

UIL No. 0141.01-01 Private activity bond; Qualified bond; Private business tests; Business use test. IRS Letter Ruling 200502012 (Sep. 28, 2004), Internal Revenue Service, (Sept. 28, 2004)

Uniform Issue List No. 0141.01-01

[Code Sec. 141]

LTR 200502012, September 28, 2004

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Private activity bond; Qualified bond; Private business tests; Business use test.

This responds to the Authority's request for a ruling that the acquisition of various interests in land (the "Property Interests") and related arrangements as described below will not give rise to private business use within the meaning of § 141 of the Internal Revenue Code. The Authority also requests a ruling that the related arrangements are uses related and not disproportionate to the government use of the proceeds.

FACTS AND REPRESENTATIONS:

The City created the Authority for the purpose of acquiring, operating, and maintaining property for the City. The Authority will acquire the Property Interests through arm's length negotiations with the current landowners (the "Sellers"), typically farmers and ranchers. The Authority will not pay more than fair market value for any such Property Interest. By purchasing a Property Interest with respect to a parcel of property, the Authority will secure the development rights so that the parcel may be preserved as open space for the scenic enjoyment of the public, for agricultural use, and to conserve the natural habitat (the "Open Space Program").

The Authority intends to issue bonds to finance at least a portion of some of the Property Interests. The Authority will issue some of the bonds in the form of an installment sale note to the Seller (the "Note"). Payment of the Note may be secured by the Authority's rights in the Property Interest or by a general obligation pledge from the City.

Based on the negotiations between the particular Seller and the Authority, the Authority will acquire a parcel for the Open Space Program through one of the following types of arrangements.

1) The Authority may purchase a conservation easement in perpetuity from the Seller. The conservation easement will restrict the Seller's use of the parcel subject to the easement, generally to residential and agricultural uses, so that the Seller's use will not impinge upon the Authority's use of the parcel for the Open Space Program.

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2) The Authority may purchase a future interest in fee simple in the parcel, with the Seller retaining a life estate.

3) The Authority may purchase a present interest in fee simple in the parcel and enter into a lease with the Seller or a third party, granting the leaseholder certain agricultural rights to the parcel (the "Lease"). Examples of the agricultural rights include haying, grazing, raising of livestock, farming of marketable crops, and water storage.

4) The Authority may purchase a present interest in fee simple in the parcel, subject to a profit à prendre interest¹ retained by the Seller. The profit à prendre interest will allow the holder to enter the parcel for limited agricultural purposes, such as haying and grazing of animals. The rights and uses permitted under the profit à prendre interest will be less extensive than those under the Lease and will not impinge upon the Authority's use of the parcel.

5) Lastly, the Authority may acquire a present interest in fee simple in the parcel and convey a profit à prendre interest in the parcel to a third party. The profit à prendre interest will be exactly as that described directly above. The value of the profit à prendre interest conveyed by the Authority, when aggregated with other private business use of the parcel, will not exceed 10 percent of the proceeds of the issue used to acquire the parcel.

LAW

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 1.141-3(a)(1) of the Income Tax Regulations provides that the private business use test relates to the use of the proceeds of an issue. The 10 percent private business 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. Unless the context or a provision clearly requires otherwise, this section also applies to the private business use test under § 141(b)(3) (unrelated or disproportionate use).

Section 1.141-3(a)(2) provides that in determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of proceeds. For example, a facility is

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treated as being used for a private business use if it is leased to a nongovernmental person and subleased to a governmental person or if it is leased to a governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person's use is in a trade or business. Similarly, the issuer's use of the proceeds to engage in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met. In addition, proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

Section 1.141-3(a)(3) provides that the use of proceeds by all nongovernmental persons is aggregated to determine whether the private business use test is met.

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)(3) provides generally that the lease of financed property to a nongovernmental person is private use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease.

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.

Section 1.141-3(g)(1) provides, in general, that the private business use of proceeds is allocated to property under § 1.141-6. The amount of private business use of that property is determined according to the average percentage of private business use of that property during the measurement period.

Section 1.141-3(g)(2) provides, in general, that the measurement period of property financed by an issue begins on the later of the issue date of that issue or the date the property is placed in service and ends on the earlier of the last date of any bond of the issue financing the property (determined without regard to any optional redemption dates).

Section 1.141-3(g)(3) provides that the average percentage of private business use is the average of the percentages of private business use during the 1-year periods within the measurement

period. Appropriate adjustments must be made for beginning and ending periods of less than 1 year.

→ Section 1.141-3(g)(4) provides for determining the average amount of private business use for a 1-year period. In general, the percentage of private business use of property for any 1-year period is the average private business use during that year. This average is determined by comparing the amount of private business use during the year to the total amount of private business use that is not private use (government use) during that year.

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.

For purposes of paragraphs (g)(4)(ii) through (iv) of §1.141-3, if private business use is reasonably expected as of the issue date to have a significantly greater fair market value than government use, the average amount of private business use must be determined according to the relative reasonably expected fair market values of use rather than another measure, such as average time of use. This determination of relative fair market value may be made as of the date the property is acquired or placed in service if making this determination as of the issue date is not reasonably possible (for example, if the financed property is not identified on the issue date). In general, the relative reasonably expected fair market value for a period must be determined by taking into account the amount of reasonably expected payments for private business use for the period in a manner that property reflects the proportionate benefit to be derived from the private business use.

✓ Section 141(b)(3)(A) provides that an issue shall be treated as meeting the tests of § 141(b)(1) if such tests would be met by substituting 5 percent for 10 percent in § 141(b)(1) by taking into account only the proceeds of the issue which are to be used for any private business use which is not related to any government use of such proceeds and the disproportionate related business use proceeds of the issue.

For purposes of § 141(b)(3)(A), § 141(b)(3)(B) provides that the disproportionate related business use proceeds of an issue is an amount equal to the aggregate of the excesses (determined under the following sentence) for each private business use of the proceeds of an issue which is related to a government use of such proceeds. The excess determined under this sentence is the excess of (i) the proceeds of the issue which are to be used for the private business use, over (ii) the proceeds of the issue which are to be used for the government use to which such private business use relates.

Section 1.141-9(a) provides in general, that under §141(b)(3) (the unrelated or disproportionate use test), an issue meets the private business tests if the amount of private business use and private

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security or payments attributable to unrelated or disproportionate private business use exceeds 5 percent of the proceeds of the issue. For this purpose, the private business use test is applied by taking into account only use that is not related to any government use of proceeds of the issue (unrelated use) and use that is related by disproportionate to any government use of those proceeds (disproportionate use).

Under § 1.141-9(a)(2)(i), the unrelated or disproportionate use test is applied by first determining whether a private business use is related to a government use. Next, private business use that relates to a government use is examined to determine whether it is disproportionate to that government use.

Under 1.141-9(a)(2)(ii), all the unrelated use and disproportionate use financed with the proceeds of an issue are aggregated to determine compliance with the unrelated and disproportionate use test. The amount of permissible unrelated and disproportionate private business use is not reduced by the amount of private business use financed with the proceeds of an issue that is neither unrelated use nor disproportionate use.

Section 1.141-9(b)(1) provides that whether a private business use is related to a government use financed with the proceeds of an issue is determined on a case-by-case basis, emphasizing the operational relationship between government use and the private business use. In general, a facility that is used for a related private business use must be located within, or adjacent to, the governmentally used facility.

Section 1.141-9(b)(2) provides that use of a facility by a nongovernmental person for the same purpose as use by a governmental person is not treated as unrelated use if the government use is not insignificant. Similarly, a use of a facility in the same manner both for private business use that is related use and private business use that is unrelated use does not result in unrelated use if the related use is not insignificant. For example, a privately owned pharmacy in a governmentally owned hospital does not ordinarily result in unrelated use solely because the pharmacy also serves individuals not using the hospital. In addition, use of parking spaces in a garage by a nongovernmental person is not treated as unrelated use if more than an insignificant portion of the parking spaces are used for a government use (or a private business use that is related to a government use), even though the use by the nongovernmental person is not directly related to that other use.

Under § 1.141-9(c)(1), a private business use is disproportionate to a related government use only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds for the related government use. For example, a private use of \$100 of proceeds that is related to a government use of \$70 of proceeds results in \$30 of disproportionate use.

Section 1.141-9(c)(2) provides that if two or more private business uses of the proceeds of an issue relate to a single government use of those proceeds, those private business uses are aggregated to apply the disproportionate test.

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ANALYSIS

Private Business Use under § 141(b)(1)

In determining whether the Authority's acquisition of the various Property Interests and related arrangements will give rise to private business use of bond proceeds, we look to the use of the bond-financed property in each type of arrangement. We note that the type of property interest is not the sole factor in our determination.

1) In the case of the purchase of the conservation easement described in this case, the easement is the bond-financed property (i.e., the bond-financed facility). The Authority and the Seller will have distinct property interests in the parcel, granting them different rights. The use by the Seller of the retained interest in the parcel will not impinge upon the use of the parcel by the Open Space Program. The Authority will be the owner of the easement in perpetuity, and thus the Seller will not have any interest in the easement, such as a reversionary interest. The Seller, as owner of the parcel subject to the conservation easement, will be restricted in use of the parcel by the easement. Thus, we consider only the use of the conservation easement in determining whether the Seller's use of the parcel will be private business use of the proceeds. The City and the public will have beneficial use of the easement through the Open Space Program. The Seller's only use of the easement will be as a member of the general public. Other than as a member of the general public, the Seller's use of the parcel is not use of the bond-financed property. Thus, the Authority's acquisition of the conservation easement will not give rise to private business use of the proceeds.

2) In the case of the purchase of the future interest in fee simple with the Seller retaining a life estate, the Authority is purchasing the future interest. The future interest is the bond-financed property. The Authority and the Seller will have distinct property interests, and although their rights are similar, these rights will occur at different times. The use of the parcel by the Seller during the retained life interest will not impinge upon the use by the Open Space Program during the Authority's future interest. Thus, we consider only the use of the future interest in determining whether the Seller's use will be private business use of the proceeds. Because the Seller's use of the parcel will end with the termination of the life estate, the Seller will not use the bond-financed property. Accordingly, the Authority's acquisition of the future interest in fee simple does not give rise to private business use of the proceeds.

3) In the case of the purchase of a present interest in fee simple with the granting of a Lease, the Authority is purchasing the fee simple. The fee simple is the bond-financed property. The Authority will then lease the bond-financed property to a nongovernmental person. Under § 1.141-3(b)(3) and (g)(4)(iii), the lease of property to a nongovernmental person is private use of that property and is treated as use of the entire property. Thus, the Lease will give rise to private business use during the term of the Lease of 100 percent of the proceeds used to acquire the parcel.

4) In the case of the purchase of a present interest in fee simple subject to the profit à prendre interest described in this case, the Authority will be purchasing the fee simple subject to, or less, the

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profit à prendre interest. Under the facts of this case, the fee simple subject to the profit à prendre interest is the bond-financed property. This is the converse of the situation involving the conservation easement described above. This time, the Authority, as owner of the fee simple subject to the profit à prendre interest, will have a possessory right to use the parcel. The Seller, as holder of the profit à prendre interest, will have a non-possessory right to use the parcel for limited purposes. Again, however, the Authority and the Seller will have distinct interests in the parcel, granting them different rights. The permitted uses by the holder under the profit à prendre interest herein will not impinge upon the use of the parcel by the Open Space Program. Thus, we consider only the use of the Authority's interest in determining whether the Seller's use will be private business use of the proceeds. The Seller's only use of the Authority's interest will be as a member of the general public. Other than as a member of the general public, the Seller's use of the parcel is not use of the bondfinanced property. Accordingly, the Authority's acquisition of a present interest in fee simple subject to a profit à prendre interest will not give rise to private business use of the proceeds.

5) In the case of the purchase of a present interest in fee simple (not subject to a profit à prendre interest) where the Authority conveys the profit à prendre interest to a third party, the fee simple (not subject to a profit à prendre interest) is the bond-financed property. When the Authority sells the profit à prendre interest, it will be conveying a portion of the fee simple to a nongovernmental person. The Authority's conveyance of the profit à prendre interest will result in private business use of the bond-financed property. There will be no private business use of the interest retained by the Authority. The issue then is how to measure the amount of private business use of the bondfinanced property. The profit à prendre interest, like a discrete portion of a facility, is a distinct property interest. The holder of the profit à prendre interest has rights different from those of the Authority under its remaining interest in the parcel. The use of the profit à prendre interest by the holder will not impinge upon the use of the parcel by the Open Space Program. Therefore, it is appropriate to measure the private business use based on a reasonable basis that reflects the proportionate benefit to the users, such as the fair market value of the interests. The Authority has represented that the value of any such profit à prendre interest in addition to any other private business use of the parcel will not exceed 10 percent of the proceeds of the issue.

Unrelated or Disproportionate Use

The Authority also has requested a ruling regarding the applicability of § 141(b)(3) to the transactions involving the life estate, the Lease, and the profit à prendre interest. The questions to be considered are whether use of proceeds for these purposes is unrelated to the government use of the issue and, if not, whether such use is disproportionate related use. Because we have concluded that the acquisition of the fee simple with the reservation of the life estate will not result in private business use of proceeds, we need not address the life estate. For the same reason, we need not address the profit à prendre interest retained by the Seller.

Both the Lease and the profit à prendre interest conveyed by the Authority will result in private business use of the fee simple acquired by the Authority. The location of the government use and the private business use, thus, will be the same. The purposes of the Open Space Program are to preserve the parcel for open space for scenic enjoyment, for agricultural use, and to conserve

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natural habitat. The agricultural use by the holder of the Lease or the profit à prendre interest will be complementary and contribute to the Open Space Program. We conclude that the private business use arising under the Lease and the profit à prendre interest conveyed by the Authority will be uses related to the government use.

To determine whether a related use is disproportionate, we look for the excess of the proceeds used for the private business use over the proceeds used for the government use to which it relates. The Lease is treated as 100 percent use of the proceeds used to acquire the parcel for the term of the Lease. Where the terms of any such Leases on a specific parcel in the aggregate exceed the period of government use of the parcel, this excess will be the disproportionate use.

A comparison of the value of the profit à prendre interest to the value of remaining portion of the fee simple is needed to make a determination for this type of private business use. Where the value of the profit à prendre interest exceeds the value of the interest retained by the Authority, this excess will be the disproportionate use. The Authority has represented that the value of the profit à prendre interest will not exceed 10 percent of the issue. Thus, where the proceeds of the issue are used solely for the purpose of purchasing one fee simple parcel (such as the Note), private business use of the proceeds used to acquire the parcel will not exceed 10 percent, and accordingly, such private business use will not be disproportionate to the government use. We do not rule on this question where proceeds of the bond issue are used for purposes in addition to acquiring one fee simple parcel.

CONCLUSIONS

1. a. The Authority's purchase of a conservation easement, purchase of a future interest in fee simple with the Seller retaining a life estate, or purchase of a present interest in fee simple with the Seller retaining a profit à prendre interest as described herein will not give rise to private business use.
- b. The Authority's purchase of a present interest in fee simple and entering into the Lease will give rise to private business use of 100 percent of the proceeds for the term of the Lease.
- c. The Authority's purchase of a present interest in fee simple with the conveyance of a profit à prendre interest as described herein will give rise to private business use, but not in excess of 10 percent of the issue.
2. a. The Lease will be a use related to the government use. This use will be disproportionate if the terms of any such Leases on a specific parcel in the aggregate exceed the period of government use of the parcel.
- b. The conveyance of a profit à prendre interest will result in a use related to the government use. Where the value of the profit à prendre interest exceeds the value of the interest retained by the Authority, this excess will be the disproportionate use. Where the proceeds of the issue are used solely for the purpose of purchasing one fee simple parcel, the private business use will not be disproportionate.

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. Specifically, no opinion is expressed on whether the conveyance of a profit à prendre interest will result in a private loan under § 141(c).

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 Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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

Sincerely, Assistant Chief Counsel (Exempt Organizations/Employment Tax/Government Entities),
Johanna Som de Cerff, Assistant Branch Chief, Tax Exempt Bond Branch.

cc: *****

Footnotes

¹ A profit a prendre interest is an interest in real property defined under State law as an easement that confers the right to enter and remove timber, minerals, oil, gas, game, or other substances from land in the possession of another. In contrast to the possessory rights of a leaseholder, the rights of a holder of a profit à prendre interest are non-possessory.