Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

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CC:TEGE:EOEG:TEB-PLR-142479-01
Date:
November 22, 2002

Re:

LEGEND

City =

Authority =

Bonds =

Other Bonds =

Date 1 =

Date 2 =

Date 3 =

Signs =

a =

b =

c =

d = _____

e =

f =

g =

h =

i =

j =

k =

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m =

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o =

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Dear

This is in response to the City's request for a ruling that the proposed naming rights contract described below (the "Contract") will not cause the Issue (hereinafter defined) to meet the private business use test under § 141(b) of the Internal Revenue Code (the "Code").

FACTS AND REPRESENTATIONS

The City has made the following representations.

On Date 1, the City issued the Bonds in order to finance the construction of a convention center, an arena, and the surrounding infrastructure (the "Project"). The Bonds are part of larger issue of bonds (the "Issue"), consisting of the Bonds and the Other Bonds. The yield on the Issue is a%. The total amount of proceeds from the Issue is $b. The total amount of proceeds from the Bonds is $c. Of the proceeds of the Bonds, $d have been or are to be used for the arena and convention center (the "Facility"), and $e have been or are to be used to finance the surrounding infrastructure (the "Infrastructure"). The total estimated cost of the Facility is $f, with the portion of the costs not paid from the proceeds of the Bonds being paid from private donations.

The Facility is expected to be placed into service on Date 2. The reasonably expected economic life of the Facility is g years. The latest maturity date of the Issue and the Bonds is Date 3.

The Facility will be owned by the City and leased to the Authority. The Authority will operate the Facility. The City represents that the Authority is an instrumentality of

the City pursuant to Rev. Rul. 57-128, 1957-1 C.B. 311. The Authority is run by a h-member board of directors (the "Board").

The Authority is in the process of selling the naming rights with respect to the Facility pursuant to the Contract. The following is an exclusive list of the material terms of the Contract:

1. The Contract will be between the Authority and a private party engaged in a trade or business (the "Naming Party");

2. The term of the Contract shall be not more than i years, including any renewal option (as defined in § 1.141-1 of the Income Tax Regulations);

3. The Naming Party shall pay not more than $j per year to the Authority for the term of the Contract;

4. The official name of the Facility (the "Official Name") shall be as specified in the Contract and shall contain both the Naming Party's name and the name of the City;

5. The Authority shall use only the Official Name when referring to the Facility;

6. All contracts, agreements, writings, and communications pertaining to the Facility and the Facility operators between the Authority and other tenants, event providers, users of the Facility, suppliers, media users, or advertisers shall require the Facility to be referred to and designated by the Official Name;

7. The Naming Party shall not use the Official Name nor allow a third party to use the Official Name, for any purpose, without approval from the Authority;

8. The Authority shall have the exclusive right to use the Official Name and logo of the Facility for commercial purposes;

9. The Facility shall contain the Signs containing the Official Name.

10. Each program produced by a tenant of the Facility shall contain one identification page which contains the Official Name;

11. Any newsletter produced by the Authority to announce upcoming events at the Facility shall contain the Official Name;

12. Any pocket schedules produced by a tenant of the Facility shall contain the Official Name;

13. The Official Name shall appear on uniforms of the Authority's employees, trash cans, paper cups, and napkins used at the Facility;

14. All printed material such as stationery and ticket stock shall contain the Official Name;

15. The Naming Party shall be allowed to use the Advertising Space;

16. If the Naming Party shall be allowed to appoint one of the members of the Authority's Board, the Authority's board shall be expanded by one (from h to k members);

17. The Naming Party may change the Official Name only if the Naming Party changes its name and the Authority approves the change;

18. The Contract may be terminated in any of the following three circumstances:

    i. The Naming Party fails to cure a payment default within 30 days of written notice from the Authority to the Naming Party of its intent to terminate the Contract;

    ii. Either the Authority or the Naming Party fails to comply with a material term of the Contract; or

    iii. The Authority fails to agree to a change of the Official Name after the Naming Party's name changes;

19. Upon termination of the Contract, the Authority may grant naming rights to another entity; and

20. If the Authority defaults, the Naming Party may discontinue payments under the Contract until the default has been cured and may seek specific performance of the Authority's duties under the Contract.

The Contract will be negotiated at arm's length and the amount paid by the Naming Party will be equal to the fair market value of the rights received, which the City does not expect will exceed $j per year for i years.

The Naming Party may purchase items from the Authority which are not included in the Contract, such as tickets to a luxury suite in the arena. However, all such items purchased by the Naming Party will be available to the general public and the Naming Party will not be given any priority to such items. All such items are intended to be available and in fact reasonably available for use on the same basis by natural persons

not engaged in a trade or business. Use of any such items shall be treated as general public use under § 1.141-3(c).

LAW AND ANALYSIS

Generally, under § 103(a), gross income does not include interest on any state or local bond. However, § 103(b)(1) provides that interest on a state or local bond is not excluded from gross income if the bond is a private activity bond that is not a qualified bond (within the meaning of § 141).

Section 141(a) defines the term private activity bond to mean any bond issued as part of an issue which meets either (1) the private business use test and the private security or payment test (the "private business tests"), or (2) the private loan financing test.

Section 141(b)(1) states that except as otherwise provided, an issue meets the private business use test if more than 10% of the proceeds of the issue are to be used for any private business use. Section 141(b)(2) provides that an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10% 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.

In addition, § 141(b)(3) provides that the 10% thresholds in §§ 141(b)(1) and 141(b)(2) are reduced to 5 % when the private business use is either unrelated or disproportionate to the government use financed with the bonds.

Section 141(b)(5) provides that if the nonqualified amount with respect to an issue exceeds $15,000,000, but does not exceed the amount which would cause a bond which is part of that issue to be treated as a private activity bond (without regard to § 141(b)(5)), that bond is nonetheless treated as a private activity bond unless the issuer allocates a portion of its volume cap under § 146 to that issue in an amount equal to the excess of the nonqualified amount over $15,000,000. Section 141(b)(8) defines the term nonqualified amount with respect to an issue to mean the lesser of the proceeds of such issuer which are to be used for any private business use or the proceeds of such issue with respect to which there is private security or payments.

Section 141(b)(6)(B) defines private business use to mean use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. Section 141(b)(6)(A) provides that use as a member of the general public is not taken into account.

Section 1.141-2(d)(1) provides that an issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. Section 1.141-2(d)(1) further provides that an issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of the private business tests or the private loan financing test to be met.

Section 1.141-3 provides rules pertaining to the definition of private business use. Section 1.141-3(a)(1) states that the use of financed property is treated as the direct use of proceeds. Under § 1.141-3(a)(3), use of proceeds by all nongovernmental persons is aggregated.

Section 1.141-3(b) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. Section 1.141-3(b)(1) provides that, 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. Under § 1.141-3(b)(7)(i), any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to ownership, leases, management contracts, output contracts, or research agreements results in private business use.

Under § 1.141-3(d)(5), certain incidental uses of a financed facility are disregarded to the extent that those uses do not exceed 2.5% of the proceeds of the issue used to financed the facility. A use of a facility by a nongovernmental person is incidental if:

(A) Except for vending machines, pay telephones, kiosks, and similar uses, the use does not involve the transfer to the nongovernmental person of possession and control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers, such as a night gate affixed to a structural component of a building (a “nonpossessory use”);

(B) The nonpossessory use is not functionally related to any other use of the facility by the same person (other than a different nonpossessory use); and

(C) All nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5% of the facility.

Examples under § 1.141-3(f) illustrate the application of the private business use test. Example 5 provides as follows:

> *Rights to control use of property treated as private business use-parking lot.* Corporation C and City D enter into a plan to finance the construction of a parking lot adjacent to C's factory. Pursuant to the plan, C conveys the site for the parking lot to D for a nominal amount, subject to a covenant running with the land that the property be used only for a parking lot. In addition, D agrees that C will have the right to approve rates charged by D for use of the parking lot. D issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied. The issue meets the private business use test because a nongovernmental person has special legal entitlements for beneficial use of the financed facility that are comparable to an ownership interest.

Section 1.141-3(g) provides the rules for measurement of private business use. Section 1.141-3(g)(1) provides that in general, the private business use of proceeds is allocated to property under § 1.141-6. Section 1.141-6(a) provides that allocations generally may be made using any reasonable, consistently applied method, and that allocations under § 141 and § 148 must be consistent with each other.

Section 1.141-3(g)(1) also provides that the amount of private business use of property to which bond proceeds have been allocated 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 that in general the measurement period of property financed by an issue begins on the later of the issue date of that issue or on the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity 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 one-year periods within the measurement period. Section 1.141-3(g)(4) provides that the percentage of private business use of property for any one-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 and use that is government use during that year.

Section 1.141-3(g)(4)(iii) provides, in general, that for a facility in which government use and private business use occur simultaneously, 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 (*e.g.*, reasonably expected fair market value of use).

Section 1.141-3(g)(4)(iv) provides that the measurement of the use of proceeds allocated to a discrete portion of a facility is determined by treating that discrete portion as a separate facility. Section 1.141-1(b) provides that the term discrete portion means a portion of a facility that consists of any separate and discrete portion of a facility to which use is limited, other than common areas.

Section 1.141-3(g)(4)(v) provides that for purposes of paragraphs (g)(4)(ii) through (iv), 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 (*e.g.*, 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 properly reflects the proportionate benefit to be derived from the private business use.

Section 1.141-9(a)(1) provides 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 security or payments attributable to unrelated or disproportionate private business use exceeds 5% 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 but disproportionate to any government use of those proceeds ("disproportionate use").

Section 1.141-9(b)(1) provides that, in general, 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 the 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(c)(1) provides that 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 used for the related government

use. For example, a private business use of $100 of proceeds that is related to a government use of $70 of proceeds results in $30 of disproportionate use.

Private Business Use

The first step in determining whether the Contract causes the Issue to satisfy the private business use test is to determine whether the Contract gives rise to private business use of the Facility. For the reasons discussed below, we believe it does. However, the Contract does not give rise to private business use of the Infrastructure because the Contract does not give the Naming Party any rights with respect to the Infrastructure that could give rise to private business use.

We first note that the Contract does not result in the Naming Party being a private business user due to ownership, lease, management or other incentive payment contract. Notwithstanding, the Contract provides the Naming Party with legally enforceable rights with respect to the Facility for a term of years, that is, the right to require the Facility to be referred to with the name of the Naming Party. The Contract provides specific rules regarding the manner in which the Facility will be operated. As such, the Contract will give the Naming Party special legal entitlements to control the use of the Facility. While the Contract relates only to a narrow set of rights with respect to the Facility, we do not believe that this precludes a finding of private business use. If anything, this impacts the measurement of private business use, not the existence of such use. Finally, a nongovernmental person need not have physical possession of property in order to be a private business user. The power to control how the facility is used is sufficient to give rise to private business use of the Facility.

The concept that the power to control how the facility is used is sufficient to result in private business use is illustrated in § 1.141-3(f), *Example 5*. In that example, there is a finding of private business use where a corporation transfers property to a city subject to an easement that the property be used as a parking lot. In addition, the corporation and the city enter into an agreement under which the corporation has the right to approve the parking rates charged to members of the general public for the garage. As with the Naming Party, the corporation in Example 5 does not physically possess the facility, rather it controls elements of how the facility is operated.

The City argues that even if the Naming Party has a special legal entitlement, the use of under the Contract is incidental use under § 1.141-3(d)(5). We agree that the type of use under the Contract is similar to the types of use that are described in that section. The Contract does not involve the transfer to the nongovernmental person of possession of space that is separated from other areas of the facility by walls, partitions, or other physical barriers. Moreover, the Naming Party's use is not functionally related to any other use of the Facility by the Naming Party. However, even if the Contract satisfies the first two parts of the incidental use exception, as

discussed below, we believe that the Contract results in more than 2.5% use, and therefore, does not satisfy the incidental use exception.

The City also argues that a naming rights agreement cannot give rise to private business use because there are no bond proceeds that can be traced to the creation of the naming rights. We do not find this argument compelling. For example, in § 1.141-3(f), *Example 5*, there are no bond proceeds that can be traced to the creation of the right to control parking rates. Certain rights are inherent in an asset. In the example, this includes the right to control the parking rates. In the case at hand, it is the right to the name of the Facility and control over its use.

Measurement of Private Business Use

Having determined that the Contract gives rise to private business use, we next turn to the measurement of the use. The first step is to determine which of the methodologies contained in the regulations is appropriate to measure the use that results from the Contract. The City has argued that the private business use should be measured under the discrete portion approach contained in § 1.141-3(g)(4)(iv), whereby the private business use would be based on the amount of physical space in the Facility used pursuant to the Contract (*e.g.*, the Signs and the Advertising Space). We do not believe this approach is appropriate. This approach does not properly reflect the value of the Contract to the Naming Party. The Naming Party receives benefits under the Contract beyond any benefit from the physical uses of the Facility, such as all references to the Facility including a reference to the Naming Party and all items produced with respect to the Facility referring to the Naming Party. These benefits are not adequately represented by the measuring physical space used by the Naming Party at the Facility.

Because the Naming Party is using the Facility at the same time as all other uses occurring at the Facility, we apply the simultaneous use rule under § 1.141-3(g)(4)(iii). That rule states that, in general, simultaneous governmental and private business use results in private business use of the entire facility. For example, a governmentally owned facility managed by a private business user is treated as entirely used for a private business use. In the case at hand, we do not believe that this is the correct way to measure the private business use under the Contract, because the use is not as pervasive a use of the Facility as with the management contract described in the regulations. In that regard, it is similar to the nonpossessory uses to which the incidental use rule of § 1.141-3(d)(5) applies. As such, it is appropriate to measure the private business use on a reasonable basis that properly reflects the proportionate benefit to be derived from the various users of the Facility.

To measure the proportionate benefit to be derived by the Naming Party under the Contract, we look to the fair market value of the Contract as compared to the fair market value of the Facility. This approach takes into account the non-physical nature

of the use of the Facility by Naming Party. Moreover, because the fair market value of the Facility represents the present value of the future uses of the Facility, it takes into account the value of the Contract to the City. Thus, comparing the fair market value of the Contract to that of the Facility reasonably measures the use by the Naming Party.

Applying this concept under the regulations, § 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 one-year periods within the measurement period. The average private business use from the Contract during any one-year period is determined by comparing the amount of private business use from the Contract during that year to the total amount of private business use and government use of the Facility during that year. Accordingly, we must determine the fair market value of the Contract and the Facility for each year of the Contract to compute the average amount of private business use during each year of the Contract.

With respect to the Contract, the fair market value of the private business use for each year is equal to the payments to be made to the City each year under the Contract (*i.e.*, not more than $j). While no facts have been presented indicating that § 1.141-3(g)(4)(v) applies to the Contract, we note that the regulation supports the use of payments to measure private business use. It provides that, 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 properly reflects the proportionate benefit to be derived from the private business use.

We have not been provided the fair market value of all of the other uses in each year of the Contract. However, the cost to construct the Facility ($f), is a reasonable proxy for the minimum value of the Facility. The value of the Facility is equal to the present value of the expected uses during the reasonably expected economic life of the Facility. The reasonably expected economic life of the Facility is g years. Accordingly, the value of all the uses of the Facility each year is equal to a g-year annuity (with payments at the beginning of each year), the present value of which is $f. Using the yield on the Issue as the discount rate, the value of all the uses of the Facility each year during the reasonably expected economic life of the Facility will be approximately $l. Therefore, based on payments of $j per year under the Contract, the amount of private business use of the Facility arising from the Contract for each one-year period during the term of the Contract is equal to $j divided by $l, or m% of the Facility.

Next, we determine the amount of private business use of the Facility during the measurement period. The first day the Facility is expected to be placed in service is Date 2. The final maturity date of the Bonds and the Issue is Date 3. Thus, the measurement period runs from Date 2 to Date 3, a total of p years. The Contract will result in m% private business use of the Facility during each of the first i years of the measurement period. For the remaining q years of the measurement period, the

average amount of private business use from the Contract is zero. As such, the average amount of private business use of the Facility from the Contract during the measurement period will be n% (or $o) of the $d of Bond proceeds used to finance the Facility. This results in r% (less than 10%) of the $b of proceeds of the Issue being used for a private business use.

Disproportionate or Unrelated Use

In evaluating whether the Contract causes the Issue to satisfy the private business use test, we next determine whether the unrelated and disproportionate use test of § 141(b)(3) applies to reduce the permitted amount of private business use to 5%.

With regard to the unrelated use element of the test, the regulations provide that the determination should emphasize the operational relationship between the government use and the private business use and that a facility that is used for a related private business use must generally be located within, or adjacent to, the governmentally used facility. Under the facts presented, the Contract is integrally related to the Facility, which is otherwise used for a government use. The Naming Party wants to use the Facility (pursuant to the Contract) because of the government use of the Facility. Operationally, the Facility and the Contract cannot be separated. The rights of the Naming Party under the Contract arise from, and are part of the Facility. Accordingly, we conclude that the private business use arising from the Contract is a related use.

With regard to the disproportionate use element of the test, we determined above that n% (or $o) of the $d of Bond proceeds used for the Facility are used for a private business use. While we have not been presented with information regarding any other potential private business use of the Facility, this amount is far less than the Bond proceeds used for the remaining portion of the Facility. Thus, the Contract will not, by itself, give rise to disproportionate use.

$15 million Limitation

While the private business with respect to the Issue is less than 10%, under § 141(b)(5), the Issue will nonetheless be treated as a private activity bond to the extent that the nonqualified amount with respect to the Issue exceeds $15,000,000, unless the City allocates a portion of its volume cap under § 146 to that issue in an amount equal to the excess of the nonqualified amount over $15,000,000. In this case, the Contract will result in only $o of nonqualified use, which is less than $15,000,000, and thus, § 141(b)(5) does not apply.

CONCLUSION

The Contract will not, by itself, cause the Issue to satisfy the private business use test under § 141(b).

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. This office has not verified any of the material submitted in support of the request for rulings.

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 as to whether the Bonds are tax-exempt under § 103.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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 the taxpayer's representative.

Sincerely,

Assistant Chief Counsel (Exempt Organizations/Employment Tax/ Government Entities)

By: _____

Cc: