JDOLAW
JERMAIN DUNNAGAN & OWENS, P.C.

3000 A STREET, SUITE 300, ANCHORAGE, ALASKA 99503-4097

SERVING ALASKANS SINCE 1976

MEMORANDUM

TO: Alaska Legislative Budget and Audit Committee

FROM: Eric E. Wohlforth

DATE: August 22, 2016

RE: Tax Exempt Financing of Proposed Trans Alaska Natural Gas Pipeline - Draft

---

Question: Is tax exempt financing of the proposed trans Alaska natural gas pipeline and/or the related LNG plant (the "Project") possible under general federal law?

Answer: Under existing federal law, and with my understanding of the use of the line by the three producers up to 75 percent of capacity, in my opinion, there is no possibility that interest on State of Alaska or Alaska Gasline Development Corporation ("AGDC") bonds to finance the project would be exempt from federal income taxation under federal tax law generally applicable to state and local government financing.

There is a possibility that bonds issued by the Alaska Railroad Corporation ("ARC") for this purpose under the special tax exempt financing permission in the Federal Railroad Transfer Act would be tax exempt.

General Federal Tax Law

26 U.S.C. § 103 states that tax exempt interest exclusion from taxation of state or local bonds does not extend to a "private activity bond" which is not a qualified bond under 26 U.S.C. § 141.

Obligations issued by the state or any state corporation or authority of the state for the Project would be "private activity bonds" as defined in 26 U.S.C. § 141. Section 141(b) sets up private business tests to define "private activity bond."

The private business tests are two-fold: a private business use test and a private security or payment test (IRC § 141(a)(1) and Treas. Reg. § 1.141(b)). Meeting the test means in IRC parlance failing tax exemption. An issue meets the private business use test if more than 10 percent of the proceeds of the issue is to be used for any private business use (IRC § 141(b)(1)). An issue meets the private security or payment test if the payment of principal or interest of the issue is directly or indirectly secured by or payable from property or payments used for a private business use (IRC § 141(b)(2)). A 5 percent test applies if the use is not related, or is related but disproportionate, to governmental use (IRC § 141(b)(3)).

As applicable here, it is understood that an issue of State or AGDC bonds might finance the entire pipeline which would be used by the state for its share of royalty gas and by the producers for transport of their gas. Use by the producers in excess of 10 percent of the pipeline capacity would satisfy the private use test. Payments for such use by the producers would meet the security or payment test.

IRC § 141(e)(1) defines a "qualified bond" as including an "exempt facility bond." "Exempt Facility Bonds" which are defined at 26 IRC § 142 include "(8) facilities for the local furnishing of electric energy or gas" (emphasis added). The Marine Terminal Revenue Bonds first issued by the City of Valdez in 1977 in the amount of $250 million were issued under Section 142 as an Exempt Facility Bond pursuant to then Section 103(b)(4)(D) which referred to docks, wharves or related facilities. The docks and wharves and related facilities financed was the TAPS marine terminal owned by the producers through Alyeska. This was, of course, a private use. A private letter ruling was issued affirming the tax exempt status of these bonds on January 12, 1977. Bonds for this purpose could not be issued today due to an amendment to Section 142 passed in the Tax Reform Act of 1986, requiring that all the property to be financed be owned by a governmental unit.

Alaska Railroad Financing

The federal transfer legislation endowed the Railroad with a unique tax exempt financing privilege unencumbered by the above cited restrictions of the Internal Revenue Code ("IRC") otherwise applicable to state and local government financings.

ARC received State legislative authority to provide financing for the acquisition, construction, improvement, maintenance, equipping, and operation of a natural gas pipeline for the transportation of North Slope gas in 2003 (SLA 2003 ch 71 § 2, AS 42.40.560). Tax exempt financing for this purpose would require a ruling from the Internal Revenue Service ("IRS").

However, the IRS is historically dedicated to limiting tax exempt financing. According to the US Congress Joint Committee on Taxation, the tax exempt bond subsidy is generally considered to be inefficient because, in most cases, the cost in terms of

forgone tax revenues exceeds the value of the subsidy to State and local governmental issuers.[1] Both the intent and the letter of the authorizing state law and the project must be congruent with federal tax law, regulations and rulings for a positive ruling to result. Also, rulings on financing arrangements are typically only given when there is a measure of certainty on financing arrangements. Every ruling request must contain a full description of all facts relevant to the transaction and the IRS is not bound by a ruling if there are undisclosed facts.[2] In addition, material facts that are recited in supporting documents must be included in the ruling request or in a supplemental letter and not merely incorporated by reference.[3] Any substantial change in the financing arrangement or in the project description from that set forth in the ruling request jeopardizes tax exemption. That is why the IRS declines to act on a series of hypothetical questions where, for example, the final form of the deal is not fixed.

A ruling request for a project of this magnitude and complexity would be detailed and take some time to prepare. Response from the IRS can take a year or more. There is only a possibility that the Service's response would be positive.

The question of financing the Project through use of the Alaska Railroad Corporation's permission to issue bonds on a tax exempt bases has been considered since the early 2000s. Prior work has considered the provisions of the Railroad Transfer Act, 45 U.S.C. § 1207(a)(6)(A) passed in 1982 which provides:

> After the date of transfer, continued operation of the Alaska Railroad by a public corporation, authority or other agency of the State shall be deemed to be an exercise of an essential governmental function, and revenue derived from such operation shall be deemed to accrue to the State for the purposes of section 115(a)(1) of Title 26. Obligations issued by such entity shall also be deemed obligations of the State for the purposes of section 103(a)(1) of Title 26, but not obligations within the meaning of section 103(b)(2) of Title 26.

Apparently Alaska Railroad bonds and bonds issued by one other entity elsewhere in the country are still not covered by the general tax law provision cited above in 26 U.S.C. § 149(c)(2). A ruling request to the IRS would cite the provisions of 45 U.S.C. § 1207 (a)(2) as indicating a federal intention that the authority of ARC was broad. It reads:

> The transfer to the State authorized by section 1203 of this title and conferral of jurisdiction to the Interstate Commerce Commission pursuant

---

1 Joint Committee on Taxation, *The Federal Revenue Effects of Tax-Exempt and Direct-Pay Tax Credit Bond Provisions* (JCX-60-12), at 6, July 16, 2012 (available at https://www.jct.gov/publications.html?func=startdown&id=4470).

2 Section 7.01 of the 1st RevProc.

3 Id.

> to paragraph (1) of this subsection are intended to confer upon the State-owned railroad all business opportunities available to comparable railroads, including contract rate agreements meeting the requirements of section 10713 of Title 49, notwithstanding any participation in such agreements by connecting water carriers.[4]

The request would, however, have to contend with 45 U.S.C. § 1207(a)(5) which states:

> Revenues generated by the State-owned railroad shall be retained and managed by the State-owned railroad for railroad and related purposes.[5]

It would also have to contend with 45 U.S.C. §1207(a)(1) which states in pertinent part that "After the date of transfer the State-owned railroad shall be a rail carrier engaged in interstate and foreign commerce . . . ."

Section 1207(a)(5) could be read as a limitation on ARC's ability to expend its revenues only for railroad related purposes, arguably, but legislative history indicates otherwise. Those involved in the transfer apparently wanted to make sure the State-owned railroad was not subject to the annual State appropriation process, to buttress its independence. The Senate Committee Conference Report, submitted by Senator Packwood, states, "[Section 1207(a)(5)] provides that the railroad shall retain and manage its own revenues. The purpose of this provision is to avoid the need for annual appropriations by the State for the railroad."[6]

What did the phrase "all business opportunities available to comparable railroads" mean? In answering this question the request would cite the fact that railroad holding companies have historically operated both railroads and pipeline companies and cite the fact that Burlington Northern Inc., a railroad holding company, acquired El Paso Co., a natural gas pipeline operator, at the same time that the railroad transfer act passed Congress, and that there are many companies both historically and currently which operate both railroads and pipelines.

ARC authorizing legislature enacted in 1984 (AS 42.40) which authorized ARC to apply for approvals ". . . to construct, maintain and operate transportation and related services, and obtain, hold, and reuse permits in the same manner as other railroad operators" (AS 42.40.250(13)). ARC gained legislative permission to finance the North Slope gas line in 2003 and in 2007 gained authority to finance the Kenai gasification project (SLA 2007, ch 65). It did not otherwise expand its bonding powers. Neither of

---

4 45 U.S.C. § 1207(a)(2) (2002) (emphasis added).

5 45 U.S.C. § 1207(a)(5) (2002).

6 S. Conf. Rep. No. 97-479, at 20 (1982).

these financing permissions is likely to persuade the IRS since they occurred well after the federal transfer legislation.

The ultimate problem with the ruling request lies in the fact that the railroad when it received tax exempt financing permission was simply a railroad. Other railroad holding companies operated pipelines, the Alaska Railroad was neither a holding company empowered to operate a pipeline nor did it operate one. The IRS very possibly would cite this fact in an effort to ascertain the legislative intent of Congress.

The IRS would note that the above cited language of the Committee stating that it was intended to confer on the railroad all business opportunities available to comparable railroads references the Interstate Commerce Commission and contract rate agreements. The IRS is unlikely to find authority for a very large pipeline financing to have been within the ambit of this language.