than 10 percent of the proceeds of an issue are to be used for any private business use. Section 141(b)(6) defines private business use as use directly or indirectly in a trade or business that is carried on by any person other than a governmental unit. Section 141(b)(7) defines government use as any use other than a private business use.

The private security or payment test is met if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of an issue is directly or indirectly (1) secured by an interest in property used or to be used for a private business use, (2) secured by an interest in payments in respect of such property, or (3) 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 1.141-7 of the Income Tax Regulations provides rules under which the purchase pursuant to a contract by a non-governmental person of available output of an *output facility* (output contract) may be taken into account under the private business tests. 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 141(b)(4) contains a special limitation under which an issue five percent or more of the proceeds of which are to be used with respect to any output facility (other than a facility for the furnishing of water) will be treated as meeting the private business tests if the nonqualified amount for the issue exceeds the excess of \$15 million, over the aggregate nonqualified amounts with respect to all prior tax-exempt issues 5 percent or more of the proceeds of which are or will be used with respect to such facility (or any other facility which is part of the same project). Section 141(b)(8) defines *nonqualified amount* as the lesser of (1) the proceeds used for a private business use, or (2) the proceeds with respect to which there are payments, property or borrowed money taken into account under the private security or payment test.

The Conference Committee Report to the Tax Reform Act of 1986, H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-690 (1986), 1986-3 (Vol. 4) C.B. 686 (the Conference Report), contains an example that illustrates the treatment under section 141(b)(4) of an output facility the output of which is sold for both a government use and a private business use (a mixed use output facility), but the amount of private business use and private payments would cause bonds to be private activity bonds if they financed the entire facility. In the Conference Report example, a single issue of tax-exempt bonds is contemplated to finance the acquisition of a \$500 million electric generating facility. Ten percent of the output of the facility will be sold to an investor-owned utility under an output contract that gives rise to private business use. The Conference Report example concludes that \$465 million of tax-exempt bonds may be used to acquire the facility, \$450 million for the 90 percent of the facility that is used for a government use, plus \$15 million for the allowable private business use portion under section 141(b)(4). Section 1.141-8(c) contains an example that is substantially the same as the example contained in the Conference Report.

The IRS and Treasury Department are reviewing the application of section 141 to mixed use output facilities. This Announcement describes and illustrates rules that the IRS and Treasury Department expect to propose in a notice of proposed rulemaking (the proposed regulations) as part of the

2002-2003 Guidance Priority Plan. The proposed regulations will provide guidance regarding the issuance of tax-exempt bonds for the government use portion of a mixed use output facility without the bonds being characterized as private activity bonds.

Explanation of Provisions

A. *Mixed Use Allocations*

1. *In general*

The proposed regulations will provide that tax-exempt bonds may be issued to finance costs attributable to the government use portion of a mixed-use output facility (plus any costs attributable to *de minimis* private business use permitted under section 141) without the bonds being characterized as private activity bonds. For this purpose, the term facility includes an undivided ownership interest in a facility. With respect to arrangements for the purchase of output, the government use portion of an output facility is determined based on the percentage of the available output of the facility that is not used for a private business use (as determined under § 1.141-7).

2. *Allocation of private business use and payments*

The proposed regulations will provide that, in the case of a mixed use output facility, output contracts that result in private business use (including any payments thereunder) are allocated first to the portion of the facility that is financed with equity. For this purpose, *equity* means any amount other than proceeds of a tax-exempt bond, including funds of the issuer that are not derived from a borrowing and proceeds of taxable bonds, but does not include any amount allocable to a tax-exempt bond that has been retired. With respect to each issue of bonds, the portion of the output facility financed with equity is determined based on expenditures of equity that are made contemporaneously with expenditures of proceeds of the issue as part of the same plan of financing. In order for an output contract to be allocated (in whole or in part) to the equity-financed portion of an output facility as described in this paragraph, it first must be allocable to the facility under the facts and circumstances test contained in § 1.141-7(h). For example, an output contract that is allocable to two output facilities under § 1.141-7(h) may not

be allocated in its entirety to the equity-financed portion of one of the facilities.

B. *Examples*

The provisions of the proposed regulations described above are illustrated by the following examples (although the examples involve only an electric transmission facility, the principles illustrated apply equally to all output facilities):

Example 1.

Authority is a governmental person that owns and operates an electric transmission facility. Prior to 2003, Authority incurred capital costs of \$500 million for the facility. None of those costs was financed with tax-exempt bonds. In 2003, Authority needs to make repairs, upgrades and improvements to the facility in the amount of \$50 million. On April 10, 2003, Authority issues an issue with proceeds of \$30 million and uses those proceeds to pay capital costs of the facility. As part of the same plan of financing, Authority also uses \$20 million of its own funds which are not derived from a borrowing to pay capital costs of the facility. With respect to the 2003 issue, 46 percent of the available output (as determined under § 1.141-7) of the facility is sold under output contracts that result in private business use. Thus, of the \$50 million of new capital costs, \$27 million (54 percent) are attributable to government use and \$23 million (46 per-

cent) are attributable to private business use. In general, output contracts that result in private business use are allocated first to the portion of the output facility that is financed with equity. Therefore, of the \$23 million of costs attributable to private business use, \$20 million are allocable to Authority's equity and \$3 million are allocable to the 2003 issue. Thus, \$27 million (90 percent) of the proceeds of the issue are used for a government use. The issue does not consist of private activity bonds.

Example 2.

The facts are the same as in *Example 1*, except that by 2010, only 75 percent of the original principal amount of the 2003 issue remains outstanding. The retirement of a portion of the issue does not affect the amount of private business use of the facility that must occur in order for the issue to consist of private activity bonds.

Request for Comments

Before the notice of proposed rulemaking is issued, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying. In addition to comments regarding allocation and accounting rules for mixed use output facilities, comments are also invited on allocation and accounting

rules under section 141 for other facilities that are used for both a government use and a private business use.

Reliance on Announcement

Issuers may rely on the rules described in this Announcement with respect to any issue that is sold before the date the proposed regulations are published in the **Federal Register** (or such later date as may be specified in the proposed regulations or final regulations). Issuers may rely on this Announcement with respect to bonds that are subject to the Internal Revenue Code of 1986 or the Internal Revenue Code of 1954.

Drafting Information

The principal authors of this advance notice of proposed rulemaking are Bruce M. Serchuk and Rose M. Weber, Office of Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service, and Stephen J. Watson, Office of Tax Legislative Counsel, Department of the Treasury. However, other personnel from the IRS and Treasury Department participated in its development.