Lesson 5

Internal Revenue Code § 144(a)
Qualified Small Issue Bonds

Overview

Introduction

Lesson 5 continues the discussion of qualified private activity bonds by focusing on qualified small issue bonds. These bonds are described in IRC § 144(a).

Objectives

After completing this lesson, you will be able to:

- Define a qualified small issue bond
- Identify a manufacturing facility
- Identify directly related and ancillary facilities
- Define:
  - Principal user
  - Related person
- Determine whether a qualified small issue bond meets the:
  - $1M limitation
  - $10M/20M capital expenditure limitations
  - $40M limitation

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Overview, Continued

Contents

This lesson contains the following topics:

Section 1
General Rules

Overview

Introduction

This section discusses the general rules applicable to qualified small issue bonds. These rules are found in IRC § 144(a).

Statutory Provisions

The specific requirements for qualified small issue bonds are provided in IRC § 144(a). Prior to the Tax Reform Act of 1986, the requirements for the predecessor to qualified small issue bonds, small issue industrial development bonds, were provided in section 103(b)(6) of the 1954 Code.

Regulations

Treas. Reg. § 1.103-10 provides rules which applied to small issue industrial development bonds under section 103(b)(6) of the 1954 Code, and which may be applicable to qualified small issue bonds under IRC § 144(a). Note that portions of these regulations include proposed regulations.

Treas. Reg. §§ 1.144-2 and 1.150-4 contain remedial actions which are applicable to qualified small issue bonds.

Contents

This section contains the following topics:

Introduction

Definition of Qualified Small Issue Bonds

IRC § 144(a)(1) provides, in part, that the term "qualified small issue bonds" means:

- Bonds issued in the aggregate authorized face amount of $1 million or less, **AND**
- At least 95 percent of the net proceeds of the bonds are to be used:
  - to acquire, construct, or improve land or depreciable property, **OR**
  - to redeem bonds previously issued for such purposes

Facilities Financed

Under IRC § 144(a)(12), for small issue bonds issued after December 31, 1986, 95 percent or more of the net proceeds must be used to finance only **"manufacturing facilities"** or land or property in accordance with IRC § 147(c)(2).

Under IRC § 147(c)(2) first time farmers are allowed to finance up to $250,000 in expenditures for land with bond proceeds.

Use of Proceeds

IRC § 144(a)(1) provides that at least 95 percent of the net proceeds of the bonds (bond proceeds less amounts in the reasonably required reserve fund) must be used for qualified purposes.

If bonds are used to refund prior qualified small issue bonds, different rules apply. These rules are discussed later in this module.

Manufacturing Facility

Definition

IRC § 144(a)(12)(C) defines a "manufacturing facility" as any facility used in the manufacturing or production of *tangible personal property*. This includes:

- Processing which results in a change in the condition of tangible personal property, **AND**
- Facilities that are directly related and ancillary to a manufacturing facility if:
  - Located on the same site**, AND**
  - Not more than 25 percent of the net proceeds are used to provide these ancillary facilities. (See IRC § 144(a)(12)(C).)

Note: The American Recovery and Reinvestment Act (ARRA) expands the definition of manufacturing facilities under IRC § 144(a)(12)(C)(iii) for bonds issued **after February 17, 2009 and before January 1, 2011.** See ARRA changes below.

Core Manufacturing

The manufacturing activity must constitute substantially all of the on-site economic activity per H.R. Rep. No. 100-795, at 576 (1988).

It is important to distinguish between "core manufacturing" and "directly related and ancillary" elements of a facility. Core manufacturing involves property directly used in the production of the product. Core manufacturing facilities are those parts of the facility where manufacturing actually takes place. Unlike directly related and ancillary facilities (discussed below) core manufacturing facilities may be financed with bond proceeds without limitation.

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Manufacturing Facility, Continued

Common Characteristics

Common characteristics of a manufacturing facility are:

- Facilities must be of a character subject to the allowance for depreciation.
- The property produced must be tangible personal property (pre-ARRA).
- There must be a “change” or “transformation” of the original materials and such “transformation” should be substantial.
- Manual or machine labor must be expended in the process (as opposed to natural growth).
- As a result of the process, a new and different article must be created that has a distinctive name, character, or use.

Example 1

A facility engaged in the transformation of rolls of paper into paper bags is a manufacturing facility. (See PLR 8815033)

Example 2

A facility used to crush and flatten aluminum, glass, or plastic is not a manufacturing facility because this does not create tangible personal property. (See PLR 8829048)

Example 3

Facilities used in a printing company, printing presses and other similar equipment used in the printing company are considered manufacturing facilities because they transform paper and ink into a book. (See PLR 8934063.)

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Manufacturing Facility, Continued

Example 4

A facility is used to publish business directories in which the activities represented included: 1) sale of advertising, 2) creating the advertisement and designing the directories, 3) formatting and downloading to a CD, and 4) printing and binding the directories. Only activities 2 and 3 occur at the facility. It was held that there was an insufficient core manufacturing as nearly all of the process involved the transformation of data, intellectual and artistic ideas (See PLR 200234012.)

Example 5

A facility used to feed, grow and harvest live animals is not a manufacturing facility. (See PLR 8819026.)

Example 6

Snowmaking at a ski resort is not manufacturing. Although air and water are used to make snow, snow-making is not the primary economic activity; but is incidental to the recreational activity. (See GCM 39379.)

Example 7

A facility used for processing (shucking, sorting, washing, boxing and freezing) of raw scallops constitutes manufacturing as it transforms ocean scallops into harvested scallops ready for commercial consumption and use. (See PLR 9014014.)

Example 8

In TAM 200025004, a bond financed facility used to cure cheese has a controlled atmosphere. Employees monitor and control temperature, airflow, and humidity. Only the curing phase of the cheese making process occurs at the facility. No ingredients are added to the cheese while it is in the facility. The Service ruled that the facility is a manufacturing facility because curing is part of the core manufacturing of cheese.

Manufacturing Facility, Continued

ARRA Changes

For issuances after February 17, 2009 and before January 1, 2011, the ARRA expands the definition of manufacturing facilities under IRC § 144(a)(12)(C)(iii) to include any facility that is used in the manufacturing, creation or production of *intangible* property (within the meaning of IRC § 197(d)(1)(C)(iii)), *or a facility which is functionally related and subordinate to a manufacturing facility if such facility is located on the same site as the manufacturing facility.* Note: This section also eliminates the 25 percent cap on use of net proceeds for facilities that are directly related and ancillary to a manufacturing facility.

IRC § 197(d)(1)(C)(iii) defines "intangible property" to include "any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item." (H.R. Conf. Rep. 111-16, p 579) It is intended to include, among other items, the creation of computer software and intellectual property associated with bio-tech and pharmaceuticals.

Example 9

In 2010, a company that produces software programs for the administration of hospital billing services wishes to expand its product base to include software for sharing of medical data. In order to do this, the company must construct a wing to house design personnel and a testing lab. This facility qualifies as a manufacturing facility per IRC § 144(a)(12)(C)(iii).

Directly Related and Ancillary

General Rule

Property that is directly related and ancillary to the facility for which the bonds are issued may be financed with the proceeds of the bond, with limitation. Directly related ancillary activities are secondary or supplemental facilities rather than integral to the core manufacturing process. Ancillary facilities may be financed if they occur at the same site as the manufacturing activity, and manufacturing constitutes substantially all of the on-site economic activity. All other activities must be subordinate and integral to the manufacturing process. H.R. Report No. 100-795 at page 576.

IRC §§ 144(a)(12)(C)(i) and (ii) limits these ancillary facilities to those located on the same site as the manufacturing facility. In addition, not more than 25 percent of the net proceeds of the bond issue may be used to provide these facilities. This amendment was intended to clarify that the definition of manufacturing and did not preclude the use of a portion of the proceeds to finance ancillary facilities, provided such facilities meet several criteria and no more than 25 percent of the net proceeds of the issue are used for non-core facilities.

When a distinct and separate economic activity is performed at a single physical location where manufacturing takes place, an activity, such as warehousing, should be treated as a separate and not part of the manufacturing facility whenever the employment in each such economic activity is significant.

Example 10

An employee parking lot adjacent to the plant that does not cause the firm to hire parking attendants and does not generate revenue for the firm would not be a separate activity. Similarly, a separate room stocked with samples to show buyers can be integral to the successful operation of a manufacturing facility. However, a showroom staffed with full-time sales personnel is outside the scope of a manufacturing facility. H. R. Report No 100-795 at page 576.

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Example 11

Corporation X uses proceeds of a 2004 bond to finance a facility that manufactures machine parts. The net proceeds of the bond equal $7 million. Corporation X uses $1 million of the proceeds of the bond to finance a warehouse to store raw materials and finished products that are to be shipped within 60 days of manufacture. The warehouse is a directly related and ancillary facility for which less than 25 percent of the net proceeds were spent on such facility.

Office Space

Office space is generally not part of the core manufacturing facility and may not, unless it fits within rules similar to § 142(b)(2), be financed with bond proceeds. Section 142(b)(2) provides that office space, that is located on the same premises of the facility and not more than a *de minimis* amount of the functions to be performed at such office is not directly related to the day-to-day operations at such facility, may be bond financed.

Administrative offices for the employees at the facility (such as, supervisors of the manufacturing process in the facility) may be financed with proceeds of bonds used to finance the facility, if the offices are:

- Located on the same property as the facility, AND
- Reasonable in size and cost.

A separate office wing of a larger, mixed-use building is not treated as directly related and ancillary to the manufacturing facility. Sales, payroll and marketing office space is not functionally related or subordinate to the manufacturing facility.

Storage

Short-term warehousing of raw materials necessary to the production, or temporary warehousing of the finished product, is directly related and ancillary to a manufacturing facility.

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Directly Related and Ancillary, Continued

Example 12

Storage spaces for raw materials and finished products, which are located on the same site as the facility, may be financed with proceeds of bonds used to finance the facility. The storage spaces must be reasonable in size to the needs of the facility. (See PLR 8815033.)

Others

An on-site laboratory for quality control or testing of raw materials to be used in the production is directly related and ancillary to manufacturing facility.

A laboratory for new research and development is not included.

Machinery used to load or unload the raw materials or finished product, such as forklifts, is directly related and ancillary to a manufacturing facility.

Vehicles used in the delivery of the raw materials or finished product are not directly related and ancillary to the manufacturing activity.

ARRA Changes

IRC § 144(a)(12)(C)(iii) not only expanded the definition of manufacturing facilities to include intangible property, it also eliminated the 25 percent cap for directly related and ancillary components for bonds issued after February 17, 2009 and before January 1, 2011. It expanded the definition of a manufacturing facility to include facilities that are functionally related and subordinate to a manufacturing facility if such facilities are located on the same site as the manufacturing facility.

Example13

Corporation X uses proceeds of a July 1, 2009, bond to finance a facility that produces software for construction firms. The net proceeds of the bonds equal $7 million. Corporation X uses $5 million of the proceeds of the bonds to finance the warehouse located at their site to house the finished products that are to be shipped within 60 days of manufacture. The warehouse is functionally related and subordinate to the production of the software and located on the same site. Therefore, it falls within the expanded definition of a manufacturing facility and qualifies for bond-financing.

Farm Property

General

After December 31, 1986 (except for the temporary ARRA rules under 144(a)((12)(C)(iii)), proceeds of qualified small issue bonds may be used to finance only manufacturing facilities or land or property in accordance with IRC § 147(c)(2).

IRC § 147 (c)(2) provides an exception to IRC § 147(c)(1) which limits the net proceeds of private activity bond issuances that may be used to acquire land. IRC § 147(c)(1) provides that less than 25 percent of the net proceeds may be spent on land acquisitions (or an in interest in land), and no portion of the proceeds may be used for the acquisition of land for farming purposes.

The exception provided for in IRC § 147(c)(2) allows first time farmers to use up to $250,000 of bond proceeds to acquire land for farming purposes.

First-Time Farmer

IRC § 147(c)(2)(C) defines "first-time farmer" as any individual who has not:

- At any time had direct or indirect ownership of, and material participation in, "substantial farmland," AND
- Received financing under this paragraph in an amount which, when added to current financing exceeds $250,000.

In applying the above rule:

- Material participation or financing by a spouse or minor child is treated as ownership and material participation by the individual. A parent's ownership of a farm is not treated as ownership by the first-time farmer.
- The individual acquiring the farmland must be the principal user of the land and must materially participate in the operation of the farm. If an individual previously owned farmland and disposed of the land due to insolvency, the individual will be considered a first-time farmer.

Farm Property, Continued

Substantial Farmland

IRC § 147(c)(2)(E) provides that "substantial farmland" means any parcel of land unless:

- It is smaller than 30 percent of the median size of a farm in the county where it is located, **AND**
- The fair market value of the land does not exceed $125,000 at any time while held by the individual.

Equipment

First-time farmers may use bond proceeds to purchase depreciable used farm equipment in an amount of not greater than $62,500 of the $250,000 limit. (See IRC § 147(c)(2)(F).)

Note

The rules regarding first-time farmers are provided in IRC § 147(c)(2).

IRC § 147(c)(2) was amended by section 1117 of the Small Business Job Protection Act of 1996. The amendments are effective after August 20, 1996.

Prior to August 20, 1996, first-time farmers could not own in excess of 15 percent of the median size of a farm in the county in which such land was located.

The rules for acquisition by first-time farmers of farmland or personal property from related persons are applicable to bonds issued after August 20, 1996. (See IRC §§ 147(c)(2)(G) and 144(a)(3).)

Definitions Applicable to Qualified Small Issue Bonds

Introduction

IRC § 144 uses several defined terms that are contained within the rules regarding qualified small issue bonds. In particular, the terms "principal user" and "related person" are considered when applying the various limitations associated with IRC § 144. These terms will be defined first as they are referred to in the rest of this section.

Principal User

In general, a principal user is the user of more than 10 percent of the facility.

A user includes a(n):

- Owner,
- Lessee, or
- Output purchaser.

These terms are defined below.

When a person or entity exerts use and control of facilities beyond that typical of a customer, that person may become principal user. (See PLR 8443115.)

Principal Owner

A principal owner is a person who at any time owns more than 10 percent of the facility. A person has an ownership interest in the facility if this person is an owner for federal income tax purposes. This interest is measured by the value of the facility.

In determining whether a person owns more than 10 percent of a facility, the person is treated as owning or using the facility to the extent that any person related to such person owns or uses the facility.

If the facility is owned by a number of persons, none of whom own more than a 10 percent interest in the facility, then the principal owner is the person who owns the largest ownership interest.

A person, considered to be a principal user of the facility because that person is related to another person who is a principal user, ceases to be a principal user when the related person ceases to be a principal user or the two persons become unrelated.

Definitions Applicable to Qualified Small Issue Bonds, Continued

Example 14

The fair market value of a facility is $2 million. The facility is owned equally by five partnerships. Because each partnership owns more than 10 percent of the value of the facility (20 percent), each of the partnerships is a principal owner of the facility.

Example 15

A facility with a fair market value of $1 million is owned by 20 different entities. Entity A owns a portion, which is valued at $250,000 and the remaining portions of the facility are owned equally by the other 19 entities.

Because Entity A owns more than 10 percent of the facility, it is the principal owner.

Principal Lessee

A principal lessee is a person who at any time leases more than 10 percent of the facility disregarding portions used by the lessee under a short-term lease. A short-term lease is one which has a term of 1 year or less, taking into account all options to renew and reasonably anticipated renewals. The portion leased by a person is generally determined on the basis of the fair rental value of the facility.

Example 16

In TAM 8838003, the Service ruled that a sub-lessor is a principal user of the bond-financed facility. In 1980, $4.6 million of bonds were issued for partnership's medical office building. (Prior to TRA 86.) Up to a third of the facility is leased to an HMO, although most of the space is occupied by Entity X that provides medical services to HMO customers, leaving only seven percent of space for HMO. The Service made the following conclusions:

- The argument that there can be only one principal user, under section 103(b)(6)(E),was rejected.
- Both the HMO and X are principal users because a lessee who provides space to another person remains a user of the entire leasehold even though the lessee does not physically occupy all of the space.

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Definitions Applicable to Qualified Small Issue Bonds, Continued

US Government as a User

A facility financed with proceeds of small issue bonds was leased to the United States government. The United States government is the principal user of the facility. (See *Fairfax County Economic Development Authority* v *Commissioner*, 77 TC 546 (1981) Affd 679 F2d 261 (DC Cir 1982).)

Principal Output Purchaser

A principal output purchaser is any person who purchases output of an electric or thermal energy, gas, water, or other similar facility. However, a person who purchases 10 percent or less of the output of a facility during each 1-year period, beginning with the date the facility is placed in service, is NOT a principal output purchaser.

Related Person

For purposes of qualified small issue bonds, IRC § 144(a)(3) provides that a person is related to another person if, on the date of issuance of the bonds:

- The relationship between such persons would result in disallowance of losses under IRC §§ 267 and 707(b), **OR**
- Such persons are members of the same controlled group of corporations under IRC § 1563(a).

For purposes of applying IRC § 1563(a), "more than 50 percent" is substituted for "at least 80 percent" each place it appears therein."

Related persons may include the following:

- Brothers and sisters (whole and half blood), spouse, ancestors (grandparents) and lineal descendants (children)
- Grantors
- Fiduciaries and beneficiaries of trusts
- Fiduciaries of a corporation
- Persons controlling a corporation
- The controlled corporation

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Definitions Applicable to Qualified Small Issue Bonds,
Continued

Related Persons (continued)

- Controlling shareholders of a corporation
- Certain corporations if more than 50 percent of their shares are owned by the same persons, and
- Certain partners and partnerships

Example 17

City X issues qualified small issue bonds and loans the proceeds to Partnership Y. Partnership Y leases 75 percent of the facility financed with the proceeds of the bonds to Company A. Company A subleases half of its leased portion to Partnership B. Partnerships Y and B have the same general partner who owns 50 percent interest in each partnership.

Partnership Y, Company A and Partnership B are all principal users of the facility even though this combined use is over 100 percent. Each is a principal user because:

- Partnership Y is the owner of the facility.
- Partnership B is considered a principal user, because it is a principal lessee (leases 37.5 percent, which is over 10 percent).
- Company A is considered a principal user because it is a principal lessee (leases 75 percent, which is over 10 percent).
- Combined use is over 100 percent because each user is considered to use the following portions of the facility:
    - Partnership Y - 100 percent
    - Partnership B - 37.5 percent
    - Company A - 75 percent
    - Partnerships Y and B are not related because the general partner owns only 50 percent. (IRC §§ 144(a)(3)(B)(ii) and 707(b)). Since they are not related, their use can be double-counted.

Section 2
Limitations on Principal Amount of Bonds

Overview

Introduction

In addition to having qualifying use of bond proceeds, as discussed previously, the face amount of a qualified small issue bond may not exceed $1 million and under certain circumstances, this $1 million limitation may be increased to $10 million at the election of the issuer. The $10 million limit is discussed in Section 3.

Contents

This section contains the following topics.

Aggregation Rules

General Rules

To determine whether a bond issue meets the $1 million limitation or the issuer-elected $10 million limitation, the *outstanding* principal amounts of certain prior issues are aggregated with the face amount of the bond issue in question.

IRC § 144(a)(2) states that to determine whether the $1 million limitation for a bond issue is met, the outstanding principal amounts of the following prior issues are aggregated with the face amount of the bond issue in question(regardless of whether or not the bonds were issued by the same issuer):

- Qualified small issue bonds, the proceeds of which were used with respect to facilities located in the same incorporated municipality or the same county (but not in an incorporated municipality) as the facilities financed with the issue in question, **AND**
- Bonds wherein the principal users (user of over 10 percent) of the facilities financed with the prior issue and the bond issue in question are the same person or 2 or more related persons

The aggregate face amount of an issue does not include the principal amount outstanding of any bond which is to be redeemed (other than an advanced refunding) from the net proceeds of the issue under consideration.

Incorporated Municipality and Counties

Each incorporated municipality and the unincorporated areas within a county are treated as separate jurisdictions.

Towns and townships which have substantial governmental powers qualify as "incorporated municipalities" under § 103(b)(6)(E)(i) of the 1954 Code if a state statute or the highest court of the State recognized the entities as municipal corporations. (See Rev. Rul. 80-136.)

Example 18

On July 1, 2004, County M issued bonds with a face amount of $5,000,000 to finance the construction of Factory 1 to be located in the County, but not within any incorporated municipality. The sole user of Factory 1 is Corporation X. On August 1, 2004, Corporation X requests City P, an incorporated municipality located entirely within County M, to issue bonds in the face amount of $5,500,000 to finance the construction of Factory 2.
The two bond issues need not be aggregated**.**

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Contiguous or Integrated Facility

A contiguous (Rev. Rul. 75-193) or integrated facility (Rev. Rul. 76-427), which is located on both sides of a border between two or more political jurisdictions, is treated as if it is entirely within each such political jurisdiction Treas. Reg. § 103-10(d)(2)(i).

Two facilities will be treated as an integrated facility if they are:

- In close proximity, and
- The use of the two facilities is functionally dependent on each other. (A factory producing carpet yarn for the manufacturing of carpet in another factory a half mile apart is treated as integrated with the other.)

Example 19

Town X issues qualified small issue bonds for Company Y which will construct a facility in Town X. The facility will be located on land adjacent to County Z. Company Y owns the adjacent land in County Z and the facility's parking lot will be on that land. The facility is treated as being located in both Town X and County Z.

Example 20

County X issues qualified small issue bonds and loans the proceeds to Partnership A for a factory located in County X. City Z issues small issue bonds and loans the proceeds to Partnership A for a factory located in City Z. The two factories are 10 miles apart. However, the factory located in County X produces materials which are essential for use in the factory located in City Z.

The two factories are not integrated facilities because they are not in close proximity **AND** functionally related.

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Example 21

On September 1, 1986, City L issues $8 million face amount of qualified small issue bonds and loans the proceeds to Corporation Z to acquire a facility. Corporation Z is a principal user. Beginning September 1, 1986, the entire facility is leased to Corporation Y, an entity unrelated to Corporation Z. The term of the lease is 2 years. Corporation Y is also a principal user of the facility. In April 1987, Corporation Y makes $1.5 million of capital expenditures within City L. On August 31, 1988, Corporation Y ceases to lease the facility. On October 1, 1988, Corporation Y incurs $20 million of capital expenditures in connection with the purchase of an office building also located in City L.

For purposes of the $10 million limitation on capital expenditures, the $1.5 million expenditures made by Corporation Y in April, 1987 are included. However, the $20 million capital expenditures incurred by Corporation Y after August 31, 1988, when Corporation Y ceased to be a principal user, are not included.

Composite Issues

Introduction

The definition of an "issue" for tax exempt bond financing is a concern to issuers of Qualified Small Issue bonds for aggregation purposes. The $1M limitation is applied to any bond issued as part of an "issue" of qualified small issue bonds.

Definition

Treas. Reg. § 1.150-1(c) defines an issue and is applicable to bonds issued after June 30, 1993 for all purposes under IRC §§ 103 and 141-150.

Multiple lots of bonds of $1 million each are treated as a single large issue (composite issue) rather than separate exempt issues if the bonds meet all of the following requirements:

- The bonds are sold at substantially the same time (less than 15 days apart); AND,
- The bonds are sold under the same plan of financing, determined by taking into account:
  - The purpose of the bonds (i.e. to finance the same or related facilities)
  - The structure of the financing (i.e. short-term bonds for working capital expenditures and long-term bonds for capital projects are not part of the same plan of financing.; certificates of participation and general obligation bonds are not part of the same plan of financing); **AND**
- The bonds are reasonably expected to be paid from the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

Example 22

On January 1, 1994, Issuer issues 25 bond issues within a two-week period, each having a $1 million face amount. Each issue is secured only by the revenues of a separate facilities financed by the separate bonds. The proceeds are loaned to separate unrelated corporations.

The 25 issues do NOT meet the requirements for a composite issue because the bonds are reasonably expected to be paid from different sources of funds. The bonds are NOT aggregated and do not violate the $1 million limitation.

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Composite Issues, Continued

Limitations for Qualified Small Issue Bonds

IRC § 144(a)(6)(A) states that bonds that would be treated as the same issue are treated as separate issues unless the proceeds are to be used with respect to two or more facilities 1) located in more than one State; OR, 2) which have, as the same principal user the same person or related persons.

IRC § 144(a)(6)(B) expands the definition of "principal user" for purposes of applying § 144(a)(6)(A).

IRC § 144(a)(7) provides that small issue bonds issued under 144(a) are not aggregated with other tax-exempt bonds.

IRC § 144(a)(9) provides for aggregation of issues with respect to a single project.

Prior Law

For bonds issued before July 1, 1993, the composite issue rule for IRC § 144(a) purposes is stated in Rev. Rul. 81-216, 1981-2 CB 21. Under that ruling, separate issues of bonds are treated as a single large issue if:

- The obligations were sold at substantially the same time ,
- The obligations were sold under a common plan of marketing,
- The obligations were sold at substantially the same rate of interest, AND
- A common or pooled security was either used or available to pay debt service on the obligations.

Example 23

On September 15, 1989, 20 cities and counties located in the same state each issue $1 million small issue bonds and loan the proceeds to Corporation M to finance 20 separate facilities. Each issue bears the same rate of interest. The debt service on each issue is payable only from the facility which it financed. However, Corporation M guarantees the debt service on each issue.

The 20 issues meet the requirements set forth in Rev. Rul. 81-216 for a composite issue because a common security (Corporation M's guarantee) was available to pay the debt service on the obligations. As a result, the bonds are aggregated, thus violating the $1 million limitation and causing the bonds to be taxable.

Section 3

$10 Million/$20 Million Capital Expenditure Limitation

Overview

Introduction

At the election of the issuer, the aggregate face amount of the issue may be increased from $1 million to an amount not to exceed $10 million. This election is permitted by IRC § 144(a)(4)(A)(i).

In determining whether the aggregate face amount of a bond issue is $10 million or less, certain capital expenditures incurred by the principal users of the facility (or a related person) are included per § 144(a) (4)(A)(ii).

For bonds issued after December 31, 2006, capital expenditures not exceeding $10,000,000 are excluded from the computation of the aggregate face amount of the issue (having the result of increasing the capital expenditure limitation by $10,000,000); however, the limitation on the principal amount of bonds that may be issued or outstanding remains at not more than $10,000,000.

The aggregation rules set forth in Section 2 of this lesson are also applicable to the $10M/$20M capital expenditure limitation.

How Election Is Made

- The election must be affirmatively made prior to, or at the time of, the issuance of the bonds.
- The election can be made on the books and records of the issuer, such as in the bond resolution or similar document, or in the bond transcript.
- The election should be properly reflected on the Form 8038 filed with respect to the issue.
- Failure to make a proper election will cause the interest on the bonds to be taxable.

See Treas. Reg. § 1.103-10(b)(2)(vi).

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Contents

This section contains the following topics:

Aggregate Face Amount of the Issue

Sizing the Issue

In determining the aggregate face amount of the issue for purposes of the $10 million limitation, the following amounts are included:

- The aggregate face amount of the bond issue,
- The aggregate face amount of tax-exempt bonds previously issued and outstanding (determined under the aggregation rules discussed in Section 2 of this lesson), and
- Certain capital expenditures of the principal user or related persons paid or incurred during the 6-year period beginning 3 years before the issue date of the bonds and ending 3 years after such date.

Capital expenditures made from bond proceeds in the two preceding categories are not double-counted.

See § 144(a)(4)(A)(ii) and Treas. Reg. § 1.103-10(b)(2).

Example 24

City X issued $4 million principal amount of bonds in 1982 and loaned the proceeds to Corporation Y. In 1987, City X issues $5 million principal amount of bonds and loans the proceeds to Corporation Z, a wholly owned subsidiary of Corporation Y. At the time of issuance of the 1987 bonds, the outstanding amount of the 1982 bonds is $3.4 million. (Assume that Corporation Y and Corporation Z's facilities are located in the same incorporated municipality.)

To determine the aggregate face amount of the bonds for purposes of the capital expenditure rule, the following are includible:

- $3.4 million outstanding 1982 bonds,
- $5 million face amount of the 1987 bonds

This is because:

- The facilities to be financed by the prior and current issues are located in the same incorporated municipality, AND
- Corporation Y and Corporation Z are related parties.

Includable Capital Expenditures

General

In addition to the outstanding amount of any prior tax-exempt bond issues, certain capital expenditures paid or incurred by the principal user of the facility financed with the proceeds of the bond issue are also included in determining whether the aggregate face amount of the issue meets the $10 million limitation.

Capital expenditures are included if:

- The capital expenditure was financed with other than the proceeds of small issue bonds,
- The capital expenditures were paid or incurred during a 6-year period that BEGINS 3 years BEFORE the date of issuance of the bonds (the current issue) and ENDS 3 years AFTER the date of issuance of the bonds,
- The principal user of the bond financed facility and the principal user of the capital expenditures is the same person or two or more related persons,
- Both facilities are located within the same incorporated municipality or the same county outside of the incorporated municipality, AND
- The capital expenditure was properly chargeable to the capital account of any person or state or local governmental unit whether or not such person is the principal user of the facility or a related person.

See § 144(a)(4)(A)(ii) and Treas. Reg. § 1.103-10(b)(2)(i) and (ii).

Example 25

City X issues $9 million face amount of bonds and loans the proceeds to Corporation Y to acquire and construct a manufacturing facility. The bonds are issued on June 1, 1993. On August 17, 1992, Corporation Y purchased and installed certain equipment at the facility at a cost of $2.3 million. This expenditure was properly chargeable to Corporation Y's capital account. The bonds do not qualify as tax-exempt small issue bonds because the total capital expenditures of Corporation Y, the principal user (as owner), within the 6-year period exceeded $10 million.

Continued on next page

Includable Capital Expenditures, Continued

Facilities taken into account

Capital expenditures include those for all facilities

- Located within the same incorporated municipality (or if located in an unincorporated area of a county, all facilities located in unincorporated areas of the county) in which the bond-financed facilities are located, and
- The principal user of which is or will be the same person or two or more related persons.

Whether two or more facilities are located in the same governmental unit shall be made as of the date of issue of the issue in question. (See § 144(a)(4)(B).)

Example 26

On September 13, 1992, City B issues $7.6 million face amount of bonds and loans the proceeds to Partnership YZ. Partnership YZ leases the facility financed with the proceeds of the bonds to Corporation M. Corporation M is a principal user of the facility. Corporation M also owns and operates another facility in City B, and between January 1990 and August 1992, Corporation M performed extensive renovations costing $5 million at the other facility.

