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Date:
April 15, 2008

LEGEND:

Agency =
Bonds =

Seller =
State =
Subsidiary =
a =
b =
c =
d =
e =
f =

Dear :

This is in response to your request for rulings that: (1) tax-exempt bonds issued by Agency will be considered issued by or on behalf of a state or political subdivision thereof for purposes of § 103 of the Internal Revenue Code (Code), and (2) no portion of the depreciable property allocable to a working interest in acquired mineral properties will be treated as used in a private business use under § 141 of the Code.

Facts and Representations

You have presented the following facts and made the following representations. Agency is a joint action agency organized under the nonprofit laws of State. Agency

was formed by its members for the purpose of acquiring and managing long-term natural gas supplies for the benefit of its members. Agency currently has a members (the "Members") located in b states. Agency represents that its Members consist of natural gas and electric joint action agencies and natural gas and electric distribution systems. Agency's Members who are themselves joint action agencies have members who are natural gas and electric distribution systems. Agency represents that each of its Members are political subdivisions.

Agency was formed by its Members and is organized under the non-profit corporation laws of State for the purpose of benefiting its Members. Agency was formed after the formal approval of its creation by all of its Members, each of which is a political subdivision of a state, and has the power under state law to participate in the organization of the Agency. Each Member adopted a resolution specifically approving the creation of Agency and approving its articles of incorporation. Agency is controlled by a board of directors that is composed exclusively of representatives of the Members. Each Member appoints a representative to the Agency's board of directors, and each Member may remove its director at any time, with or without cause, and appoint a replacement. Each Member will specifically approve any debt issued by Agency on its behalf, and each will be responsible for its proportionate share of debt service on any debt so issued. Agency's articles of incorporation specifically provide that no part of the net earnings of Agency will be paid to or inure to the benefit of any person or entity other than a Member. Upon dissolution of Agency, any assets remaining after payment of Agency's debts will be distributed to its Members.

Agency is the sole member of Subsidiary. Subsidiary was formed as a limited liability company under State law to acquire, own and operate, on behalf of Agency, the natural gas reserves or other sources of natural gas supplies described below. Agency has previously received a private letter ruling which holds, in part, that Agency and Subsidiary are instrumentalities of the Members for purposes of § 141 of the Code. Agency is now seeking additional rulings as described herein.

In an arm's-length transaction, Agency through Subsidiary purchased an undivided c percent of the working interests ("Agency's Working Interests" or the "Properties") in d natural gas wells (the "Wells") from Seller. Seller retained the remaining undivided e percent of the working interests in the Wells ("Seller's Working Interests"). As a result of the acquisition, Agency acquired undivided interests in the minerals in place (the "Mineral Properties") as well as undivided ownership interests in certain depreciable property used to extract minerals from the Wells (the "Depreciable Property"). Agency obtained interim financing to acquire the Properties in the amount of f (the "Purchase Price"). The interim financing does not consist of tax-exempt bonds. The Agency intends to issue the Bonds to refinance the interim financing.

Agency represents that most purchasers of interests in minerals of this type, including Agency, develop the price that they are willing to pay for the acquisition of such

interests based in the first instance on the expected quantity of mineral production from the interest as estimated by one of the several nationally recognized reservoir engineering firms engaged by purchasers. Adjustments to these purchase prices are then made to account for the rights and obligations of owners of different types of mineral interests (e.g., working interests, royalty interests). For example, when a purchaser acquires a working interest in a gas well, including any depreciable property associated with that well, and that working interest is subject to an existing royalty interest, the purchase price for the working interest is reduced to reflect the existence of the royalty interest. This reduction is designed to reflect the fact that, as more fully described below, the owners of the working interest are responsible for not only the cost of extracting their share of the gas from the well, but also the cost of extracting the share of the gas of the royalty interest owner. Agency represents that in this transaction, the Purchase Price was similarly adjusted to reflect the presence of other mineral interests as more fully described below.

Pursuant to operating agreements related to the Properties, the Agency provides to each Member its share of available production from Agency's Working Interests in the Wells. Correspondingly, each Member is unconditionally obligated to pay its share of costs associated with all aspects of the Properties, including debt service payments on the Bonds, whether or not any gas is produced or delivered from the Properties.

