DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF CHIEF COUNSEL

August 7, 2002

Number: **200245048** CC:TEGE:EOEG:TEB
Release Date:11/8/2002 POSTF-103113-02
UILC: 141.00-00; 141.01-00; 141.01-04; 141.03-00; 148.02-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR HELENE A. WINNICK
DEPUTY AREA COUNSEL CC:TEGE:PCCM:THO

FROM: Acting Assistant Chief Counsel CC:TEGE:EOEG

SUBJECT: Purchase of Working interest in Gas Field

This Chief Counsel Advice responds to your memorandum dated March 15, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Utility

Gas Field

Series B Bonds

Series C Bonds

Series D Bonds

Issuer

Owner 1

Hydroelectric Project

Corporation X

POSTF-103113-02

Pipeline

Public Utilities Commission

State

Year 1

Year 2

Year 3

Year 4

Year 5

Year 6

Year 7

Month

Date 1

Date 2

Date 3

Date 4

Date 5

Date 6

Date 7

a

b

c

d

e

f

g

h

i

j

k

l

m

n

p

q

ISSUES

1. Whether bonds used to purchase a working interest in the Gas Field are private activity bonds because those bonds purchased nongovernmental output property, within the meaning of § 141(d) of the Internal Revenue Code (the “Code”).

2. Whether Utility's allocations of gas from its working interest to its own use should be respected.

3. Whether proceeds of the Series B Bonds were used indirectly to fund Utility’s purchase of its working interest in the Gas Field.

4. Whether any of the Series B Bonds are part of the same issue as the Series C Bonds or the Series D Bonds.

5. Whether Utility acquired investment-type property under § 148 when it acquired contracts to sell gas.

CONCLUSIONS

1. An argument can be made that Utility's working interest in the Gas Field is output property acquired from a nongovernmental person and that, therefore, the bonds used to purchase the working interest are subject to the limitations in § 141(d). We do not have enough information to determine whether the exception in § 141(d)(3) applies.

2. Whether we should respect Utility's allocations of gas depends upon the reasonableness of those allocations under all of the facts and circumstances, including the legal and physical possibility of those allocations. We recommend factors for you to consider.

3. Both direct and indirect use of proceeds are considered under § 141. Further development is needed before we can make a legal determination on this issue.

4. Under the facts presented and the definition of issue in § 1.150-1(c) of the Income Tax Regulations, the Series B Bonds appear to be a separate issue of bonds.

5. It is unclear whether the gas sale contracts Utility acquired are passive investments. In addition, we will need to determine the principal purpose for acquiring the working interest in the Gas Field and the gas sale contracts.

FACTS

Utility is a municipal electric utility owned and operated by the Issuer. At all times during the ten-year period ending on the date Utility acquired the working interest in the Gas Field (further described below), Utility provided electricity to customers within a service area (the "Service Area").[1] Utility did not provide natural gas to customers during that period. But Utility has used, and continues to use, gas to run its gas-fired electric generating turbines.

Prior to Year 4, Utility obtained all of the gas it needed to run its gas-fired turbines under separate, but substantially identical, contracts (the "gas purchase contracts") that it entered into in Year 1 with the three owners of the Gas Field (the "owners"). These contracts provide Utility with an equal share of its gas requirements from each owner. The gas purchase contracts expire no later than Date 7. The information submitted includes one of the gas purchase contracts. According to that

[1]The agent indicates that Utility also provides electricity to certain customers outside of its Service Area. Utility asserts that these customers are within the Service Area.

contract, the delivery point for the gas is the outlet side of the relevant owner's meters[2] at the Gas Field.

The Gas Field is operated by one of the owners (the "Operator"), a private corporation,[3] and consists of gas in place and physical assets for the production of gas, such as wells, dehydration and other facilities, pads, pipes, meters, and wells. Gas produced at the Gas Field is essentially of the type that can be sold to retail customers; however, gas for Utility's electric generation facility and other customers that have gas transported from the Gas Field through the Pipeline is further treated at the Gas Field to permit transportation on the Pipeline.