The bonds do not qualify as tax-exempt small issue bonds because Corporation M, a principal user (as lessee), had capital expenditures of $5 million which are includable in determining the $10 million limitation. These capital expenditures occurred within the 3-year period before the date of issuance of the bonds.

Includable Capital Expenditures, Continued

Example 27

City Z issues $9 million principal amount of bonds for Corporation A's manufacturing facility on November 23, 1990. On March 7, 1992, Corporation A purchases equipment at a cost of $1.5 million and installs it in its plant in County X. Corporation A intends to keep the equipment at the County X plant for its entire useful life. However, due to a change of plans on August 18, 1994, Corporation A moves the equipment to the plant in City Z.

The $1.5 million cost of the equipment is not included in the $10 million capital expenditure limitation. This is because Corporation A had no intent to use the equipment in City Z when it was purchased, and did not change its intent nor install it in City Z until after the 3-year period following the date of issuance of the bonds had ended. (See Rev. Rul. 83-18, 1983-1 CB 28.)

Intangibles

Purchase of goodwill made within the 6-year period is included as a capital expenditure for purposes of the $10 million limitation. (See Rev. Rul. 81-56, 1981-1 CB 53.)

Purchase of covenant not to compete is also a capital expenditure for purposes of the $10 million limitation. (See Rev. Rul. 81-55, 1981-1 CB 52.)

Includable Capital Expenditures, Continued

Includable Expenditures of a State or Local Government

Capital expenditures subject to the $10 million limitation include capital expenditures which are properly chargeable to the capital account of any person or state or local governmental unit (whether or not that person or state or local government is a principal user or related person). This determination is made without regard to any other rule in the Code that permits expenditures properly chargeable to the capital account to be treated as current expenses. In other words, items that may be treated as a current expense for other tax purposes are treated as a capital expenditure for this purpose.

If a state or local government incurs capital expenditures in the same jurisdiction as the facility financed with proceeds of small issue bonds, and these capital expenditures principally benefit a principal user's facility, the capital expenditures are included in the $10 million limitation.

Example 28

For example, expenditures for roads or drainage pipes provided by a city that principally benefit the financed facility are included in the computation. (See Treas. Reg. § 1.103-10(b)(2)(ii)(e).)

The city issues bonds for $6 million for Company X. Company X incurs $3.625 million in capital expenditures in the 3 years prior to the bond issuance. The city spends $900,000 to construct a parking garage leased to Company X for exclusive use. The $900,000 capital expenditure by the city must be taken into account in determining the limitation resulting in taxability of the bonds. (See PLR 8624037.)

Excludible Capital Expenditures

General

In computing the $10 million capital expenditure limitation, IRC § 144(a)(4)(C) excludes specific capital expenditures, such as expenditures:

- To replace property destroyed or damaged by fire, storm, or other casualty to the extent of the fair market value of the property replaced,
- Incurred due to a change in federal, state or local law occurring after the date of issuance of the bonds,
- Up to $1M, made as a result of mistake of fact or law or required as a result of circumstances reasonably unforeseen on the date of issuance of the bonds,
- Relating to certain in-house research expenses under § 41(b)(2)(A)(i) and (ii) for which a deduction was allowed under § 174(a) relating to the treatment of research expenditures as business expenses.

In addition, capital expenditures made by a public utility with respect to bond-financed property are excluded if the public utility is not a principal user of the property. (See Treas. Reg. § 1.103-10(b)(2)(iv)(a).)

Example 29

Qualified small issue bonds were issued to construct a facility. When the construction was nearly complete, a change in state law occurred. As a result, more expensive fire alarm equipment had to be installed. The additional capital expenditure incurred to meet the new state law requirement was not includible in the $10 million capital expenditure limitation.

Leases

Leased equipment is not included as a capital expenditure if it is of the type ordinarily leased. However, equipment purchased pursuant to a sale/ leaseback agreement within the 6-year period is includable in the capital expenditure computation.

Continued on next page

Excludible Capital Expenditures, Continued

Example 30

County B issues $7 million principal amount of bonds and loans the proceeds to Partnership XYZ to acquire and construct a manufacturing facility. Partnership XYZ leases equipment from an unrelated party. The equipment is of a type ordinarily leased. The $2 million cost of the equipment is not included in the $10 million limitation. (See Rev. Rul. 77-262, 1977-2 CB 41.)

Example 31

Company Z purchased equipment on December 1, 1978. On December 15, 1978 Company Z sold the equipment to an unrelated party, M, who is in the business of leasing such equipment. Company Z then leased the equipment back from M. The equipment is of the type ordinarily leased. Company Z exceeded the limitation as a result of the requirement to aggregate the face amount of the bonds and the capital expenditures on December 1, 1978. (See Rev. Rul. 79-248, 1979-2 CB 41.)

Increase in Capital Expenditure Limitation

$20 Million Limitation

Code § 144(a)(4)(G) provides that, for bonds issued after December 31, 2006, capital expenditures during the 6-year period of up to $10 million are disregarded for purposes of determining the aggregate face amount of the issue under § 144(a)(4)(ii).

Example 32

In 2007, Alpha Widget Company has financing needs of $12 million and made $4 million in capital expenditures during the last 3 years. Alpha can finance up to $10 million of its needs with tax-exempt Qualified Small Issue bonds. The remaining $2 million of capital expenditures cannot be financed with proceeds of tax-exempt bonds. Alpha is both within the principal limitation of $10 million and also comfortably within the $20 million aggregate face amount determination; with the ability to make additional capital expenditures of up to $4 million over the next 3 years.

Capital Expenditure Limitation Where There Is an Urban Development Action Grant

When Applicable

At the election of the issuer, the provisions of § 144(a)(4)(F) shall apply to those bonds, where at least 95 percent of the net proceeds of which, are used to provide facilities in an area where an urban development action grant (UDAG) has been made.

The application for a UDAG must be made prior to the issuance of the bonds and the UDAG funds must benefit the facility financed with the qualified small issue bonds.

Size of Issue

IRC § 144(a)(4)(F) provides that in determining the aggregate face amount of the bonds, capital expenditures in an amount not to exceed $10 million are not to be taken into account for purposes of § 144(a)(4)(ii). This subparagraph does not apply to bonds issued after December 31, 2006.

Therefore, where a UDAG has been made, the $10 million limitation on capital expenditures is increased to $20 million (with the face amount of the bond issue limited to $10 million.)

Example 33

City A issues qualified small issue bonds for Developer X's office building and makes the election under section 144(a)(4). UDAG funds have been provided for City A's parking garage which is separated from the office building by a driveway, but connected by a pedestrian bridge. Developer X will lease 550 of the 660 spaces available at the garage.

Because the financial assistance provided by the UDAG is for the direct benefit of the office building financed with the proceeds of the bonds, the $20 million capital expenditure limit is available. (See PLR 8025119.)

Special Rule for Exempt Persons

Definition

Prior to the 1986 Act, the term "exempt person," included an organization described in IRC § 501(c)(3) or a state or local government. The term "exempt person" is defined in Proposed Reg. 1.103-7(b)(2) and in § 103(b)(3).

Special Rule

Proposed Reg. 1.103-10(h)(3) states that, if an exempt person is the principal user of a facility financed with proceeds of qualified small issue bonds, the following amounts must be aggregated with the issue in determining the $1 million and $10 million limitations:

- The outstanding face amount of any prior small issue bonds used to finance a facility in the same locality of which the exempt person is the principal user,
- For purposes of the $10 million limitation, capital expenditures paid or incurred with respect to other facilities used by the exempt person as a principal user in an unrelated trade or business, as described in IRC § 513, and
- Any capital expenditures paid or incurred with respect to the facility financed with the bond issue under consideration.

Continued on next page

Special Rule for Exempt Persons, Continued

Example 34

On November 1, 1985, City A issues bonds to finance an office building for Corporation B, an organization described in IRC § 501(c)(3). More than 25 percent of the office building will be subleased to non-exempt persons. Corporation B will use more than 10 percent of the office building for administrative services. The bonds were issued as qualified small issue bonds and the election for $10 million limitation was made by City A.

The amounts that will be **included** in the determination of the aggregate face amount of the issue are:

- The face amount of the bonds,
- The outstanding face amount of any prior small issue bonds used to finance a facility in the same locality of which the exempt person is the principal user,
- Capital expenditures, of any principal user of the office building within City A over the 6-year period, paid or incurred with respect to other facilities used by the exempt person as a principal user in an unrelated trade or business, as described in IRC § 513, and
- Any capital expenditures paid or incurred with respect to the facility financed with proceeds of the bonds.

The amounts that will be **excluded** from the computation of the aggregate face amount of the issue are those expenditures made by tenants at the office building, who are not principal users, for moveable equipment or non-permanent improvements.

Loss of Tax Exemption as a Result of Capital Expenditures Exceeding the $10 Million Limitation

General Rules

If an issuer has made an election under IRC § 144(a)(4) to have the $10M limitation apply to an issue, the bonds will become taxable if the $10 million limitation is violated as a result of excessive capital expenditures.

Limitation

For capital expenditures made within 3 years after the issue date of the bonds, the bonds will cease to be treated as a qualified small issue bond on the date a capital expenditure is paid or incurred that causes the limitation to be exceeded. (See IRC § 144(a)(4)(D).)

Example 35

On June 7, 1988, County X issues $8.7 million face amount of bonds to finance a manufacturing facility to be owned by Corporation Y. Corporation Y leases the entire facility to Corporation Z for a term of 5 years. Corporation Z owns another facility in County X and incurs capital expenditures with respect to that facility in the amount of $4.5 million from April 6, 1989 to May 5, 1990.

Corporation Z is a principal user of the facility and its capital expenditures will be included in determining the $10 million limitation with respect to the bonds. If it is determined that Corporation Z's capital expenditures at its other facility exceeded $1.3 million as a result of an expenditure made on October 8, 1989, the bonds will be taxable on October 8, 1989 (assuming that all other requirements of IRC §§ 141 through 150 were met), not the date of issue of the bonds.

Note

If Corporation Z made additional capital expenditures after June 7, 1991, these expenditures would NOT be aggregated because they were made after the 3-year period following the date of the issue. (See IRC § 144(a)(4)(A)(ii)).

Section 4
$40 Million Limit

Overview

Introduction

Thus far, the text has discussed the $1 million limit on the face amount of the bonds, as well as the determination of the face amount of the issue when the election to increase that limit to $10 million is made.

The $1 million limit is determined by aggregating the outstanding principal amounts of certain prior tax-exempt issues together with the face amount of the bond to be issued.

The $10 million limit is determined by aggregating the following:

- The face amount of the bond issue in question,
- The face amount of certain outstanding prior bond issues, and
- Capital expenditures of the principal user or related persons.

Section 4 discusses the $40 million limitation which limits the amount of bonds that may be outstanding for the benefit of any test-period beneficiary (including related persons to that beneficiary) to $40 million.

The $40 million limitation is set forth in IRC § 144(a)(10).

Regulations

The $40 million limitation, test-period beneficiaries, and test periods are discussed in Treas. Reg. § 1.103-10(i) of the proposed regulations. The proposed regulations have not been finalized and may not reflect the current position of the Service.

Continued on next page

Overview, Continued

Contents

This section contains the following topics:

Introduction

Limitation

IRC § 144(a)(10) limits the amount of bonds that may be outstanding for the benefit of any test-period beneficiary (including related persons to that beneficiary) to $40 million.

Bonds to be included in the $40 million limitation include all bonds described below.

The $40 million limitation is imposed on each test-period beneficiary of the bonds.

Determination of Limit

The $40 million limit is different from the $1 million and $10 million limitations. The $40 million limit is determined on a **nationwide basis**. Exceeding the $40 million limit will generally cause the bonds to be taxable from their issue date.

The $40 million limit is calculated by including the portion of the:

- Aggregate face amount of the bond issue in question allocated to any test-period beneficiary, and
- Outstanding principal amount of certain prior private activity bonds issued by any issuer in the United States or its territories allocated to the same test-period beneficiary or a related party to that beneficiary. Prior bonds that are to be redeemed by the net proceeds of the later issue are disregarded unless they are an advance refunding issue.

Example 36

City B issued $10 million principal amount bonds for the benefit of Company Y on July 1, 1987 for a facility located in City B. On October 12, 1987, County C issued $7 million principal amount of bonds for Company Y for a facility located in County C. On January 15, 1988, City D issued $17 million principal amount of bonds for Company X for a facility located in City D. Company X and Company Y are related. Assume for purposes of this Example that Company X and Company Y meet the definition of test-period beneficiary.

In calculating the $40 million limitation, all three issues of bonds are aggregated.

Continued on next page

Introduction, Continued

Prior Bonds

The prior bonds to be included in determining the $40 million limitation are all outstanding:

- Exempt facility bonds, as described in IRC § 142,
- Qualified small issue bonds, as described in IRC § 144(a),
- Qualified redevelopment bonds, as described in IRC § 144(c), AND
- Industrial development bonds, as defined in IRC § 103(b)(2) as it was in effect prior to the 1986 Act to which § 141(a) does not apply.

(See IRC § 144(a)(10)(B)(ii).)

Outstanding Bonds

For purposes of determining the $40 million limitation, the principal amount of any prior bonds outstanding at the time of issuance of the bonds in question is included.

If the bonds in question will redeem all or a portion of any prior bonds (other than an advance refunding), the redeemed amount of the prior bonds is not included.

In the case of a bond in question or a prior bond that will be redeemed with other than tax-exempt bond proceeds, the redemption must occur as soon as is reasonably possible, but in no event, beyond 180 days after the person becomes a test-period beneficiary in order to be excluded from the computation.

Test-Period Beneficiary

Definition

IRC § 144(a)(10)(D) provides in part, that a “test-period beneficiary” is: any person who at any time during the test period for the issue is the owner or principal user of a facility financed with the proceeds of the issue, or a person related to the principal user.

Related to Principal User

In determining the test-period beneficiary of a facility, a person related to the principal user is included. A person is considered a related person to a principal user if such:

- Person is related to the principal user at any time during the test period (same relationship rules as for capital expenditure test), **and**
- User does not cease to use the facility before the persons become related.

Test Period

IRC § 144(a)(10)(D) provides that the test period is the 3-year period beginning on the later of the date:

- Of issuance of the bonds in question, OR
- The facility is placed in service.

Proposed Treas. Reg. 1.103-10(i)(3)(ii) provides that if separate facilities are financed with proceeds of bonds and each is placed in service on a different date, then there will be separate test periods for each facility.

If a single facility is placed in service in stages, then the entire facility is placed in service when the last portion of the facility is placed in service.

Placed in Service

A facility is placed in service when:

- It has reached a degree of completion which would permit its operation at substantially its design level, **AND**
- The facility is, in fact, in operation at such level.

For purposes of determining when a facility is "placed in service," the definition in Treas. Reg. § 1.150-2(c) should be applied.

Allocation of Issue to Test-Period Beneficiary

General Rule

The portion of an issue allocated to a test-period beneficiary is equal to the highest percent of use of the facility financed with the issue by the test-period beneficiary. The portion of the face amount of an issue allocated to a test-period beneficiary who is an owner, is equal to the percent of ownership of the facility financed; i.e., if a test period beneficiary of an $18M issue owns 50 percent of the facility, $9M shall be allocated to that test-period beneficiary. (See § 144(a)(10)(C).)

Example 37

An entity that owns the entire facility financed with the proceeds of an issue is allocated 100 percent of the issue.

The portion of an issue allocated to a person who is a test-period beneficiary because he is related to a principal user is the same portion allocated to such principal user.

Example 38

An entity that leases 90 percent of the facility financed with the proceeds of an issue for the first 2 years of the test period, and 35 percent for the third year, is allocated 90 percent of the issue. (See Treas. Reg. § 1.103-10(i)(4)(i).)

Multiple Allocation

The total amount of an issue allocated to test-period beneficiaries may exceed 100 percent of the outstanding face amount of the issue. For example, if one person owns the entire facility and an unrelated person leases the facility for over a year, the use is counted in each test-period beneficiary's $40 million computation. Thus, the combined percentage will be more than 100 percent.

However, if the lessee is related to the owner, the combined amount allocated on account of the facility may not exceed 100 percent of the outstanding amount of the issue for the purpose of computing the $40 million limitation.

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Example 39

Corporation X owns an undivided 50 percent of a facility while related Corporation Y is lessee of 60 percent of the facility, the portion of the issue financing the facility allocated to X is 80 percent (50 percent plus 30 percent) because one-half of the 60 percent used by Y is attributable to the portion owned by X.

In TAM 9841004, qualified small issue bonds were issued by Authority and proceeds lent to Company. At the time of issuance, Company was the sole owner and principal user of the Project. After operating the Project for some time, Company entered into an asset purchase agreement with Purchaser. Purchaser acquired all of the assets and liabilities of Project, including Company's liability under the Bonds. At the time of its purchase of Project, Purchaser was the sole principal user of a solid waste facility for which two issues of exempt facility bonds were previously issued. Authority subsequently refunded the qualified small issue bonds. After the refunding, additional exempt facility bonds were issued for the solid waste facility. Thereafter, the total amount of outstanding qualified small issue and exempt facility bonds allocated to Purchaser exceeded $40 million.

The Service ruled that (i) Purchaser was the owner of the Project at the time of issuance of the refunding bonds and, therefore, is a test-period beneficiary of the refunding bonds; (ii) all of the refunding bonds are allocable to Purchaser; (iii) the exempt facility bonds issued prior to the acquisition of Project by Purchaser are allocable to Purchaser; (iv) under 144(a)(10)(A), the refunding bonds would not qualify for the small issue exemption if the total bonds allocable to Purchaser at that time exceeded $40 million; and (v) since at the time of the refunding the aggregate outstanding amount was less than $40 million, the $40 million limitation was not violated. The additional exempt facility bonds issued after the refunding bonds were not counted as they were not in existence when the refunding bonds, the bonds being test in this TAM, were issued.

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Example 40

On October 1, 1986, City K issues an $8M issue of obligations to finance acquisition of a newly-constructed manufacturing plant owned by Corporation L. On the same date, Corporation M has $35M of prior outstanding obligations allocable to it. On the same date, L has no prior outstanding obligations allocable to itself. On April 1, 1988, M acquires 100 percent of the stock of L, which still owns the plant financed by the 1986 issue. Since M and L became related to each other during the 3-year test period of the 1986 issue and L had not ceased to use the facility, the $8 million issue is allocated to M under § 144(a)(10)(C). This allocation causes the 1986 issue to exceed the $40 million limitation of § 144(a)(10) and the interest on the issue to become taxable on and after October 1, 1986. However, if at least $3 million of the 1986 issue or of other issues allocated to M are redeemed as soon as reasonably practicable, and no later than 180 days after M's acquisition of L's stock, then the 1986 issue would not exceed the $40 million limitation. (See Proposed Treas. Reg. 1.103-10(i)(6) Example 3.)

Example 41

The facts are the same as in Example 40, except:

- The October 1, 1986 bonds were issued on January 1, 1985,
- The plant acquired with the proceeds of the issue was placed in service on January 1, 1985, AND
- M had $39 million of prior outstanding bonds allocable to it on January 1, 1991.

Because M and L became related to each other after the test period for the January 1, 1985 issue ended, M is not a test-period beneficiary, and the January 1, 1985 issue does not exceed the $40 million limitation of IRC § 144(a)(10). However, if either M or L subsequently becomes a test-period beneficiary of a later issue of obligations, then the outstanding principal amount of the January 1, 1985 issue and of the other issues allocable to M would be taken into account in applying the $40 million limitation to that issue. (See Proposed Treas. Reg. 1.103-10(i)(6) Example 4.)

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Allocation of Issue to Test-Period Beneficiary, Continued

Note

The allocation rules stated in this section are provided in Proposed Treas. Reg. 1.103-10(i)(4). The proposed regulations have not been finalized and may not necessarily reflect the position of the Service at this time.

Example 42

On September 1, 1986, City M issues $9 million principal amount of bonds to finance a shopping center that is placed in service on September 1, 1986. The shopping center is owned by Corporation X. Half of the shopping center is leased by Corporation Y for a term exceeding 1 year. Corporation X owns 60 percent of the shares of Corporation Y.

The other half of the shopping center is leased in equal amounts to Corporations A and B, two unrelated corporations. As of September 1, 1986, $30 million principal amount of prior bonds are outstanding and allocable to Corporation X as test-period beneficiary. No prior issues were allocable to Corporations Y, A or B on that date.

Because Corporation X owns the entire shopping center, 100 percent of the $9 million issue is allocable to it as a test-period beneficiary. Therefore, for purposes of determining whether the $40 million limitation for Corporation X is exceeded, the full face value of the $9 million bonds must be added to the $30 million prior bonds.

Because Corporation Y leases half of the space in the shopping center during the test-period, half of the Sept 1986 issue ($4.5 million) is allocated to Corporation Y. Although Corporations X and Y are related, the $4.5 million allocated to Corporation Y is not added to the $39 million allocated to Corporation X. This is because Corporation X already owns the entire shopping center and is allocated 100 percent of it.

Lessee Corporations A and B are each allocated 25 percent ($2.25 million) of the Sept 1986 issue. (See Proposed Treas. Reg. 1.103-10(i)(6) Example 1.)

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Example 43

Same facts as in Example 42 except that Corporation A owns a 60 percent interest in an exempt facility described in IRC § 142(a). Because of this interest, Corporation A is allocated $15 million of prior outstanding bonds for this exempt facility. In October 1986, County N issues $25 million principal amount of bonds to finance a solid waste facility to be owned by Corporation C, a wholly owned subsidiary of Corporation A.

With regard to the September 1986 issue, Corporation A is allocated $2.25 million **(see Example 42)** and the $15 million of the exempt facility issue for a total of $17.25 million. However, the $25 million solid waste bonds were issued in October 1986, a month after the September 1986 bonds and *were not outstanding on the date of issuance* of the 1986 bonds. Therefore, no amount of the October 1986 bonds allocated to Corporation A, because of its relationship with Corporation C, are included in the $40 million limitation with respect to the 1986 issue. (See IRC § 144(a)(10)(B)(i)(II).)

Due to the relationship between Corporations A and C, Corporation A is a test-period beneficiary for the October 1986 bonds.

Because, the October 1986 bonds were not small issue bonds issued under IRC § 144(a), the $40 million limitation is not applicable to the 1987 bonds.
(See Proposed Treas. Reg. 1.103-10(i)(6) Example 2.)

Section 5
Sunset Provisions/Refunding Bonds

Overview

Introduction

The TEFRA Act of 1982 provided that any small issue IDB issued after December 31, 1986 would not be a tax-exempt obligation. The Deficit Reduction Act of 1984 extended this sunset date to December 31, 1988 for small issue bonds used to finance manufacturing facilities.

The Tax Reform Act of 1986 Act further extended the sunset date to December 31, 1989 for small issues that finance a manufacturing facility or certain farm property. There were several further extensions until the Revenue and Reconciliation Act of 1993 extended the small issue exception for manufacturing facilities permanently, retroactive to June 30, 1992.

Section 5 of this lesson discusses the special rules for refunding bonds. There are different rules for refunding bonds depending on the date of issue of the refunded bonds. There is also a transitional rule regarding refunded bonds not subject to the $40 million limitation. These rules are found in the Tax Reform Act of 1986.

Contents

This section contains the following topics:

Refunded Bonds Issued Before August 16, 1986

Applicable Law

Refunding bonds issued after August 15, 1986 to refund bonds issued before August 16, 1986 must meet the requirements of:

- Sections 1313(a)(1) and 1313(a)(3) of the Tax Reform Act of 1986, AND
- Section 103(b)(6)(N) of the 1954 Code.

Section 1313(a)(1) of the 1986 Act

Section 1313(a)(1) of the 1986 Act provides the following:

- (A) The amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds, **AND**
- (B)(i) The average maturity of the refunding bonds does not exceed 120 percent of the average reasonably expected economic life of the facilities financed with the proceeds of the refunding bonds, **OR**
- (ii) The refunding bonds have a maturity date not later than 17 years after the date of issuance of the refunded bonds.

Section 1313(a)(3) of the 1986 Act

Under the transitional rules of section 1313(a)(3), the refunding bonds must meet the following requirements of the 1986 Code:

- IRC § 147(f) relating to public hearing, if the maturity date of the refunding bonds is later than the maturity date of the prior bonds
- IRC § 147(g) relating to restrictions on costs of issuance
- IRC § 148 relating to arbitrage
- IRC § 149(e) relating to information reporting
- IRC § 150(b) relating to changes in use

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Refunded Bonds Issued Before August 16, 1986, Continued

Section 103(b)(6)(N) of the 1954 Code

Section 103(b)(6)(N) of the 1954 Code provides the following to which the refunding bonds are subject:

- The average maturity date of the refunding bonds determined under § 147(b) is not later than the average maturity date of the refunded bonds.
- The amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds.
- The net proceeds of the refunding bonds are used to redeem the refunded bonds not later than 90 days after the date of issuance of the refunding bonds.

Refunded Bonds Issued After December 31, 1986

Applicable Law

If the refunded bonds were issued after December 31, 1986 and qualify under IRC § 144(a), they may be refunded in accordance with the general current refunding rules. (See § 144(a)(12).)

The refunding bonds must also meet the requirements in IRC §§ 147(f), 147(g), 148, 149(e) and 150(b).

Transitional Rule Regarding the $40 Million Limitation

Refunding Bonds

As stated above, IRC § 144(a)(10) limits the aggregate face amount of qualified small issue bonds which may be outstanding for any test-period beneficiary to $40 million.

Section 1313(c) of the TRA 1986 provides that IRC § 144(a) shall not apply to refunding bonds issued to refund bonds if the refunded bonds were not required to meet the $40 million limitation of the 1954 Code.

For the refunding bonds to qualify under the transitional rule, the following requirements must be met:

- The average maturity date (determined under § 147(b)(2)(A)) of the refunding bonds is not later than the average maturity date of the refunded bonds.
- The amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds.
- The net proceeds of the refunding bonds are used to redeem the refunded bonds not later than 90 days after the date of issuance of the refunding bonds.

Effects of Change in Law

Effective Dates

The 1986 Code limits the issuance of small issue bonds to financing manufacturing facilities and certain farm property.

Although the TRA 1986 was generally effective for bonds issued on or after August 16, 1986, the provision limiting the use of small issue bonds to finance manufacturing facilities and farm property was not effective until after December 31, 1986. (See IRC § 144(a)(12).)

Due to this effective date, the date on which the refunded bonds were issued is important in determining which rules are applicable to refunding bonds issued to refund small issue bonds.

Note: Under the 1954 Code "substantially all" (90 percent) of the proceeds of such issue is to be used for the acquisition, construction, reconstruction or improvement of land or property of a character subject to the allowance for depreciation.

Section 6
Other Rules

Overview

Introduction

Section 6 of this lesson discusses other rules that apply to qualified small issue bonds. Included here are some rules that apply only to small issue bonds issued before 1987. Also included are references to rules found in IRC §§ 146-150 that are applicable to small issue bonds.

Contents

This section contains the following topics:

Miscellaneous Restrictions Under IRC Section 144(a) for Bonds Issued Before 1987

Anti-Condo Provision

Under IRC § 144(a)(9), two or more issues, part or all of the proceeds of which are used to finance a single building, an enclosed shopping mall, or a strip of offices, stores, or warehouses using substantial common facilities shall be treated as one issue.

Residential Purposes

Under IRC § 144(a)(5), if 5 percent or more of the net proceeds of an issue are used directly or indirectly to provide residential real property, the bond does not qualify under IRC § 144(a).

Certain Facilities Restricted

Under IRC § 144(a)(8), IRC § 144(a) will not apply to an issue if:

- More than 25 percent of the net proceeds are used to provide a facility the primary purpose of which is retail food, beverage services, automobile sales or services, or recreation or entertainment, OR

- Any portion of the proceeds are used to provide a private or commercial golf course, country club, massage parlor, tennis club, skating facility, racquet sports facility, hot tub facility, suntan facility, or racetrack.

Other Applicable Private Activity Bond Rules

Applicable Rules

The following private activity bond rules are applicable to qualified small issue bonds and are described in other modules of this text.

- IRC § 146 requires that before issuance of the bonds the issuer receive volume cap allocation for the issue.
- IRC § 147(a) provides that a private activity bond will not be a qualified bond for any period where it is held by a person who is a substantial user of the facility or a related person of the substantial user.
- IRC § 147(b)(1) places a limit on the average maturity of the bonds.
- IRC § 147(c) limits the amount of bond proceeds which may be used to acquire land.
- IRC § 147(d) prohibits the acquisition of existing property unless the first use of such property is pursuant to such acquisition.
- IRC § 147(e) prohibits the use of bonds to finance certain facilities.
- IRC § 147(f) requires notice and public approval prior to the issuance of the bonds.
- The limitation of cost of issuance under IRC § 147(g).
- The arbitrage and rebate rules of IRC § 148 are applicable.
- The rules of IRC § 149 are applicable.

In addition, the requirements of IRC § 150(b)(4) regarding change of use are applicable.

Summary

Review

This lesson discussed the requirements of qualified small issue bonds under IRC § 144(a). Treas. Reg. § 1.103-10 and Proposed Treas. Reg. § 1.103-10 provide rules that also may be applicable to qualified small issue bonds. Treas. Reg. §§ 1.144-2 and 1.150-4 contain rules regarding remedial actions that are applicable to qualified small issue bonds.

Specific requirements of qualified small issue bonds are:

- At least 95 percent of the net bond proceeds must be used for qualified purposes.
- After December 31, 1986, small issue bonds may only be issued for manufacturing facilities and certain farm property. The ARRA changed the definition of manufacturing facilities for issuances after February 17, 2009 and December 31, 2010 to include intangibles.
- Qualified small issue bonds must meet two size limitations:
    - $1 million limitation on principal amount of the bonds, AND
    - $40 million limitation on outstanding bonds for a particular beneficiary.
- At the election of the issuer, the principal amount of the bonds may be increased from $1 million to an amount not to exceed $10 million, however, the $10 million limitation requires the issuer to also meet a size limitation that counts both the principal amount of the bonds and certain capital expenditures.
- The American Job Creation Act of 2004 increased the capital expenditure limitation by an additional $10 million for bonds issued after 12/31/2006.
- The Tax Reform Act of 1986 provides special rules for refunded and refunding bonds.
- Qualified small issue bonds are also subject to the rules found in IRC §§ 146 through 150, as are all qualified private activity bonds.

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