Mineral Interests

As a result of the acquisition of Agency's Working Interests, Agency acquired undivided operating or working interests in the Mineral Properties and Seller retained its undivided operating or working interests in the Mineral Properties. At the time of Agency's purchase, there existed one or more non-operating interests in the Mineral Properties. These non-operating interests include royalties, overriding royalties, net profits interests, and production payments (the "Other Mineral Interests").

An operating or working interest is an economic interest in gas or oil "in place" (that is, gas or oil in the ground). The owner of a working interest has the right to reduce the deposits to its possession and remove them from the property, and in that regard, has the right to make reasonable use of the surface as is necessary to develop the property for production. Except as described below, the owner of a working interest bears the cost of developing and operating the property and is entitled to receive a specified fraction of the total production of minerals from the property.

A royalty interest is a right to minerals in place that entitles its owner to a specified fraction of the total production from the property, free of the expense of development and operation. An overriding royalty is a variation of a royalty and is also a right to minerals in place that entitles its owner to a specified fraction of the total production from the property, free of the expense of development and operation. An overriding royalty differs from a royalty in the manner in which the two are created. An overriding

royalty is created from a working interest and its term is co-extensive with that of the working interest from which it was created. In contrast, a royalty is created from the entire mineral interest.

A net profits interest is an interest in minerals in place that is defined as a share of gross production measured by net profits from operation of the property. The owner of a net profits interest is entitled to a specified fraction of the total production from the property but, unlike the overriding royalty or royalty interest, also bears its share of development and operating costs to the extent of the income from its share of production. Thus, if there is a net loss from operations, the owner of the net profits interest will receive nothing, but will not bear any portion of the loss.

A production payment is a right to minerals in place that entitles its owner to a specified fraction of production for a limited time, or until a specified sum of money or specified number of units of minerals has been received. For Federal income tax purposes, a production payment is treated as an economic interest only if the consideration for the assigned production payment is pledged for the exploration or development of the mineral property burdened thereby, or if the production payment is retained by a lessor in a leasing transaction. Other production payments are treated as repayments of loans.

In this case, Seller and Agency each own undivided working interests in the Wells, thus entitling each to its working interest portion of the Mineral Properties extracted from each Well and obligating each to bear its working interest portion of the cost of developing and operating the Wells not borne by the owners of the net profits interests. The Agency purchased its working interests in the Wells subject to the existence of these other rights to the production from the Wells. Agency has retained and intends to retain the working interests that it acquired intact, and has not carved and does not intend to carve any interests out of its working interests.

Law and Analysis

On-behalf-of Issuer

Section 103(a) provides, in general, that gross income does not include interest on any state or local bond. Section 103(c)(1) defines a state or local bond for purposes of §§ 103, and 141 through 150, as an obligation of a state or political subdivision thereof.

Section 1.103-1(a) of the Income Tax Regulations provides, in part, that interest upon obligations of a state, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof is not includable in gross income. Section 1.103-1(b) provides, in part, that an obligation issued by or on behalf of a governmental unit by a constituted authority empowered to issue such an obligation is the obligation of such a unit.

Revenue Ruling 57-187, 1957-1 C.B. 65, holds that bonds issued by an industrial development board formed under a state statute (the "entity") are considered issued on behalf of a political subdivision of the state under the following conditions: (1) the entity is formed only after the governing body of the political subdivision has formally approved the entity's creation and the form of certificate of incorporation; (2) a board of directors of the entity is elected by the governing body of the political subdivision and serves without compensation; (3) the entity may issue bonds to carry out any of its corporate powers, which include the power to acquire, improve, maintain, equip, and furnish projects, to lease such projects and collect rent, and to sell and convey any and all of its property whenever the board of directors find such action to be in furtherance of the purposes for which the entity is established; (4) all bonds are payable solely out of revenues and receipts derived from the leasing or sale by the entity of its projects; (5) the political subdivision is not liable for the payment of principal or interest on any of the bonds of the entity; (6) the entity is exempt from all taxation, and interest on bonds issued by the entity is exempt from state taxes; (7) the entity is a nonprofit organization and none of its net earnings may inure to the benefit of any private person; and (8) upon dissolution of the entity, title to all property it owns would vest in and become the property of the state or political subdivision which creates it.

The Agency and Subsidiary have previously received rulings that they are each instrumentalities of the Members under Revenue Ruling 57-128, 1957-1 C.B. 311. In this ruling request, the Agency is asking whether the debt of the Agency can be treated as issued on behalf of a State or local governmental unit within the meaning of Treas. Reg. §1.103-1(b).

Most of the facts of this ruling are similar to those of Revenue Ruling 57-187. Further, Agency's debt will be approved and paid by its Members. Therefore, we conclude that obligations issued by Agency will be considered as issued by or on behalf of its Members for purposes of § 103.

Property Interests in Mineral Properties

Section 103(a) provides, in general, 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). Section 141(a) defines private activity bond to mean any bond issued as part of an issue which meets the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2), or which meets the private loan financing test of § 141(c).

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. Section 141(b)(6) defines private business use as use (directly or indirectly) in a trade or business 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.

Section 141(b)(4) provides that an issue 5 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) shall be treated as meeting the tests of paragraphs (1) and (2) if the nonqualified amount with respect to such issue exceeds the excess of – (A) $15,000,000, over (B) 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). There shall not be taken into account under subparagraph (B) any bond which is not outstanding at the time of the later issue or which is to be redeemed (other than in an advance refunding) from the net proceeds of the later issue.

Section 1.141-1(b) of the Income Tax Regulations provides that an "output facility" means electric and gas generation, transmission, distribution and related facilities, and water collection, storage, and distribution facilities.

Section 1.141-3(a)(1) provides that the private business use test relates to the use of the proceeds of an issue. The 10 percent private business use test of § 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Any activity carried on by a person other than a natural person is treated as a trade or business.

Section 1.141-3(b) provides for the types of arrangements that will be considered to give rise to private business use. Section 1.141-3(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

Section 1.141-3(b)(2) provides generally that ownership by a nongovernmental person of a financed property is private business use of that property. For this purpose, ownership refers to ownership for Federal income tax purposes.

Section 1.141-3(b)(7) provides that any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to special legal entitlements such as ownership or leases (or other arrangements not relevant for this purpose) results in private business use. For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use. In the case of financed property that is not

available for use by the general public, private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons, even if those nongovernmental persons have no special legal entitlements to use of the property. In determining whether special economic benefit gives rise to private business use it is necessary to consider all of the facts and circumstances, including one or more of the following factors – (A) whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person; (B) whether only a small number of nongovernmental persons receive the special economic benefit; and (C) whether the cost of the financed property is treated as depreciable by any nongovernmental person.

In general, for a facility in which government use and private business use occur simultaneously, § 1.141-3(g)(4)(iii) provides that the entire facility is treated as having private business use. For example, a governmentally owned facility that is leased or managed by a nongovernmental person in a manner that results in private business use is treated as entirely used for a private business use. If, however, there is also private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility (for example, reasonably expected fair market value of use). For example, the average amount of private business use of a garage with unassigned spaces that is used for government use and private business use is generally based on the number of spaces used for private business use as a percentage of the total number of spaces.

Section § 1.141-7 provides special rules for output facilities. Example 1 of § 1.141-7(i) provides the following example regarding joint ownership of output facilities:

> Example 1. Joint ownership. Z, an investor-owned electric utility, and City H agree to construct an electric generating facility of a size sufficient to take advantage of the economies of scale. H will issue $50 million of its 24-year bonds, and Z will use $100 million of its funds for construction of a facility they will jointly own as tenants in common. Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. H's bonds will be secured by H's ownership interest in the facility and by revenues to be derived from its share of the annual output of the facility. H will need only 50 percent of its share of the annual output of the facility during the first 20 years of operations. It agrees to sell 10 percent of its share of the annual output to Z for a period of 20 years pursuant to a contract under which Z agrees to take that power if available. The facility will begin operation, and Z will begin to receive power, 4 years after the H bonds are issued. The measurement period for the property financed by the issue is 20 years. H also will sell the remaining 40 percent of its share of the annual output to numerous other private utilities under contracts of three years or less that satisfy the exception under

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

Announcement 2002-91, 2002-2 C.B. 685, provides 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.

The Report of the Committee of Ways and Means of the House of Representatives on H.R. 3838, H.R. Rep. No. 99-426, at 538 (1985), 1986-3 (Vol. 2) C.B. 538, states as follows with respect to mixed-use facilities financed with bonds issued under § 145 of the Code:

> The committee understands that certain facilities eligible for financing with section 501(c)(3) organization bonds may comprise part of a larger facility otherwise ineligible for such financing or that portions of a section 501(c)(3) organization facility may be used for activities of persons other than section 501(c)(3) organizations. The committee intends that the Treasury Department may adopt rules for allocating the costs of such mixed use facilities (including common elements) according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the various users of the facility. Only the portions of such mixed use facilities owned and used by a section 501(c)(3) organization may be financed with bonds for such organizations.

The same language appears in the Report of the Committee on Finance of the Senate on H.R. 3838, S. Rep. No. 99-313, at 841 (1986), 1986-3 (Vol. 3) C.B. 841.

When acquiring the Properties, Agency acquired undivided working interests in the Mineral Properties. However, one or more interests in the Mineral Properties are owned by other persons, including: (1) the remaining undivided working interests owned by the Seller (Seller's Working Interests), and (2) royalties, overriding royalties, net profits interests, and production payments owned by other parties (Other Mineral Interests).[1]

[1] We do not include production payments that are treated as loans for Federal tax purposes because recipients of these payments are not treated as having an economic interest in the Mineral Properties, but are instead treated as receiving repayments of a loan.

Seller's Working Interests and the Other Mineral Interests entitle the owners thereof to a share of production from the Mineral Properties; therefore, each must be analyzed to determine if these interests result in private business use of the Properties.

Seller's Working Interests

Agency's Working Interests and Seller's Working Interests represent undivided interests in the total working interests in the Mineral Properties and the Depreciable Property. Agency and Seller proportionately share the costs of operating the Mineral Properties borne by the working interests and proportionately share any production from the Mineral Properties to which the working interests are entitled. Similar to Example 1 of § 1.141-7(i), Seller's ownership of its working interests will not be treated as private business use of the Properties.

Other Mineral Interests

Although Agency and Seller each own undivided working interests in the Wells, the Agency's Working Interests, the Seller's Working Interests and the Other Mineral Interests are not undivided interests in the Wells as a whole. Agency and Seller generally are responsible for the costs associated with extracting the minerals from the Mineral Properties and share such costs proportionately as between their working interests, similar to the joint owners in Example 1 of § 1.141-7(i). In contrast, the owners of the Other Mineral Interests are not required to contribute any share of the expense of developing or operating the Wells (with the exception of the owners of any net profits interests who will be subject to costs that are limited to the income from these interests' shares of production). Thus, unlike Example 1 of § 1.141-7(i), the Other Mineral Interests are not treated as separate facilities where use arising from ownership is disregarded and the use of the Properties must be analyzed. The Properties include Agency's interests in the Mineral Properties and in the Depreciable Property.

Agency's Working Interests, Seller's Working Interests, and the Other Mineral Interests represent legal entitlements to specified shares of production from the Mineral Properties. The Other Mineral Interests have no rights to Agency's share of production from the Mineral Properties. Thus, there will be no private business use of Agency's interests in the Mineral Properties arising from the ownership of the Other Mineral Interests.

As owners of the working interests, Agency and Seller own undivided interests in the Depreciable Property used to extract all of the minerals, including the minerals to which the Other Mineral Interests are entitled. As a result, a portion of the Depreciable Property is used by the owners of the Other Mineral Interests. However, as represented by Agency, the Purchase Price was determined in an arm's-length transaction taking into account the rights and obligations associated with the various interests, including the costs of extraction associated with the Depreciable Property. We believe that the

Purchase Price was determined using a reasonable method that reflects the proportionate benefit to Agency. Therefore, we conclude that no portion of the Purchase Price is attributable to the use of the Depreciable Property by the owners of the Other Mineral Interests.

Conclusions

Based on the foregoing, we conclude that: (1) the Bonds will be considered issued by or on behalf of a state or political subdivision thereof for purposes of § 103 of the Code, and (2) no portion of the Purchase Price will be treated as used in a private business use as a result of Seller's Working Interests or the Other Mineral Interests.

The ruling in (1) above will not apply in the event that a Member that is not a political subdivision becomes a member of the Agency or if any Member loses its status as a political subdivision.

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. In particular, this ruling does not address the application of § 141 or § 148 to sales or exchanges of gas or oil or other similar arrangements. Nor does it address the financing of any additional depreciable property to be purchased for the Wells.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the powers of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the Agency and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Associate Chief Counsel
Financial Institutions & Products

By_____
Johanna Som de Cerff
Senior Technician Reviewer
Branch 5

cc: