

percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (the customary exception).

#### B. Business Purpose Exception

The proposed regulations narrow the scope of the business purpose exception. Under the proposed regulations, a prepayment meets the business purpose exception only if the primary purpose for the prepayment is to accomplish one or more substantial business purposes that (1) are unrelated to any investment return based on the time value of money and (2) cannot be accomplished without the prepayment.

Commentators suggested that the business purpose exception in the proposed regulations would have limited usefulness and that the language in the existing regulations is superior. However, as discussed in the preamble to the proposed regulations, the business purpose exception in the existing regulations was intended to be a narrow exception and has raised difficult interpretive questions. For example, in many instances it may be unclear whether the alternatives available to the issuer are "commercially reasonable." The IRS and Treasury Department have considered all of the comments relating to the business purpose exception and have concluded that a standard that considers whether one or more business purposes and/or commercially reasonable alternatives exist is not an administrable test for determining whether prepayments give rise to investment-type property. Therefore, based on tax administration considerations and the broad scope of the investment-type property concept, the final regulations delete the business purpose exception. However, the final regulations provide that the Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

#### C. Customary Exception

The proposed regulations retain the customary exception in its present form. Commentators expressed concern that the customary exception may be difficult to apply in some cases. They suggested that the regulations identify examples of prepayments that satisfy the exception. The final regulations retain the customary exception and indicate that it generally applies based on all the facts and circumstances. In addition, the final regulations contain a safe harbor under which a prepayment is deemed to satisfy the customary

exception if: (1) The prepayment is made for maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment), or updates or maintenance or support services with respect to computer software; and (2) the same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

#### D. Certain Prepayments To Acquire a Supply of Natural Gas or Electricity

##### 1. Prepayments for Natural Gas

The proposed regulations add an exception to the definition of investment-type property for certain natural gas prepayments that are made by or for one or more utilities that are owned by a governmental person, as defined in § 1.141-1(b) (for example, if a joint action agency acquires a natural gas supply for one or more municipal gas or electric utilities). The exception applies only if at least 95 percent of the natural gas purchased with the prepayment is to be consumed by retail customers in the service area of a municipal gas utility, or used to produce electricity that will be furnished to retail customers that a municipal electric utility is obligated to serve under state or Federal law (the *use requirement*). For this purpose, the service area of a municipal gas utility is defined as (1) any area throughout which the municipal utility provided (at all times during the five-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area, or (2) any area where the municipal utility is obligated under state or Federal law to provide gas distribution services as provided in such law.

Some commentators recommended that the 95 percent threshold be reduced to 85 percent. These commentators stated that various factors make it difficult for municipal gas utilities to determine in advance the precise quantity of gas supplies they will need to serve their customers during a given period. These factors include a limited capability to store gas and variations in demand due to circumstances beyond the utilities' control, such as economic conditions and the weather. In recognition of these unique factors, the final regulations reduce the 95 percent threshold to 90 percent.

Some commentators recommended that the use requirement apply based on the issuer's reasonable expectations as

of the issue date. To ensure that the prepaid gas is consumed by retail customers in the service area of the municipal utility, the final regulations retain the requirement that the prepaid gas supply actually be used for a qualifying purpose.

Some commentators suggested that the use of natural gas to fuel the transportation of the prepaid gas supply on a pipeline should be a qualifying use under the natural gas exception. The final regulations adopt this comment. Under the final regulations, the use of gas to fuel the pipeline transportation of the prepaid gas supply is a qualifying use and is not pro-rated based on the amount of qualified and nonqualified use of the remaining prepaid gas.

Commentators indicated that most municipal gas and electric utilities do not have an obligation to serve that arises under state or Federal law. These commentators suggested replacing the "obligation to serve" requirement for municipal electric utilities with a service area rule that is similar to the rule for municipal gas utilities. The final regulations adopt this comment. Commentators also recommended that the definition of service area be expanded to include any area recognized as the service area of the municipal utility under state or Federal law. The final regulations adopt this comment.

Commentators requested clarification that sales to governmental persons are qualifying sales under the use test. Commentators also requested clarification that a retail customer of a municipal utility is a qualifying end-user even if the prepayment was made by or for another municipal utility. The final regulations do not provide that all sales to governmental persons, or to retail customers of a municipal utility, are qualifying sales. Rather, the final regulations clarify that, in the case of a natural gas prepayment by or for one or more municipal utilities (each, the issuing municipal utility), the use of prepaid gas is a qualifying use if the gas is: (1) Furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility (other than sales of gas to produce electricity for sale); (2) used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; (3) used by the issuing municipal utility to produce electricity that will be sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the