On Date 2, Utility entered into an agreement to purchase the interest of Owner 1 (a nongovernmental entity) in the Gas Field ("working interest agreement") to obtain a stable supply of gas at a stable price. Utility agreed to pay $a, of which Utility paid $b as a deposit. You have reason to believe that the next highest bid Owner 1 received for its working interest was $c, which is substantially less than what Utility agreed to pay.

Two days after entering into the working interest agreement, Utility placed the $b deposit into escrow. Some of the documents indicate that the funds for this deposit were taken from various reserves and accounts (the "Funds") maintained by Utility, including $d from the Hydroelectric Project Reserve and $e from the Operating Reserve.

The Operating Reserve was required under various bond indentures to be replenished. Whether the Hydroelectric Project Reserve had to be replenished is less clear. That fund contained monies for Utility to purchase an interest in the Hydroelectric Project. Utility asserts that the Hydroelectric Project Reserve was not a restricted fund, and that at the time the monies were withdrawn from the Hydroelectric Project Reserve, it was uncertain that the Hydroelectric Project purchase would occur and the fund was closed. As discussed below, Utility eventually purchased an interest in the Hydroelectric Project.

The record indicates the representatives of Utility made several statements that bond proceeds would be used to replace the monies it had used for the deposit and the

---

[2]While the wording of the contract makes it appear as if there are separate meters specifically designated for the respective owners, the owners each have an undivided interest in the Gas Field and one owner serves as operator of the Gas Field (see below for further description). Thus, it is more probable that the meters are those of the owners collectively.

[3]You have not indicated whether the agreement with the Operator is a qualified management contract.

cash portion of the final payment for the working interest in the Gas Field. These statements were made at a municipal assembly work session and a Public Utilities Commission ("PUC") meeting. However, Utility asserts that the Funds other than the Hydroelectric Project Reserve, which it asserts was closed, were replenished with cash flows from revenues. It appears that the agent disagrees, finding that the Funds including the Hydroelectric Project Reserve were replenished with proceeds from the Series B Bonds (described below).[4]

Under the working interest agreement, Utility acquired a share of the physical assets as well as a share of gas in the ground at the Gas Field. Utility estimated the amount of gas reserves associated with its interest to be f. Utility also acquired Owner 1's rights and obligations under existing gas sale contracts (the "gas sale contracts"). These contracts obligate Utility to supply an amount of gas potentially up to approximately h percent of the gas reserves Utility acquired through the working interest agreement.

The gas sale contract entered into on Date 1 between Owner 1 and Corporation X requires the largest potential amount of gas. This contract also has the longest term, extending at least several years beyond the date that the gas purchase contracts are scheduled to terminate. This contract is divided into three periods. You indicate that if Utility uses gas from its working interest to meet all of its obligation to supply gas to Corporation X in the third period, the Series C and D Bonds will be private activity bonds.

The gas sale contract with Corporation X provides that the delivery point for Corporation X's gas is the connection at the Gas Field between Owner 1's meters and Corporation X's facilities for receipt of such gas. Our reading of the contract with Corporation X is that Utility has the right to deliver gas to Corporation X from a source other than the Gas Field; however, Utility's obligation to deliver to Corporation X is based on its reserves of gas at the Gas Field and Owner 1's prior obligation to another purchaser under one of the other gas sale contracts that Utility acquired.

At least in part because it is a competitor of Utility, Corporation X was concerned about having its gas purchase contract assumed by Utility. Accordingly, alternatives were considered. There was an attempt to have Utility purchase Owner 1's working

---

[4]The record contains a comparative balance sheet for years ending December 31 of Years 4 and 5 that shows an entry for Year 5 labeled "Investment in ... [Hydroelectric Project]". In contrast, on the comparative balance sheet for Years 2 and 3, entries appear under the label "...[Hydroelectric Project] Account". There is no such entry for Year 4 or 5. In keeping with the notes to the financial statements, we interpret the Year 5 entry as reflecting the acquired interest in the Hydroelectric Project, rather than cash in the Hydroelectric Project Reserve.

interest without the gas sale contract with Corporation X and without the gas to satisfy that contract, but that attempt failed. You indicate that at one point during the negotiations between Utility and Owner 1, Utility notified Owner 1 that the failure to assign the gas sale contract with Corporation X would be a defect that would require a payment of $i to cure. The agent states that the $i represents the present value of the expected sales under the contract. Utility disagrees and asserts a different interpretation.

Utility asserts that it allocates some gas it acquires under the gas purchase contracts and some gas from its working interest to the gas sale contracts; however, Utility will use the gas from its working interest principally for its own use in generating electricity. Utility further asserts that after the gas purchase contracts expire (*e.g.*, in the third period of the gas sale contract with Corporation X), it expects to supply the gas sale contracts with gas it will purchase from third parties and not from its working interest in the Gas Field. Utility asserts that it does not expect to have problems acquiring gas at that time. You have not indicated whether you think Utility's expectations regarding future gas purchases are reasonable. Based on Utility's allocations of gas, it will not use more than the lesser of 5% or $5,000,000 of Series C and D Bond proceeds to supply the gas sale contracts.

The PUC has authority over publicly and privately owned utilities in State, including Utility. This authority extends to the approvals of gas purchase contracts entered into by the utilities, as well as changes to the terms and conditions of existing contracts. It is not clear whether Utility needed the consent of the PUC to resell gas obtained from the gas purchase contracts to purchasers under the gas sale contracts. From the documents provided, it appears that the PUC was aware of Utility's intent to resell the gas. It is also not clear whether it was reasonable for Utility to expect PUC approval of future contracts it might enter into to purchase gas to meet its obligations under the gas sale contracts.

The other parties to Utility's gas purchase contracts, *i.e.*, the other owners of the Gas Field, may have differing opinions as to whether Utility may resell gas purchased under those contracts. One of the owners stated that gas purchased under the gas purchase contracts could be used only by Utility. However, that owner did not respond when it was later notified of Utility's allocation. The other owner, the Operator, did not object to Utility's reselling purchased gas as long as the Operator's responsibility to supply gas was not increased and Utility's obligation to pay was not decreased. However, the Operator indicated that if Utility were to resell purchased gas, the gas that Utility would consume in its place would be classified as own use gas under the gas balancing agreement.[5]

---

[5]The gas balancing agreement serves to keep the relative shares of gas

(continued...)

Some of the incoming documents suggest that Utility was required to notify the Operator of the Gas Field monthly if it resold gas from the gas purchase contracts and consumed other gas for its own use ("gas substitution"). It does not appear that such monthly notice occurred; however, Utility did notify the other owners in Month of Year 7 of its gas substitution for the previous calendar year. Utility states that it did not substitute gas in the prior two calendar years, which are essentially the first two years Utility owned its working interest.

On Date 3, the Issuer's chief fiscal officer executed a document entitled "official intent certificate." This document indicates an intent to issue up to $j of bonds to reimburse expenses for four projects. One of the projects is the Hydroelectric Project. The other projects are more generally described as cost of construction, purchase of electric power equipment, and costs for improving/extending the system.

On Date 4, the Issuer issued the Series B Bonds. The Series B Bonds are limited obligations, payable only out of Utility's revenues. Utility states that it allocated the sale proceeds, other than those used for costs of issuance, underwriter's discount, credit enhancement premium, and a reserve account, to a variety of Utility's capital projects, but not to the purchase of the working interest. Reimbursement allocations total $k, including a small amount, $l, for the Hydroelectric Project. To obtain economies of scale, Utility sized the Series B Bonds to finance some capital expenditures it had expected to finance with tax-exempt bonds in the next year, Year 5.

On Date 5, approximately four months after Date 4, the Issuer issued the Series C Bonds and the Series D Bonds. Utility states that the Series B, C and D Bonds were sold on different dates, but the incoming documents do not indicate the date the bonds were sold. The Series C and D Bonds are limited obligations, payable out of Utility's revenues. One day after the Series C and D Bonds were issued, Utility completed the purchase of Owner 1's interest in the Gas Field for a total purchase price of $m. Sale proceeds of the Series C and D Bonds were used for $n of the purchase price.

On Date 6, Utility's acquisition of an interest in the Hydroelectric Project was finalized, with a payment of $p at that time. Utility allocated a total of $q of its Series B Bond proceeds to the Hydroelectric Project, including a small amount, $l, for costs incurred prior to the issuance of the Series B Bonds.

---

[5](...continued)
production in balance among the owners of the working interests in the Gas Field. Gas produced is classified under the gas balancing agreement as gas used for qualified contracts, non-qualified contracts, or own use.

LAW AND ANALYSIS

General law

Section 103(a) provides generally that 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 that is not a qualified bond (within the meaning of § 141), or to any arbitrage bond (within the meaning of § 148).

Section 141(a) defines "private activity bond" to include any bond issued as part of an issue that meets the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2). An issue meets the private business use test of § 141(b)(1) if more than 10 percent of the proceeds of the issue are to be used for any private business use. An issue meets the private security or payment test of § 141(b)(2) 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 property used or to be used for a private business use, or in 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 148(a) provides that the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yield investments. Section 148(b)(2) defines "investment property" to include any investment-type property.

Nongovernmental output property

Section 141(d)(1) provides that the term "private activity bond" includes any bond issued as part of an issue if the amount of the proceeds of the issue which are to be used (directly or indirectly) for the acquisition by a governmental unit of nongovernmental output property exceeds the lesser of five percent of such proceeds or $5,000,000. Section 141(d)(2) defines "nongovernmental output property" generally as any property (or interest therein) which before such acquisition was used (or held for use) by a person other than a governmental unit in connection with an output facility (within the meaning of § 141(b)(4)) (other than a facility for the furnishing of water).

Section 141(b)(4) (which sets forth lower private activity limits for certain output facilities) does not define output facility. The legislative history to § 141(d) states "[a]s under present law, output property includes, e.g., facilities such as electric and gas generation, transmission, distribution, and other related facilities." H.R. Conf. Rep. No.

100-495, at 1007 (1987), 1987-3 C.B. 287. No definitions of generation, transmission or distribution appear in the regulations or the legislative history.

Our search of industry manuals indicates that *transmission* and *distribution* are terms used for natural gas, but we could not find a definition for *generation* in connection with natural gas. *See, e.g.,* Howard R. Williams & Charles J. Meyers, Manual of Oil and Gas Terms (10th ed., Matthew Bender 1997). Generally, the transmission system consists of land, structures, and equipment used primarily to transmit gas from the production plant, delivery point of purchased gas, or other wholesale source of gas to one or more distribution areas. The distribution system accepts gas from the transmission system and transports it to residential, commercial, and industrial customers' premises. Production includes taking the gas from the well and processing the gas. [6]

Section 141(d)(3)(A) provides that nongovernmental output property shall not include any property which is to be used in connection with an output facility 95 percent or more of the output of which will be consumed in (i) a qualified service area of the governmental unit acquiring the property or (ii) a qualified annexed area of such unit.

Section 141(d)(3)(B)(i) defines qualified service area, with respect to the governmental unit acquiring the property, as any area throughout which such unit provided (at all times during the 10-year period ending on the date such property is acquired by such unit) output of the same type as the output to be provided by such property.

Section 141(d)(3)(B)(ii) defines qualified annexed area as, with respect to the governmental unit acquiring the property, any area if (I) such area is contiguous to, and annexed for general governmental purposes into, a qualified service area of such unit, (II) output from such property is made available to all members of the general public in the annexed area, and (III) the annexed area is not greater than 10 percent of such qualified service area.

Section 141(d)(4)(A) provides that generally "nongovernmental output property" shall not include any property that is to be converted to a use not in connection with an output facility. Section 141(d)(5) provides that in the case of a bond which is a private activity bond solely by reason of § 141(d), subsections (c) and (d) of § 147 (relating to limitations on acquisition of land and existing property) shall not apply, and paragraph (8) of § 142(a) shall be applied as if it did not contain "local."

When Utility purchased Owner 1's interest in the Gas Field, it acquired a share of the gas reserves and a share of the physical assets, such as wells, dehydration

---

[6] Production may also refer to the gas taken from the wells.

facilities, and equipment. The physical assets make it possible to extract the gas from the ground, dry it to the proper water content, and deliver it to the owners' meters or other delivery points. The gas produced at the Gas Field is essentially the type of gas that can be sold to retail customers. Thus, production of the gas is completed at the Gas Field, and generally, the gas is ready for transmission and distribution.

We first consider whether the Gas Field is an output facility under § 141(b)(4). Output facility includes assets used for generation, transmission and distribution of gas and electric. There does not appear to be a generation function for natural gas. However, a reasonable argument can be made that for natural gas, the parallel to generation is production. Accordingly, we think it is reasonable to conclude that Utility, by acquiring an interest in assets used for the production of gas, acquired an output facility.

Having determined that an output facility exists, the statute then requires that we include as output property any property used by a nongovernmental person in connection with the output facility. *See also* H.R. Conf. Rep. No. 100-495, at 1011 (1987), 1987-3 C.B. 291 (example of garage that had been used by investor-owned utility as nongovernmental output property and output property may be tangible or intangible). The broad breadth of the “in connection with” language appears to capture the gas as property used in connection with a production facility. Yet, there is an argument that the gas, which is the output from the output facility, is not property *used in connection with* the output facility. Based on our analysis below, we defer deciding this issue.

We next consider whether any of the exceptions in § 141(d)(3)(A) apply. The analysis differs depending on how the assets acquired through the working interest agreement are used. We first consider assets appropriately allocated to Utility's use for electric generation.

The qualified service area exception compares the type of output to be provided by the acquired property to the type of output the governmental unit provided during the 10-year period preceding the acquisition of the property. This provision could be interpreted in two ways. Under the first, the output ultimately produced for consumption from the acquired output property is compared to the output the governmental unit historically produced to determine whether it is “the same type of output.” Under the second, the output of the acquired output property (without consideration to any change in the form of the output by the governmental unit) is compared to the output that the governmental unit historically sold in its service area. Accordingly, we look to the legislative history.

The Conference Report provides that,

> Under the first exception, the acquisition of nongovernmental output property by a State or local governmental unit to meet existing or increased capacity demands within the service area throughout which the acquiring entity has provided the same type of service for at least 10 years immediately preceding the date of the acquisition is not subject to the new restrictions.

H.R. Conf. Rep. No. 100-495, at 1008 (1987), 1987-3 C.B. 288. This language suggests the better interpretation is one that compares the output ultimately produced by the governmental unit for consumption in its service area to output which the governmental unit historically produced. In this case, gas and related assets appropriately allocated to Utility's use for electric generation will produce the same type of output that the Utility historically produced for consumption in the Service Area. Moreover, it appears that Utility may sell the electricity it produces from the acquired gas in its Service Area.[7] Thus, the exception in § 141(d)(3)(A) may apply to the assets allocated to Utility's own use.

Utility intends to allocate some of the gas from its working interest to the gas sale contracts. The exception in § 141(d)(3)(A) does not apply to that portion of the bond-financed assets attributable to such gas. Under the gas sale contracts, Utility will be providing gas, which, unlike electricity, it historically did not provide. Therefore, Utility does not have a qualified service area for this type of output. However, if Utility's allocations are respected (see issue below), Utility will not have used in excess of the lesser of 5 percent or $5,000,000 of the Series C or D Bond proceeds for assets that will be used to supply gas for the gas sales contracts.

Whether Utility's Use Allocations Should Be Respected

Because of the date of issue of the Series C and D Bonds, there are no applicable regulations that address the allocation of private business use.[8] Determining private use of bond proceeds is done on a case-by-case basis, under the principles of the private business use test taking into account all facts and circumstances. *See* H. Rep. No. 99-426, at 521 (1985), 1986-3 C.B. (Vol. 2) 521. An issuer's allocations will not be respected if those allocations are unreasonable based on all the facts and circumstances. Special allocation rules for output facilities exist in § 1.141-7T(g).

---

[7]The agent suggests that Utility may sell some electricity outside of its Service Area. Utility disputes that the customers involved are outside of the Service Area. We do not know the magnitude of these sales and, if found to be outside the Service Area, we do not know whether these sales would occur within a qualified annexed area. These issues will need to be resolved.

[8]Issuer has not elected into the current § 141 regulations.

While these regulations do not apply to the bonds in this case, the regulations list factors that may be considered as part of the facts and circumstances.

Section 1.141-7T(g) provides that whether output sold under an output contract is allocated to a particular facility, to the entire system of the seller of the output, or to a portion of a facility, is based on all the facts and circumstances. Significant factors to be considered in determining the allocation of an output contract to financed property are the following:

1) the extent to which it is physically possible to deliver output to or from a particular facility or system;

2) the terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources);

3) whether the contract is entered into as part of a common plan of financing for the facility; and

4) the method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

Before acquiring Owner 1's interest, Utility used the gas it acquired under the gas purchase contracts for its own use in generating electricity. Utility states that, after acquiring its working interest, it allocates some of the gas from the gas purchase contracts to the gas sale contracts, and gas from its working interest principally to its own use. Utility appears to be making its allocations to avoid private use limits. This fact, however, does not mean that Utility's allocations are unreasonable.

We next consider whether the gas sale and gas purchase contracts suggest Utility's allocation is unreasonable. The gas sale contract with Corporation X was entered into by Owner 1, a taxable entity, prior to any contemplation of Utility’s purchase of the working interest. Another gas sale contract Utility assumed predates the contract with Corporation X. It is unlikely that these contracts and any other contract that substantially predates the working interest agreement are part of a common plan of financing for Utility's acquisition of the facility.

The gas sale contracts have provisions relating performance under the contracts to the gas Utility acquired through the working interest agreement. The obligation to deliver is based on the available reserves in the Gas Field owned by Utility. However,

the gas delivered under the gas sale contract with Corporation X[9] need not come from Utility's working interest. We read the gas sale contract to permit Utility to deliver gas from a source other than its reserves at the Gas Field.

The delivery point provisions under the gas purchase contracts and Corporation X's gas sale contract do not appear to prevent Utility from delivering purchased gas to Corporation X.[10] All of these contracts provide for delivery at the owners' meters. Accordingly, gas under the gas purchase contracts can be delivered to the owners' meter at Corporation X's facility at the Gas Field.

We have inconsistent information on whether there are other legal impediments to Utility's resale of the gas obtained under the gas purchase contracts. The parties to the gas purchase contracts may disagree about whether gas delivered under those contracts can be resold. It is also unclear whether PUC approval is necessary for Utility to resell gas obtained from the gas purchase contracts. If resale of the purchased gas is not permitted under the contracts or applicable public utility rules, a legal impediment to Utility's allocation would exist, which is a factor indicating that Utility's allocation is unreasonable.

Also relevant to the analysis is whether there are any physical impediments to Utility reselling gas obtained from the gas purchase contracts to Corporation X. All of the gas Utility receives under the gas purchase contracts and from its working interest is from the Gas Field. Accordingly, any gas obtained from the Gas Field could represent either gas under the gas purchase contracts or gas from Utility's working interest in the Gas Field. In addition, all of the gas from the Gas Field can be delivered to any of the owners' meters. Thus, absent other facts, we do not believe that there is a physical impediment to Utility's allocation. Our conclusion is supported by the agent's statement that with advance approval, rerouting of the purchased gas to Corporation X would be possible.

We note that the gas purchase contracts expire not later than Date 7, a date that is substantially earlier than the date on which the gas sale contract with Corporation X terminates. It is relevant to determine whether it was reasonable for Utility to expect to be able to purchase gas in the future to satisfy its obligations under the gas sale contracts and to obtain PUC approval for future contracts to purchase gas.

---

[9]The gas sale contract with Corporation X is the only gas sale contract for which a copy of the contract is included in the submission.

[10]We only address the delivery limitations under the Corporation X gas sale contract. However, the facts indicate that gas for the other gas sale contracts flows through the Pipeline as does Utility's purchased gas, so it appears that delivery limitations may not be present with respect to those contracts.

Finally, the agent asserts that after acquiring its working interest, Utility continued to use the purchased gas for its own electric generation and sold gas from its working interest in the Gas Field, pointing to Utility's apparent failure to report its gas substitution on a monthly basis. He argues that this is one factor supporting a conclusion that Utility's allocations are unreasonable.

We agree that for two years Utility sold gas from its working interest, rather than from its purchased gas. But Utility did not intend to use only purchased gas to supply the gas sale contracts; it intended to use some of its working interest gas for those contracts. Thus, the fact that Utility sold some of its own gas does not mean that Utility's allocations are unreasonable.[11]

We are unable to reach a conclusion on this issue without further information.

Indirect Use of the Series B Bonds

You question whether the IRS should view the Series B Bond proceeds as being used indirectly for the purchase of the Gas Field. You state that Utility concedes that if the proceeds of the Series B Bonds are allocated to the purchase of the working interest, the Series B Bonds would be private activity bonds.

Section 141(b)(6) defines private business use to include direct and indirect use. The regulations under § 141 do not apply to this case. However, regulations were issued under its predecessor (§ 103 of the Internal Revenue Code of 1954) that are applicable. *See* H.R. Rep. No 99-426, at 518 (1985); 1986-3 C.B. (Vol. 2) 518 ("...to the extent not amended, all principles of present law apply under the reorganized provisions." [footnote omitted]).

Section 1.103-7(b)(3)(ii) provides that,

> In determining whether a debt obligation meets the trade or business test, the indirect, as well as the direct, use of the proceeds is to be taken into account. For example, the debt obligations comprising a bond issue do not fail to satisfy the trade or business test merely because the state or local governmental unit uses the proceeds to engage in a series of financing transactions for property to be used by private business users in trades or businesses carried on by them. Similarly, if such proceeds are to be used to construct facilities to be leased or sold to any nonexempt person for use in a trade or business it carries on, such proceeds are to be used in a trade or business carried on by a nonexempt person and the

[11] Utility's sales under the gas sale contracts of its working interest gas may result in a change in use.

> debt obligations comprising such issue satisfy the trade or business test. If such proceeds are to be used to construct facilities to be leased or sold to an exempt person who will, in turn, lease or sell the facilities to a nonexempt person for use in a trade or business, such proceeds are to be used in a trade or business carried on by a nonexempt person and the debt obligations comprising such issue satisfy the trade or business test. In addition, proceeds will be treated as being used in the trade or business of a nonexempt person in situations involving other arrangements, whether in a single transaction or in a series of transactions, whereby a nonexempt person uses property acquired with the proceeds of a bond issue in its trade or business.

The examples in these regulations focus on an indirect use by a private user of a facility to which an issuer has allocated bond proceeds. They do not focus on a reallocation of bond proceeds based on indirect use. However, there may be situations in which it is appropriate to apply the regulations to reallocate to indirect use. One factor that might suggest such an application of the regulations would be if the Utility used its own funds to acquire its working interest with the intent to replenish those funds with bond proceeds.

The agent states that Utility made numerous statements indicating that it intended to replace the cash it used to acquire Owner 1's interest with bond proceeds. Moreover, the agent states that the Funds were in fact replenished with bond proceeds.

Utility asserts that it contributed $g for the equity portion of the purchase price. A substantial portion of that $g consists of the deposit that was made from the Funds, including the Hydroelectric Project and Operating Reserves. Utility asserts that the Hydroelectric Project Reserve was not a restricted fund. It also asserts that at the time the monies were withdrawn from the Hydroelectric Project Reserve, it was uncertain that the Hydroelectric Project purchase would occur and that fund was abolished.

Utility asserts that the Funds were not replenished by proceeds of the Series B Bonds, but from cash flows. It further asserts that the remainder of the equity came from cash flows between the date of deposit and the closing date and from reimbursements made from the Series B Bond proceeds for expenditures incurred before the bonds were issued.[12] A small portion of the reimbursement was associated with expenditures for the Hydroelectric Project.

Utility further asserts that the Series B Bond proceeds remaining after costs of issuance, underwriter’s discount, credit enhancement premium, the establishment of a

---

[12]While the agent appears to question generally the allocation of the Series B Bond proceeds, we do not have information that refutes any specific expenditure.

reserve fund, and reimbursement, were used for subsequent capital expenditures. Utility had expected some of the capital expenditures financed with the Series B Bonds to be financed with tax-exempt bonds issued in the next year, but included them in the Series B Bonds to obtain economies of scale.

We believe that further development needs to be done before we can determine that the Series B proceeds were indirectly used to acquire the working interest.

Series B, C, and D Bonds as One Issue: Anti-abuse Analysis

The incoming request raises issues under § 1.141-14. Section 1.141-14 provides an anti-abuse rule under which the Commissioner may take certain actions to reflect the economic substance of the transaction or series of transactions. These regulations do not apply to the bonds at issue in this case. However, certain concepts incorporated in these regulations existed before the regulations (e.g., substance over form).

Specifically, the request raises questions about whether the anti-abuse principles would treat 1) the proceeds of the Series B Bonds as being used for the Gas Field, or 2) Utility's allocation of purchased gas to the gas sale contracts as unreasonable. We analyze these issues above. You also raise a question about whether the anti-abuse principles would treat the Series B Bonds and the Series C and/or D Bonds as one bond issue. If proceeds of the Series B Bonds are allocated to the purchase of the working interest and such Bonds and the Series C or D Bonds are one issue, the Series B Bonds and the Series C and/or D Bonds would be private activity bonds due to excessive private use. Because the bonds would not meet the requirements for qualified private activity bonds, interest on the bonds would be taxable.

Section 1.150-1(c)(1) provides that generally the term “issue” means two or more bonds that meet all of the following requirements:

1) The bonds are sold at substantially the same time.

2) The bonds are sold pursuant to the same plan of financing. Factors material to the plan of financing include the purpose for the bonds and the structure of the financing.

3) Payment on the bonds is from the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

The definition of “issue” has its own anti-abuse rules. Section 1.150-1(c)(5) provides that in order to prevent the avoidance of §§ 103 and 141 through 150 and the general purposes thereof, the Commissioner may treat bonds as part of the same issue or as part of separate issues to clearly reflect the economic substance of a transaction.

Utility asserts that the Series B, C and D Bonds were sold at three different times. If this is correct, the bonds would not meet the definition of a single issue under § 1.150-1(c)(1). Thus, the issue would be whether the anti-abuse rule under § 150 applies.

We understand you are concerned because the Bonds were used for the same purpose. We do not think that this fact is sufficient to treat the Bonds as one issue. You also express concern because the Issuer is able to avoid tainting all of its Series C and D Bonds by allocating the private use to the Series B Bonds. We believe Congress contemplated that issuers could separately finance the private use portion of a facility in appropriate cases without affecting the tax-exempt financing of another portion of the same facility. For example, an issuer can issue private activity bonds to finance floors of a building that will be privately used without tainting governmental bonds that finance other floors in that same building that will be used by governmental entities.

The issue here is a little more difficult because the Series B Bonds (if allocated to the Gas Field) did not finance a segregated part of the facility. Rather, they financed an undivided portion of the assets in the Gas Field. However, we believe that the output rules have long recognized flexible rules for output facilities and those rules permit tax-exempt financing of a portion of a single output facility.

Investment-type Property

Section 1.148-1(b) provides that investment-type property includes any property, other than property described in § 148(b)(2)(A), (B), (C), or (E), that is held principally as a passive vehicle for the production of income. Congress added investment-type property to the definition of investment property in 1986. The House Report states that the "arbitrage restrictions are expanded to apply to the acquisition of any property held for investment other than another bond exempt from tax under the Code." H.R. Rep. No. 99-426, at 552 (1985); 1986-3 C.B. (Vol. 2) 552.

When Utility acquired its working interest in the Gas Field, it acquired not only a share of the Gas Field assets, it also acquired the rights and obligations under the gas sale contracts. You ask whether the gas sale contracts or the working interest constitutes investment-type property. In connection with your question, you indicate that the value of the gas sale contract with Corporation X is $i.

We concur that the gas sale contracts will provide a revenue stream to Utility. Utility, however, has obligations under the gas sale contracts, making us question whether the contracts are passive investments. In addition, it is not clear that Utility acquired the gas sale contracts principally as a vehicle for the production of income. While you concede that Utility acquired its working interest in the Gas Field to obtain a secure supply of gas at a secure price, you argue that no similar purpose applies to its acquisition of the gas sale contracts. However, it is not clear that Owner 1 could have

sold its working interest in the Gas Field without having its obligations under the gas sale contracts assumed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted][13]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[13] [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted][14]

[redacted]

[14] [redacted]

[redacted]

[redacted]

Assistant Chief Counsel
(Exempt Organization/Employment
Tax/Government)

By: _____

Rebecca L. Harrigal
Branch Chief
Tax Exempt Bond Branch