Internal Revenue Service

Department of the Treasury

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LEGEND:

Authority =

State =

Plants =

X =

Bonds =

Post-1994 Bonds =

Dear:

This is in response to a request you submitted on behalf of the Authority for a ruling under § 103 of the Internal Revenue Code of 1954 (the "1954 Code") about the effect that a sale of the Plants will have upon interest paid on bonds that financed all or some portion of the Plants.

Facts and Representations

You make the following factual representations. The Authority was created as a public body corporate and politic, and is an instrumentality of the State. The Authority supplies electric power and energy to the local municipal electric systems of approximately X cities and towns in State. It is authorized to issue bonds, including revenue bonds, and has the power of eminent domain.

The Authority owns undivided interests in several electric generating plants, including the Plants. The Authority's interests in each of the Plants was financed using the proceeds of its Bonds. The Bonds include new money bonds, refunding bonds issued for debt service savings, and refunding bonds issued to restructure debt service. The proceeds of the Bonds were, in general, also used to finance other facilities owned by the Authority. With the exception of the Post-1994 Bonds, all of the outstanding Bonds have been outstanding for at least 5 years since the later of the issue dates of those Bonds and the placed in service dates of the Plants. On the issue dates of the Bonds, the Authority reasonably expected to use the Bond proceeds for a qualified use throughout the term of that issue.

With respect to each issue that comprises the Bonds, one of the following statements is correct:

(1) the issue was issued prior to August 15, 1986, and, under § 1311 of the Tax Reform Act of 1986 (the "1986 Act"), § 1301 of the 1986 Act (which contains § 103 of the Internal Revenue Code of 1986 (the "1986 Code")), does not apply to that issue;

(2) the proceeds of the issue were used exclusively to refund (other than to advance refund) a bond issued before August 16, 1986 (or a bond which is part of a series of refundings of such a bond) and (i) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond; (ii) the average maturity of the issue of which the refunding bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities financed with the proceeds of the issue (determined under § 147(b)); and (iii) the provisions of the Code contained in § 1313(a)(3) were satisfied; or

(3) the proceeds of the issue were used exclusively to advance refund a bond and (i) the bond is not described in §§ 103(b)(2) or 103(o)(2)(A) of the 1954 Code and was issued (or was issued to refund a bond issued) before August 16, 1986; (ii) the average maturity of the issue of which the refunding bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with the proceeds of the issue (determined under § 147(b)); the provisions of §§ 1313(b)(3) and 1313(b)(5) were satisfied.

The terms of the bond issues comprising the Bonds are not longer than reasonably necessary for the governmental purposes of the issues (that is, the weighted average maturity of each of these issues does not exceed 120 percent of the average reasonably expected economic life of the property financed with the proceeds of the issues as of the issue dates).

For a variety of reasons, including as part of its efforts to be better prepared for the deregulation of the electric industry, to reduce its investment in baseload electric generating facilities, and the current favorable pricing for electric generation facilities, the Authority is undertaking to dispose of all or a portion of its interests in the Plants. The dispositions will be exclusively for cash (the "disposition proceeds"). Any agreements between the Authority and any purchaser of its interests in the Plants will be bona fide and arm's length and the sale price will be fair market value (as determined by an independent appraiser). In addition, the Authority will not dispose of the Plants for an amount less than the outstanding amount of the Bonds that are allocable to the Plants (the "Nonqualified Bonds"), determined by treating any Bonds that have been defeased as not outstanding.

The Nonqualified Bonds will have an issue price that bears the same relationship to the aggregate issue price of each of the issues that comprise the Bonds as the portion of the sale proceeds used for the facility for which the change of use occurs bears to the aggregate of all sale proceeds of the issues (with appropriate adjustments for pre-issuance accrued interest and original issue discount or premium). The Authority has determined the Nonqualified Bonds based on the allocation method used to allocate the proceeds of specific Bonds to specific projects in order to comply with applicable State law and the requirements of Bond resolutions. We have determined that this allocation method used by the Authority to determine the Nonqualified Bonds is a reasonable method. An attachment to the Authority's ruling request describes the Nonqualified Bonds.

For any Nonqualified Bonds that have been outstanding for at least 5 years since the later of the issue dates of those bonds and the placed in service dates of the Plants, the Authority will do the following:

(1) Not later than 90 days after the sale of the Plants the Authority will use disposition proceeds to redeem the Nonqualified Bonds, or establish an irrevocable escrow that will be used to redeem the Nonqualified Bonds at their earliest call date or maturity (whichever is earlier). Amounts in the escrow will not be invested in higher yielding investments. The escrow will be established in an amount that, together with investment earnings thereon, is sufficient to pay all principal, interest, and call premium on the Nonqualified Bonds from the date the escrow is established to, and including, the earliest call date or, if earlier, maturity. Amounts in the escrow will not be invested in any investment under which the obligor is a user of the proceeds of the nonqualified bonds (or a related party).

(2) Disposition proceeds not used to redeem the Nonqualified Bonds or to establish a defeasance escrow will be allocated by the Authority not later than one year after the disposition of the Plants to expenditures that would have qualified for tax-exempt financing (that is, for a qualified use) as of the original date of issue of the Nonqualified Bonds.

In the case of the Post-1994 Bonds (which do not satisfy the 5-year requirement), the Authority will do the following:

(1) Not later than 90 days after the sale of the Plants, use disposition proceeds to make a tender offer pursuant to which it offers to purchase the Post-1994 Bonds. The tender offer will be made at a price not less than the sum of (i) the price at which

the Nonqualified Bonds would be offered if they were defeased with United States Treasury obligations to the earliest call date or, if earlier, maturity and (ii) an additional premium designed so that a reasonable issuer under the circumstances would expect to purchase through the tender offer all of the bonds for which the tender offer was made, assuming that the holders of the bonds are reasonable persons motivated solely by economic factors (this price is referred to herein as the “Tender Price”).

(2) For any Post-1994 Bonds that the Authority is unable to purchase pursuant to the tender offer, the Authority will, not later than one year after the sale of the Plants, establish an irrevocable escrow that will be used to redeem the Post-1994 Bonds at their earliest call date or maturity (whichever is earlier). Amounts in the escrow will not be invested in higher yielding investments. The escrow will be established in an amount that, together with investment earnings thereon, is sufficient to pay all principal, interest, and call premium on the Post-1994 Bonds from the date the escrow is established to, and including, the earliest call date or, if earlier, maturity. Amounts in the escrow will not be invested in any investment under which the obligor is a user of the proceeds of the nonqualified bonds (or a related party).

(3) Disposition proceeds not used to purchase the Post-1994 Bonds or to establish a defeasance escrow will be allocated by the Authority not later than one year after the disposition of the Plants to expenditures that would have qualified for tax-exempt financing (that is, for a qualified use) as of the original date of issue of the Post-1994 Bonds.

The Authority requests a ruling that the sale of the Plants to a nongovernmental person will not cause the Bonds to meet the industrial development bond test of § 103(b) of the 1954 Code, provided that the Authority takes the actions described in its ruling request.

Law and Analysis

Sections 103 and 141 through 150, as added by § 1301 of the 1986 Act, provide the rules for determining whether interest on a State or local bond is tax exempt. Section 1311 of the 1986 Act provides the general rule that the amendments made by § 1301 apply to bonds issued after August 15, 1986.

However, § 1313(a)(1) provides, in general, that (except as provided in § 1313(a)(3)) the amendments made by § 1301 shall not apply to any bond the proceeds of which are used exclusively to refund (other than to advance refund) a qualified bond (e.g., a bond issued before August 16, 1986) if (A) the amount of the refunding bond does not exceed the amount of the refunded bond, and (B)(i) the average maturity of the issue of which the refunding bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities financed with the proceeds of the issue (determined under § 147(b)), or (ii) the refunding bond has a maturity date not later than the date 17 years after the qualified bond was issued.

Section 1313(a)(3) provides that the following 1986 Code provisions shall be treated as included in §§ 103 and 103A (as appropriate) of the 1954 Code and shall apply to refunding bonds described in § 1313(a)(1):

(A) The requirements of § 147(f) (relating to public approval required for private activity bonds) but only if the maturity date of the refunding bond is later than the maturity date of the refunded bond.

(B) The requirements of § 147(g) (relating to restriction on issuance costs financed by the issue).

(C) The requirements of § 148 (relating to arbitrage).

(D) The requirements of § 149(e) (relating to information reporting).

(E) The provisions of § 150(b) (relating to changes in use).

Section 1313(b)(1) provides, in general, that (except as provided in § 1313(b)(3)) the amendments made by § 1301 shall not apply to any bond the proceeds of which are used exclusively to advance refund a bond if –

(A) the refunded bond is described in § 1313(b)(2), and

(B) the requirements of § 1313(a)(1)(B) are met.

Section 1313(b)(2) provides that a bond is described therein if the bond is not described in §§ 103(b)(2) or 103(o)(2)(A) of the 1954 Code and was issued (or was issued to refund a bond issued) before August 16, 1986.

Section 1313(b)(3) provides that the following 1986 Code provisions shall be treated as included in §§ 103 and 103A (as appropriate) of the 1954 Code and shall apply to refunding bonds described in paragraph (1):

(A) The requirements of § 147(f) (relating to public approval required of private activity bonds).

(B) The requirements of § 147(g) (relating to restriction on issuance costs financed by the issue).

(C) The requirements of § 148 (relating to arbitrage), except that § 148(d)(3) shall not apply to the proceeds of such bonds to be used to discharge the refunded bonds.

(D) The requirements of paragraphs (3) and (4) of § 149(d) (relating to advance refundings).

(E) The requirements of § 149(e) (relating to information reporting).

(F) The provisions of § 150(b) (relating to changes in use).

Subparagraphs (A) and (E) apply only if the refunding bond is issued after December 31, 1986.

Section 103(a)(1) of the 1954 Code provides that gross income does not include interest on State or local bonds. Section 103(a)(1) of the 1954 Code does not apply, however, to an industrial development bond as defined in § 103(b)(2) of the 1954 Code. An industrial development bond is an obligation issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by a person who is not an exempt person. An exempt person is defined by § 103(b)(3) of the 1954 Code as a governmental unit or an organization described in § 501(c)(3) as exempt from tax under § 501(a).

Section 1.141-12 of the Income Tax Regulations provides rules under which a deliberate action that would cause bonds to meet the private business tests will not cause the bonds to be private activity bonds if certain conditions are met and a permitted remedial action is taken.

Section 1.141-15(b) provides that §§ 1.141-2 and 1.141-12 are effective for bonds issued after May 15, 1997, that are subject to § 1301 of the 1986 Act. Section 1.141-15(e) permits § 1.141-12 to be applied to any bonds issued before May 16, 1997. Section 1.141-15(e) is elective rather than mandatory.

Prior to the release of §§ 1.141-1 through 1.141-12, there were no specific statutory or regulatory rules governing the conditions under which a change of use of proceeds of an issue of State or local bonds would result in those bonds being treated as violating the requirements of §§ 103 and 141-150 of the 1986 Code or § 103 of the 1954 Code. However, Rev. Proc. 93-17, 1993-1 C.B. 507, contained certain conditions under which changes in the use of proceeds of an issue of state or local bonds would not result in those bonds being treated as violating certain requirements of §§ 141 through 150 of the 1986 Code. Rev. Proc. 93-17 also applied to the corresponding provisions under the 1954 Code.

The preamble to Treasury Decision 8712, adopting §§ 1.141-1 through 1.141-12, states that Rev. Proc. 93-17 is obsolete for actions that occur on or after May 16, 1997. However, § 1.141-12 does not apply to the Bonds unless the Authority elects to have it apply. The Authority has not elected to apply § 1.141-12. Under these circumstances, the principles underlying Rev. Proc. 93-17 may be used to determine whether the IRS will give an advance ruling that a change from a qualified to a nonqualified use will not cause bonds to meet the industrial development bond test of § 103(b) of the 1954 Code.

Rev. Proc. 93-17 applied to any change from a qualified to a nonqualified use. Section 4.01(1) of Rev. Proc. 93-17 provided that a “change of use” is a change in the use of the proceeds of an issue from the actual or expected use to a different use. Section 4.01(6) provided that a “qualified use” is any use of the proceeds of an issue in a manner that satisfies all of the applicable requirements for tax-exempt bonds under §§ 103 and 141 through 150. Section 4.01(5) provided that a “nonqualified use” means any use of the proceeds of an issue in a manner that fails to satisfy the applicable requirements for tax-exempt bonds under certain specified sections of the 1986 Code, including § 141(b).

Section 4.01(4) of Rev. Proc. 93-17 provided that “nonqualified bonds” means, for purposes of the revenue procedure, the portion of the bonds that is properly allocable to proceeds with respect to which there occurs a change of use that results in a change from a qualified use to a nonqualified use. This portion of bonds must have an issue price that bears the same relationship to the aggregate issue price of the issue as the portion of the sale proceeds used for the facility for which the change of use occurs bears to the aggregate sale proceeds of the issue. Appropriate adjustments must be made to properly allocate pre-issuance accrued interest and original issue discount or premium. In determining the portion, allocations must be done in a reasonable, consistently applied manner. Ratable allocations are generally presumed to be reasonable.

Under Rev. Proc. 93-17, if certain conditions were met, a change of use resulting in a nonqualified use would not be treated as causing interest on the bonds to fail to be excluded from gross income under § 103(a) because of a failure to satisfy the requirements of the 1986 Code specified in the revenue procedure. Specifically, under Rev. Proc. 93-17 to maintain tax-exempt status following a change of use to a nonqualified use, it was necessary that the following conditions be met:

(1) The issuer and all conduit borrowers must reasonably expect on the issue date to use the bond proceeds for a qualified use for the entire term of the issue.

(2) The bond proceeds must have been used for a qualified use for a substantial time period of at least 5 years after the later of the issue date or the date on which the financed facilities were placed in service.

(3) Any agreements between the new user and the original user are bona fide and arm's length, and the new user must pay fair market value for the facilities.

(4) No circumstances can be present that suggest an attempt to avoid the requirements of §§ 103 and 141 through 150.

(5) The issuer must take one of the three remedial actions set forth in the revenue procedure, two of which are relevant in this case. Section 4.02(5)(a) provides that a valid remedial action is the redemption of all of the nonqualified bonds at the earliest call date after the change of use. If the nonqualified bonds are not redeemable within 90 days of the change of use, an irrevocable escrow must be established within this 90-day period and used to redeem the bonds at their earliest call date. The escrow may not be invested in higher yielding investments. The escrow must be established in an amount that, together with investment earnings thereon, is sufficient to pay all principal, interest, and call premium on the nonqualified bonds from the date the escrow is established to, and including, the earliest call date. The amounts in the escrow may not be invested in any investment under which the obligor is a user of the proceeds of the nonqualified bonds or any related party to that user.

Section 4.02(5)(b) generally provided that, for governmental bonds or § 501(c)(3) bonds, where the change of use arises from a sale, exchange, or other disposition of a facility financed by an issue, a qualifying remedial action includes the use of the disposition proceeds of the issue in an alternative manner that would have resulted in qualified use of those disposition proceeds and other proceeds of the issue (excluding the proceeds of the nonqualified bonds) in the aggregate. This determination of qualified use is made as of the original issuance of the issue after giving effect to the cure provision under § 4.03. The disposition proceeds must be allocated to expenditures for the alternative use within one year after the change of use. The amount of disposition proceeds used in this manner must at least equal (but not exceed) the proceeds of the issue allocable to the nonqualified bonds. Any disposition proceeds allocable to the nonqualified bonds that are not used for this alternative manner must be used to redeem a pro rata portion of the nonqualified bonds in the manner described in § 4.02(5)(a). In addition, if the amount of disposition proceeds is less than the proceeds of the issue allocable to the nonqualified bonds, funds other than proceeds of tax-exempt bonds must be used to redeem a pro rata portion of the nonqualified bonds in a manner that satisfies § 4.02(5)(a).

Section 4.06 of Rev. Proc. 93-17 provided that the IRS will consider requests for rulings in the case of changes of use in which the safe harbors provided in § 4 are not satisfied.

With respect to the Nonqualified Bonds other than the Post-1994 Bonds, the Authority would have satisfied all of the requirements of the safe harbors in Rev. Proc. 93-17. In addition, with respect to the Post-1994 Bonds, the Authority would have satisfied all of the requirements of the safe harbors in Rev. Proc. 93-17 other than the 5 year requirement. Specifically, there were reasonable expectations on the dates of issuance of the Bonds that the facilities financed by the Bonds would be used for a qualified use throughout the terms of the Bonds, any disposition of the Plants will be for fair market value and the payment will be determined in an arm's length transaction, and there appear to be no circumstances indicating an attempt to pass the subsidy of the tax-exemption to a private business or to avoid the requirements of § 103 of the 1954 Code or §§ 103 and 141 through 150 of the 1986 Code.

The Post-1994 Bonds were outstanding only a relatively short time before the decision to sell was made and would not have satisfied the 5-year requirement of Rev. Proc. 93-17. However, by either purchasing the Post-1994 Bonds or establishing an irrevocable escrow for those Bonds, in the manner described above, the Authority is taking practical, good faith action to prevent its subsequent deliberate action from adversely affecting the status of the interest on the Post-1994 Bonds. The proposal promotes a reasonably practical matching between the subsidy provided by the tax exemption and the facilities financed with Post-1994 Bond proceeds.

Conclusion

Based solely upon your representations and the facts presented, we conclude that the sale of the Plants to a nongovernmental person will not cause interest on the Bonds to meet the industrial development bond test of § 103(b) of the 1954 Code, provided that the Authority takes the actions described in this letter. No opinion is expressed concerning any aspects of the Bonds under any other section of the 1954 Code, including whether interest on any of the issues is excluded from gross income under § 103 of the 1954 Code, except as specifically stated in this ruling.

This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Pursuant to a Power of Attorney on file with this office, a copy of this letter is being sent to the Authority's authorized representative.

Sincerely yours,
Assistant Chief Counsel
(Exempt Organizations/Employment Tax/
Government Entities)
By: Timothy L. Jones
Assistant to the Chief
Tax Exempt Bond Branch

cc: