Module G

IRC § 144(a) – Qualified Small Issue Bonds

Overview

Introduction

Module G continues the text's discussion of qualified private activity bonds by focusing on qualified small issue bonds. These bonds are described in IRC § 144(a).

Although IRC § 144 also discusses qualified student loan bonds (IRC § 144(b)), they will be discussed in Module H.

Objectives

At the end of this module you will be able to:

- Define a qualified small issue bond.
- Identify a manufacturing facility.
- Identify functionally related buildings and equipment.
- Define the following terms:
  - → principal user
  - → principal owner
  - → principal lessee
  - → principal output purchaser
  - → related person
- Determine if a qualified small issue bond meets the $1M limitation.
- Determine if a qualified small issue bond meets the $10M capital expenditure limitation.
- Determine if a qualified small issue bond meets the $40M limitation.
- Describe the rules found in other sections of the Code which apply to qualified small issue bonds.

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Overview, Continued

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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 rules about remedial actions, which are applicable to qualified small issue bonds.

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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 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), small issue bonds issued after December 31, 1986, can finance only “manufacturing facilities” or land or property for first-time farmers under IRC § 147(c)(2).

Under IRC § 147(c)(2) expenditures up to $250,000 for certain farm expenditures are excluded from the limitation of the use of bonds for land acquisition. This expenditure exception is discussed later in this section.

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 reasonable 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 were used to provide these ancillary facilities. **(See IRC § 144(a)(12)(C).)**

Tests for what is manufacturing do not necessarily follow other sections of the Code or regulations. The guidelines used are:

- something built, installed, or established to facilitate manufacturing,
- the implements of fabrication, OR
- a combination of the above.

Common Characteristics

Common characteristics of a manufacturing facility are:

- Facilities must be of a character subject to allowance for depreciation.
- The property produced must be tangible personal property.
- 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.

Note

Mere assembling is not manufacturing. Putting a few parts together is not "manufacturing" under IRC § 144(a)(12). However, major assembly may be manufacturing, such as automobile plants.

Example 1

Facility engaged in the transformation of rolls of paper into paper bags is a manufacturing facility. **(See PLR 8815033.)** Mere cutting of timber into boards might not be enough.

Continued on next page

Example 2

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. **(See PLR 8934063.)** However, photocopying with finishing may not be manufacturing.

Example 4

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

An entire operation of processing, cleaning and canning food is manufacturing. For example, meatpacking is manufacturing, but a butcher shop is not.

Example 5

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

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Example 6

In TAM 199904034 Company used proceeds of bonds to purchase equipment used by Company to mine and crush limestone. In excess of 25% of the net proceeds of the bonds were allocated to bulldozers used to prepare a site for extraction of limestone and to reclaim the site once extraction is completed (see the *General Rule* on page G-8); bulldozers must be part of a core manufacturing facility for the bonds to be qualified small issue bonds. The Service ruled that based on the statute and legislative history, core manufacturing should be narrowly defined. Company's mining and rock crushing process is not a single core manufacturing facility. Additionally, even if it were a core manufacturing process, the bulldozers would not be part of either process. Bonds are not qualified small issue bonds.

Example 7

In TAM 200025004, the bond financed facility is 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.

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 bonds.

IRC §§ 144(a)(12)(C)(i) and (ii) limit these ancillary facilities to those located on the same site as the manufacturing facility. In addition, no more than 25 percent of the net proceeds of the bond issue may be used to provide these facilities.

Example 8

Corporation X uses proceeds of bonds to finance a facility that manufactures machine parts. The net proceeds of the bonds equal $7 million. Corporation X uses $1 million of the proceeds of the bonds to finance the warehouse to store raw materials and finished products that are to be shipped within 60 days of manufacture. The warehouse is directly related and ancillary facility and 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 be financed with bond proceeds. Section 144(a)(12)(C) refers to section 142(b)(2).

Section 142(b)(2) provides that office space that is *de minimis* in cost and size, and located on the premises of the financed facility may be bond financed.

Sales, payroll and marketing office space is not functionally related or subordinate to the manufacturing facility.

A separate office building is not treated as directly related and ancillary to the manufacturing facility.

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Directly Related and Ancillary, Continued

Example 9

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**
- are reasonable in size and cost.

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.

Example 10

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. **(See PLR 8815033.)** The storage spaces must be reasonable in size to the needs of the facility.

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 related and ancillary to a manufacturing facility. Such machinery is treated in the same manner as fabricating equipment within the plant.

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

Farm Property

General

IRC § 147(c) provides that no more than 25 percent of bond proceeds may be spent on land acquisitions, and no portion of the proceeds may be used for the acquisition of land for farming purposes. However, the Code provides an exception to this rule for land acquisitions by first-time farmers. (This rule applies to all qualified private activity bonds. It is discussed here because small issue bonds are more likely to be issued for farming purposes than other types of qualified private activity bonds.)

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**
- who has not received financing under this paragraph in an amount which, when added to current financing exceeds $250,000.

Other rules applicable to first-time farmers are:

- Ownership, material participation or financing by spouse or minor child is treated as ownership and material participation by the individual. 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 had previously owned farmland and had disposed of the land due to insolvency, the individual will be considered a first-time farmer.

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.

Acquisition from Related Persons

New rules for acquisition of farmland from related persons are applicable to bonds issued after August 20, 1996. **(See IRC §§ 147(c)(2)(G) and 144(a)(3).)**

Continued on next page

Limitation

There is a lifetime limit of $250,000 of bond proceeds for use by a first-time farmer. This limit does not include bond-financed land disregarded due to insolvency of the farmer.

First-time farmers may use bond proceeds to purchase new and used farm equipment, but only up to $62,500 of the $250,000 limit may be used to acquire used agricultural equipment. In addition, the used equipment must be purchased in conjunction with financing farmland**. (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, the first-time farmer 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 1996 Act also permits a first-time farmer to purchase family farming operations.

Definitions Applicable to Qualified Small Issue Bonds

Introduction

IRC § 144 uses, several other defined terms which must be understood before the rules regarding qualified small issue bonds, can be applied. 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. This 10 percent is measured according to the type of use of the facility made by the person.

A user includes a(an):

- owner,
- lessee, or
- output purchaser.

These terms are defined below.

Principal Owner

A principal owner is a person who at any time owns more than 10 percent of the facility. This interest is measured by the value of the facility.

If the facility is owned by a number of persons none of which 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 has an ownership interest in the facility if this person is an owner for federal income tax purposes.

Example 11

The fair market value of the 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, each of the partnerships is a principal owner of the facility.

Example 12

A facility having 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.

Continued on next page

Principal Lessee

A principal lessee is a person who at any time leases more than 10 percent of the facility. The portion leased by a person is generally determined on the basis of the fair rental value of the facility.

Example 13

In TAM 8838003 the Service ruled that a sublessor is a principal user of the bond-financed facility. In 1980, $4.6 million of bonds were issued for partnership's medical office building. Up to a third of the space is leased to an HMO, although most of its space is occupied by an entity, X, that provides medical services to HMO customers, leaving only seven percent of space for HMO. Partnerships, that are related persons to partnership, own other office buildings in town and have incurred capital expenditures during the six-year period, including for-tenant improvements. Tenants have also made improvements that have been affixed to the buildings. The Service made the following conclusions:

(a) The argument that there can be only one principal user, under section 103(b)(6)(E), is rejected (among other reasons, "use of the article 'the' to modify the term 'principal user' in section 103(b)(6) of the 1954 Code should not be given much weight, because that term is modified by the article 'a' in section 103(b)(15)(D)");

(b) 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;

(c) Partnership's payments for improvements to space leased to section 501(c)(3) tenant are capital expenditures, as are payments by the tenant for improvements affixed to the building;

(d) Partnership's payments for non-affixed tenant equipment are capital expenditures;

(e) Payments to remodel space vacated by a bankrupt tenant and to enlarge drainage culvert to handle unexpectedly large flow are excludable, under section 103(b)(6)(F), if financed otherwise than out of bond proceeds.

As $10 million limit of section 103(b)(6)(D) was exceeded January 1, 1983, interest accrued on or after that date will not be excludable.

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Example 14

In GCM 36021 the Service stated that a lessee under a one-year lease is a principal user. Corporation X is the equitable owner and sole user of a department store financed by county M's bonds. Corporation Y leased a warehouse, located in M, to X for one year. Since X is the principal user of both the department store and the warehouse and since both facilities are located in the same county, capital expenditure on the warehouse must be taken into account in determining whether the capital expenditure limit, set forth in section 103(c)(6)(D), has been exceeded.

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 one-year period beginning with the date the facility is placed in service, is NOT a principal output purchaser.

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Definitions Applicable to Qualified Small Issue Bonds,
Continued

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:

- blood relatives,
- grantors,
- fiduciaries and beneficiaries of trusts,
- fiduciaries of a corporation,
- persons controlling a corporation,
- the controlled corporation,
- 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.

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Definitions Applicable to Qualified Small Issue Bonds,
Continued

Example 15

City X issues qualified small issue bonds in 1992 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

$1 Million Limitation on Principal Amount of Bonds

Overview

Introduction

In addition to having a qualifying use of bond proceeds, as discussed above under IRC § 144(a)(1), the face amount of a qualified small issue bond may not exceed $1 million. Section 2 discusses the rules relating to this limit.

Under certain circumstances, this $1 million limitation may be increased to $10 million. The $10 million limit is discussed in Section 3.

The statute also limits the aggregate principal amount of qualified small issue bonds, which may be outstanding nationwide for a particular beneficiary to $40 million. This $40 million limit is discussed in Section 4.

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Aggregation Rules

General Rules

To determine whether a bond issue meets the $1 million limitation, outstanding principal amounts of some prior issues are aggregated with the face amount of the bond issue in question.

The rules regarding which prior issues must be included are stated in IRC § 144(a)(2).

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:

- the proceeds were used with respect to facilities located in the same incorporated municipality, or the same unincorporated area of a county as the facilities financed with the issue in question, **AND**
- the principal users of the facilities financed with the prior issue and the bond issue in question are the same person or related persons.

Incorporated Municipality and Counties

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

Towns and townships which are separate municipal corporations under state law and which have substantial governmental powers are treated as incorporated municipalities.

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Example 16

On July 1, 1974, County M issued bonds with a face amount of $2,000,000 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, 1974, Corporation X requests City P, an incorporated municipality located entirely within County M, to issue bonds in the face amount of $1,500,000 to finance the construction of factory 2. Factory 2 will not be contiguous to or integrated factory 1. X will be the sole user of factory 1. X proposes that P issue the bonds on August 1, 1975, but prior to the issuance of the bonds, P negotiate with M for the annexation of the factory 2 site. The purpose for consummating the annexation would be to reduce the possibility of exceeding the $5,000,000 limitation set forth in section 103(c)(6)(D) of the Code. All of the legal processes for annexing land will, however, be complied with. The annexed area is to remain a part of P indefinitely. P will also bear all of the burdens (such as taxation) and enjoy all of the benefits (such as police and fire protection) of other parts of P.

The Service ruled that the two bond issues need not be aggregated, by either political jurisdiction, even though City before issuing its bonds annexed its construction site land from the County as long as the land remains annexed to the City and bears the burdens and benefits of the City. See **Rev. Rul. 75-333, 1975-2 CB 40.**

Continued on next page

Aggregation Rules, Continued

Contiguous or Integrated Facility

Any facility, which is physically located outside an incorporated municipality or outside a county, but is contiguous to, or integrated, with the facility is treated as being located in each jurisdiction.

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.

Example 17

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 18

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 must be in proximity **AND** be functionally related.

Composite Issues

Definition

The $1M limitation is applied to each "issue" of qualified small issue bonds. Treas. Reg. § 1.150-1T(c) provides the definition of "an issue." This definition is applicable to bonds issued after June 30, 1993 and is applicable 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 are:

- sold at substantially the same time (within 15 days of each other),
- sold under a common plan of financing, determined by taking into account the purpose of the bonds and the structure of the financing, **AND**
- reasonably expected to be paid from the same source of funds, determined without regard to guarantees from unrelated third parties.

Example 19

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

See Rev. Rul. 81-216 1981-2 CB 21.

Prior Law

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

- the obligations were sold at substantially the same time (generally 30 days apart),
- 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.

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Composite Issues, Continued

Example 20

Twenty cities and counties in the same state, on September 15, 1989, 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, the bonds are aggregated, thus violating the $1 million limitation, and causing the bonds to be taxable.

Section 3

$10 Million Capital Expenditure Limitation

Overview

Introduction

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. This election is permitted by IRC § 144(a)(4).

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.

Note that the aggregation rules regarding location of the facilities, contiguous or integrated facilities, and composite issues applicable to $1 million limitation are applicable to the $10 million 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.
- It can be made on the books and records of the issuer, such as in the bond resolution or the arbitrage certificate.
- It should also be properly reflected on form 8038.
- 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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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 face amount of the bond issue in question,
- the face amount of all issued AND OUTSTANDING prior bond issues, **AND**
- certain capital expenditures of the principal user or related persons.

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

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

Outstanding Issues

To be included, the proceeds of the prior issue must have been used with respect to facilities the principal user of which is the same as the principal user (or a related person) of the facilities financed with the bond issue in question.

Example 21

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.) In addition, in 1985, Corporation Y spent $875,000 of its own money on capital expenditures on the facility financed with proceeds of the 1982 bonds. At the time of the examination, no other capital expenditures had been undertaken by Corporations X or Y.

To determine the aggregate face amount of the bonds for purposes of the $10 million capital expenditure rule, the agent would include:

- $3.4 million outstanding 1982 bonds,
- $875,000 capital expenditures, AND,
- $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.

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Example 22

City X issues qualified small issue bonds in 1992 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 51 percent interest in each partnership.

City X issues a second series of qualified small issue bonds in 1994. In each of the following scenarios, assume that the facilities financed with the 1992 and 1994 issues are located in the same incorporated municipality and that the issuer validly elects the $10M limitation.

Scenario 1: City X loans the proceeds of the 1994 bonds to Partnership Y. Because Partnership Y is the owner of the facility financed with the 1992 bonds, 100 percent of the outstanding face amount of the 1992 bonds will be included with the face amount of the 1994 bonds for purposes of computing the $10 million limitation related to Partnership Y.

Scenario 2: City X loans all of the proceeds of the 1994 bonds to Company A. Because Company A leased 75 percent of the facility financed with the proceeds of the 1992 bonds, 75 percent of the face amount of the 1992 bonds will be included with the face amount of the 1994 bonds in computing the $10 million limitation related to Company A.

Scenario 3: City X loans all of the proceeds of the 1994 bonds to Partnership B. Recall that Partnership B subleases half of the facility financed with the proceeds of the 1992 bonds from Company A (which leases 75 percent of the facility). Therefore, 37½ percent of the face amount of the 1992 bonds will be included with the face amount of the 1994 bonds in computing the $10 million limitation related to Partnership B.

However, Partnership Y and Partnership B have the same general partner which owns 51 percent interest in each partnership. Therefore, partnership Y's 100 percent of the outstanding face amount of the 1992 bonds are attributable to Partnership B, and used (in lieu of Partnership B’s 37 ½ percent) toward the computation of the $10 million limitation related to Partnership B.

Includable Capital Expenditures

General

In addition to prior 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 principal amount of the issue meets the $10 million limitation.

Certain expenditures which may also be included are:

- capital expenditures for intangibles not subject to allowance for depreciation, such as goodwill, covenants not to compete, and construction interest and taxes that must be capitalized under other Code provisions,
- certain capital expenditures of a state or local government, AND
- certain equipment purchased pursuant to a sale and leaseback agreement.

All of these types of expenditures are discussed below.

The aggregation rules regarding location of the facilities, contiguous or integrated facilities, AND composite issues applicable to the $1 million limit are also applicable to the $10 million capital expenditure limitation.

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

Time period

Capital expenditures included are those paid or incurred by the principal user of the facility with moneys other than proceeds of prior small issue bonds during a six-year period. This six-year period BEGINS three years BEFORE the date of issuance of the bonds (current issue), and ENDS three years AFTER the date of issuance of the bonds (current issue).

Example 23

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 six-year period exceeded $10 million.

Continued on next page

Location

Capital expenditures include those of the principal user (or a related person) for all of the facilities, for which it is a principal user, which are 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.

Example 24

On September 13, 1992, City B issues $7.6 million face amount of bonds and loans the proceeds to Partnership XYZ. Partnership XYZ 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 three-year period before the date of issuance of the bonds.

Example 25

County X issues $9.5 million principal 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. Corporation Y incurs $750,000 of expenditures for research and experimental activities in City B, an incorporated municipality located in County X. During the three-year period before the issuance of the bonds, Corporation Y created a product in its facility in City B to be used in the bond-financed facility in County X. The cost of the research will count as a capital expenditure for purposes of the $10 million limitation. (See Rev. Rul. 85-142, 1985-2 CB 35.)

Continued on next page

Example 26

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 three- year period following the date of issuance of the bonds had ended. (See Rev. Rul. 83-18, 1983-1 CB 28.)

See Treas. Reg. § 1.103-10(b)(2)(ii)(d).

Intangibles

Purchase of goodwill made within the six-year period, counts as capital expenditure for purposes of $10 million limitation. (See Rev. Rul. 81-56, 1981-1 CB 53.) Goodwill is not likely to be financed with proceeds of small issue bonds since it is not a depreciable item.

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

The intangibles must be:

- used in connection with the facility financed with the proceeds of the bonds, and/or
- attributable to a business enterprise located in the same jurisdiction as the facility financed by the bonds.

Continued on next page

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 a principal user or related person.) These are determined without regard to any other rule in the Code that permits expenditures properly chargeable to the capital account to be treated as current expenses.

If a state or local government incurs capital expenditures that principally benefit the facility financed with proceeds of small issue bonds, those capital expenditures are included in the $10 million limitation. Such expenditures are roads or drainage pipes that principally benefit the facility.

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.

See Treas. Reg. § 1.103-10(b)(2)(e).

Sale and Leaseback Arrangements

Leased equipment is not included as a capital expenditure if it is the type ordinarily leased. If equipment is purchased pursuant to a sale and leaseback agreement, and the purchase is within the six-year period, the equipment is included in the capital expenditure computation.

Continued on next page

Example 27

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 28

Assume in Example 1 that Partnership XYZ purchases the equipment from an unrelated party within the six-year period. After the purchase, Partnership XYZ sells the equipment to Corporation M, an unrelated party, and leases the equipment back from Corporation M. The $2 million cost of the equipment is capital expenditure for Partnership XYZ because it purchased the equipment within the six-year period. This amount is included in the $10 million limitation. (See Rev. Rul. 79-248, 1979-2 CB 41.)

Note

For purposes of the above examples, the bonds do not necessarily become taxable from the date of their issuance. See "Loss of Tax Exemption as a Result of Exceeding the $10 Million Capital Expenditure Limitation", later in this section to determine the date on which the bonds become taxable.

Excludable 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,
- expenditures incurred due to a change in Federal, state or local law occurring after the date of issuance of the bonds, AND
- expenditures made as a result of mistake of fact or law or required as a result of circumstances unforeseen on the date of issuance of the bonds. This expenditure is limited to $1 million.

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 are issued to construct a facility. After the site work started, the engineers found an underground spring so that the method of construction initially planned could not be used. Additional capital expenditures not to exceed $1 million can be incurred to correct this unforeseen circumstance.

Example 30

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

Capital Expenditure Limitation Where There Is an Urban Development Action Grant

When Applicable

At least 95 percent of net proceeds of bonds for which an election under IRC § 144(a)(4) has been made are used to provide facilities in an area where an urban development action grant (UDAG) has been made.

The UDAG funds must benefit the facility financed with the qualified small issue bonds.

The UDAG must be applied for prior to the issuance of the 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.

Therefore, where UDAG funds are available, 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 31

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 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.)

Example 32

City A issued small issue bonds for Company B and made an election under 144(a)(4). Company B wanted to make additional capital expenditures which would cause it to exceed the $10 million capital limitation. Company B wanted to apply for UDAG after the issuance of the bonds so that an additional $10 million of capital expenditures could be excluded. PLR 8606048 states that because UDAG was applied for after the bonds were issued, the additional $10 million capital expenditure limitation was not applicable.

Operating Rules

General

A person is treated as owning or using the facility to the extent that any person related to it owns or uses the facility.

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

(See Example 33 below.)

A principal user of a facility ceases to use the facility when it ceases to own, lease, purchase the output of, or otherwise use the facility.

A principal user who ceases to use a facility continues to be the principal user for the period it used the facility.

Example 33

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 two years. Corporation Y is also a principal user of the facility. In April 1987, Corporation Y makes $1.5 million 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 $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.

Special Rule for Exempt Persons

Definition

Prior to the 1986 Act, the term "exempt person," as used by the statute and regulations included an organization described in IRC § 501(c)(3) or a state or local government.

The term "exempt person" is no longer used by the Code sections dealing with tax-exempt bonds and the related regulations.

Special Rule

If an exempt person is the principal user of a facility financed with proceeds of qualified small issue bonds, the following amounts should be included 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 in question.

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** for the $10 million capital expenditure calculations will be:

- The face amount of the bonds,
- Capital expenditures of any principal user of the office building within City A over the six-year period. The principal user is any person who rents more than 10 percent of the fair market value rental of the office building, and
- Capital expenditures by any tenant of Corporation B for permanent improvement of the office building.

Continued on next page

Special Rule for Exempt Persons, Continued

Example 34 (continued)

The amounts that will be **excluded** for the $10 million capital expenditure calculation will be 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 date of the current issue, the bonds will not be treated as taxable bonds before the date on which the expenditure is paid or incurred. (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 five years. Corporation Z owns another facility in County X and incurs capital expenditures on 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 1988 issue. The agent must determine the date on which Corporation Z's capital expenditures at its other facility exceeded $1.3 million. If that date was
October 8, 1989, and assuming that all other requirements of IRC §§ 141 through 150 were met, the 1988 issue will be taxable only after October 8, 1989.

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 Limitation

Overview

Introduction

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

The $1 million limit is determined by aggregating the principal amounts of some prior issues together with the face amount of the bond issue in question.

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

- face amount of bond issue in question,
- 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 beneficiary, and test period 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.

Content

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Allocation of Issue to Test-Period Beneficiary	G-41

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
- the portion of the outstanding principal amount of 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.

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 have the same shareholders. 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 of the three issues of bonds are aggregated.

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Prior Bonds

The prior bonds 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.

See section 144(a)(10)(B)(ii).

Outstanding Bonds

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

If the bonds in question will redeem all or a portion of prior bonds, the redeemed amount of the prior bonds is not included. Thus, the outstanding principal amount of the prior bonds does not include the face amount that has been discharged. The redemption must occur within 180 days. See section 144(a)(10)(B)(i).

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 any time during the test period (same relationship rules as for capital expenditure test), **and**
- such 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 three-year period beginning on the later of:

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

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.

Example 37

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

Example 38

An entity that leases 90 percent of the facility financed with the proceeds of an issue for the first two 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 amount of the issue. For example, one person owns the entire facility and an unrelated person leases the facility for over a year.

The issue is counted in each test-period beneficiary's $40 million computation. 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 mount of the issue for the purpose of computing the $40 million limitation.

Bonds Redeemed When a Person Becomes a Test-Period Beneficiary

If all or a portion of the outstanding principal amount of bonds of the issue in question are redeemed either before or as soon as reasonably practicable after a person becomes a test-period beneficiary, then the redeemed amounts are not allocated to this person for purposes of determining the $40 million limitation.

The redeemed amounts are excluded from the calculation of the $40 million limitation if the bonds were:

- not redeemed with proceeds of other tax-exempt bonds, AND
- redeemed no more than 180 days after the person becomes a test-period beneficiary.

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Bonds Redeemed When a Person Becomes a Test-Period Beneficiary (continued)

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 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 had previously been 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 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) the refunding bonds would not be exempt 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.

Example 39

On October 1, 1992, City K issues an $8M issue of obligations to finance acquisition of a newly-constructed manufacturing plant owned by Corporation L ("L"). On the same date, Corporation M ("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, 1994, M acquires 100 percent of the stock of L, which still owns the plant financed by the 1992 issue. Since M and L became related to each other during the 3-year test period of the 1992 issue and L had not ceased to use the facility, the $8 million issue is allocated to M under IRC § 144(a)(10)(C). This allocation causes the 1992 issue to exceed the $40 million limitation of IRC § 144(a)(10) and the interest on the issue to become taxable on and after October 1, 1992. However, if at least $3 million of the 1992 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 1992 issue would not exceed the $40 million limitation.

Continued on next page

Example 40

The facts are the same as in Example 1, except:

- the October 1, 1992 bonds were issued on January 1, 1991,
- the plant acquired with the proceeds of the issue was placed in service on January 1, 1991, 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, 1991 issue ended, M is not a test-period beneficiary, and the January 1, 1991 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, 1991 issue and of the other issues allocable to M would be taken into account in applying the $40 million limitation to that issue.

Note

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

Example 41

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 one 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 in 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.

Continued on next page

Example 41 (continued)

Because Corporation Y leases half of the space in the shopping center during the test-period, half of the 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.

Corporations A and B are each allocated 25 percent ($2.25 million) of the 1986 issue.

Example 42

Same facts as in Example 41 except that Corporation A owns 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 1987, 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 1986 issue, Corporation A is allocated $2.25 million (see Example 41) 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 after the 1986 bonds and were not outstanding on the date of issuance of the 1986 bonds. Therefore, no amount of the 1987 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 1987 bonds and will be allocated those bonds. Because, the 1987 bonds were not small issue bonds issued under IRC § 144(a), the $40 million limitation is not applicable to the 1987 bonds.

Continued on next page

Example 43 On September 1, 1985, City M issues $9 million principal amount of bonds to finance a shopping center that is placed in service on September 1, 1985. The shopping center is owned by Corporation X. On September 1, 1985, Corporation X owns 100 percent of the shares of Corporation Y.

Half of the shopping center is leased in equal amounts to Corporations A and B, two unrelated corporations. As of September 1, 1985, $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 bond must be added to the $30 million of prior bonds.

On October 15, 1987 City N issues $8 million principal amount of bonds and loans the proceeds to Corporation Y. The entire $9 million 1985 issue is allocable to Corporation Y and is added to the $8 million face amount of the 1987 issue in calculating the $40 million limitation for Corporation Y.

Because at the time of the issuance of the 1987 bonds, Corporations X and Y were related parties, the entire $8 million 1987 issue is allocable to Corporation X. This amount is then added to the $9 million 1985 issue and the $30 million prior issue in calculating the $40 million limitation for Corporation X. The $40 million limitation is exceeded by Corporation X.

Corporations A and B are each allocated 25 percent ($2.25 million) of the 1985 issue. This allocation is includible in computing the $40 million limitation for Corporations A and B in connection with any qualified small issue bonds for which they may be the test-period beneficiaries.

Section 5

Refunding Bonds

Overview

Introduction

Section 5 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.

Content

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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), 1313(a)(3) of the 1986 Act, 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, **<u>OR</u>**
(b)(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

Section 1313(a)(3) of the 1986 Act provides the following:

- Requirements of 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.
- Requirements of section 147(g) relating to restrictions on costs of issuance.
- Requirements of section 148 relating to arbitrage.
- Requirements of IRC § 149(e) relating to information reporting.
- Requirements of IRC § 150(b) relating to changes in use.

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

Section 103(b)(6)(N) of the 1954 Code provides the following:

- The average maturity date 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.

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.

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 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

As discussed in this module, the 1986 Internal Revenue 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 and 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, in determining which rules are applicable to refunding bonds issued to refund small issue bonds, the date on which the refunded bonds were issued is important.

Section 6

Other Rules

Overview

Introduction

Section 6 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.

Content

This section contains the following topics:

Topic	See Page
Overview	G-51
Miscellaneous Restrictions Under IRC § 144(a) for Bonds Issued Before 1987	G-52
Other Applicable Private Activity Bond Rules	G-53

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

Anti-Condo Provision

Under IRC § 144(a)(9), two or more issues, the proceeds of which are used to finance a single building, enclosed shopping mall, etc., shall be treated as one issue.

Residential Purposes

Under IRC § 144(a)(5), if 5 percent or more of the net proceeds of a qualified small issue bond 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.

Note

After December 31, 1986, qualified small issue bonds can only be used to finance manufacturing facilities and certain farm property. Thus, in audits of bonds issued after December 31, 1986, the agents should focus on whether the financed facility meets the requirements under section 144(a)(12).

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.

Section 7

Auditing Techniques

Overview

Introduction

Section 7 contains some techniques to help you determine if the issue meets the size limitations. It also contains three exhibits that will help you to examine qualified small issue bonds. The documents presented are not comprehensive, and you may encounter situations that are not covered here.

Content

This section contains the following topics and exhibits:

Topic	See Page
Overview	G-54
Size Limitations	G-55
Exhibit 1: *Small Issue Guidelines*	G-57
Exhibit 2: *Audit Plan*	G-61

Size Limitations

IRC 144(a) Small Issue Bond $10 Million Limit

The first step, if the issuer has made the proper election, is to determine if the $10 million limitation on capital expenditures is violated. Consider the conduit borrower and its related entities over a six-year period.

Review the conduit borrower's books and records such as:

- Depreciation schedule
- Intangible assets
- Capitalized interest
- Capital assets transferred in from other locations
- Items expensed that should or could be capitalized
- Leases

Example 45

You are working with the conduit borrower and ask them to prepare a schedule of all the capital expenditures for the applicable six-year period requirement. Information received from the examination division (an examination of the conduit borrower had previously been conducted) disclosed the existence of goodwill. The examination division also provided you with a dollar amount for the goodwill. The schedule provided by the conduit borrower came to the maximum of $10 million, but did not contain any amounts for intangible assets.

- Goodwill must be included in the calculations of the $10 million limitation.
- These bonds are possibly taxable, as of the date they exceeded the $10 million limitation.

IRC § 144(a) Small Issue Bond $40 Million Limit

The next step is to determine if the $40 million aggregate limitation of all the bonds held by the conduit borrower and its related entities over a three year period is violated.

Review the conduit borrower's books and records such as:

- Liability schedule
- CPA annual report

Request a listing of all issued and outstanding bonds from all related entities.

Small Issue Guidelines

Step	Action
1	Determine if issuer is a qualified issuer.
2	Determine if the issue is a refunding or a new money issue.

3	If it is a new money issue:
	• Determine the facilities financed with the small issue.
	• Determine if the facilities are qualified facilities to be financed with a small issue bond.
	• Determine if 95 percent of the proceeds of the issue were used for the project or for refunding.
	• Determine the principal user(s) of the facility.
	• Identify any related parties of the principal user(s).
	• Identify any other bond financed facilities of the principal user(s) or related parties in the same incorporated municipality or same county.
	• Determine the type of bond used to finance the other facilities:
	    • small issue,
	    • exempt facility,
	    • redevelopment bond, or
	    • IDB issued under the 1954 Code to which section 141(a) does not apply.

4	Determine if the bond meets the $1 million limitation:
	• Aggregate the face amount of the issue under examination with:
	    • the face amount of outstanding prior small issues used to finance facilities located within the same incorporated municipality or county, and
	    • which have the same principal users (or related party) as the facility financed with the issue under examination.

5	Determine if the issuer has made a proper election to substitute $10 million for the $1 million limitation. **(See Treas. Reg. § 1.103-10(b)(2)(vi)).** If so:
	• Aggregate the face amount of the small issue by adding:
	    • the amount determined under Step 4 above,
	    • the aggregate amount of capital expenditures with respect to the same facilities that were paid or incurred during the 6-year period beginning 3 years before the issuance date and ending 3 years thereafter.
	• Ignore up to $10 million of capital expenditures on any facility financed with the net proceeds of a small issue that also benefited from an urban development action grant.

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IRC § 144(a) Small Issue Bond $40 Million Limit (continued)

Step	Action

6	Determine if the issue meets the $40 million limitation:
	• Identify the test-period beneficiaries of the small issue-financed facility during the 3-year period beginning the later of:
	    • the date the facilities were placed in service, or
	    • the issuance date of the bonds.
	• Determine if the test-period beneficiaries were owners or users of other facilities financed with "tax-exempt facility related bonds."
	• Determine if any of the tax-exempt facility related bonds were outstanding at the time of the issuance of the small issue.
	• Determine the aggregate face amount of the outstanding tax-exempt facility related bonds allocated to a test period beneficiary by finding the proportionate amount of the outstanding tax-exempt facility related bonds allocated to each test-period beneficiary.
	• Determine if the sum of the following exceeds $40 million:
	    • aggregate face amount of the small issue, and
	    • the aggregate face amount of the facility-related bonds allocated to a test period beneficiary.

7	If the bond is a refunding: • Determine if net proceeds were used to redeem part or all of a prior issue which was used for the acquisition, construction, reconstruction of land or depreciable property. • Determine if the net proceeds of refunding bonds were used to redeem refunded bonds not later than 90 days after the date of issuance. • Determine if the average maturity date of the refunding bond is no later than the average maturity date of the refunded bond. • Determine if the amount of the refunding bond is greater than the outstanding amount of refunded bonds.
8	Determine if the average maturity of the bonds exceeds 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds (section 147(b)).
9	Determine if the issue complies with the arbitrage restrictions and rebate requirements of IRC § 148.

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IRC § 144(a) Small Issue Bond $40 Million Limit (continued)

Step	Action
10	Determine if the issue is in compliance with the applicable requirements of IRC § 146, 147, and 149.
11	Review depreciation schedules to verify that the straight-line method of depreciation was used for assets purchased with tax-exempt bond proceeds

IRC § 144(a) Qualified Small Issue Bond Audit Plan

Initial Items

1. Review key bond transcript documents:
    - official statement,
    - trust agreement between issuer and bond trustee,
    - loan or lease agreement between issuer and conduit borrower,
    - non-arbitrage certificate,
    - Form 8038.

2. What is the current status of the bonds?
    - Are they still outstanding?
    - Has there been a refunding?

3. Tour of facilities financed with bond proceeds:
    - Has purpose of bond issue been fulfilled?
    - Who is the principal user of the facility?
    - Related organization?
    - Change in use?
    - Sale of facility?
    - The facility must be a manufacturing facility for bonds issued after 12/31/86.

4. Review lease agreements involving outside parties.

5. Review independent audit reports and financial statements of conduit borrower to gain insight into:
    - operations and information concerning capital expenditures,
    - lease agreements,
    - items that were expensed rather than capitalized, AND
    - related organizations.

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Requirements of IRC § 144(a) Qualified Small Issue Bonds

1. Qualified Election for Bond Issue Over $1 Million - IRC § 144(a)(4): If bonds issued were over $1 million, a proper election should have been made by the issuer (city, state, or county). The issuer should make the election at or before the time of issuance of the bonds on its books or records. The term "books or records" includes bond resolution, bond transcript, or other bond-related documents. If the issuer fails to make this election, interest will be includable in gross income.

2. Confirm Expenditure of Bond Proceeds: 95 percent of net bond proceeds must be used for:
   - acquisition, construction, reconstruction, or improvement of land, or property subject to depreciation, OR
   - to redeem part or all of a prior bond issue which was issued for purposes described above.

Review trustee monthly statements and backup documentation related to disbursement of bond proceeds. Are there any unspent proceeds?

3. $10 Million Spending Limitation:
   - Analyze other capital expenditures with other than bond proceeds for period three years prior to and after the date of bond issue. **Include** capitalized interest, covenant not to complete, goodwill, capital leases, sale-leasebacks, expensed assets, bond issuance costs, and any equipment that was purchased in other jurisdictions and moved to the facility. **Exclude** casualty replacement costs, any capital expenditure required by change in federal, state or local law, and unforeseen circumstances (less than $1 million in expenditures.)
   - Inquire about any prior qualified small issue bonds. If applicable, determine face amount outstanding.
   - Inquire about any related or integrated facilities within the same city or county as the bond-financed facility. If facilities exist, determine capital expenditures over six-year period (three years prior to and three years after date of issue.)

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Requirements of IRC § 144(a) Qualified Small Issue Bonds, (*continued)*

- If totals of items 2+3a+3b OR 2+3a+3b+3c exceed $10 million over the six-year period, bonds do NOT qualify for tax-exempt status. Bonds would lose tax-exempt status on date the limitation is exceeded (IRC § 144(a)(4)(D)). Interest would not be deductible for any period that the bond is not a qualified small issue bond (IRC § 150(b)(6)).

4. $40 Million Aggregate Limit Per Taxpayer (IRC § 144(a)(10): If possible, inquire about any related organizations that have similar tax-exempt bond financing in other cities or states. If total exceeds $40 Million beginning on the later of the date facilities were placed in service or date of issue, the bonds do NOT qualify for tax-exempt status.

IRC § 147 Other Private Activity Bond Requirements

1. Average maturity of bonds issued cannot exceed 120 percent of average reasonably expected economic life of facility financed with net proceeds - IRC § 147(b): Where maturity date of bonds significantly exceeds economic life of facility being financed, overfunding of facility may have occurred.

2. Public approval - IRC § 147(f): This section requires public approval of qualified private activity bonds either by "applicable elected representative" after a public hearing or by voter referendum. The governmental unit that must obtain approval is the issuing unit or unit on whose behalf bonds will be issued. Applies to bonds issued after 12/31/86. No approval is necessary for refunding bonds unless advance refunding bonds or maturity date of refunding bond is later than maturity date of bond to be refunded.

3. Bond Issuance Costs - IRC § 147(g): Bond issuance costs cannot exceed 2 percent of proceeds. Bond issuance costs include underwriter's spread, bond counsel fees, underwriter's counsel fees, borrower's counsel, financial advisor on bonds, rating agency, and trustee fees.

Continued on next page

IRC § 148
Arbitrage

1. Were bond proceeds invested at a materially higher yield? If yes, does some rule permit it?
   - Temporary period - six months.
   - Reasonably required reserve or replacement fund (4R Fund) - may not exceed 10 percent of proceeds.
   - Minor portion - less of five percent of proceeds or $100,000?

2. Rebate Calculation: Rebate should be computed every five years after date of issue. Rebate is paid on Form 8038-T.

Summary

Review of Module G

Module G discussed the requirements of qualified small issue bonds under IRC § 144(a). 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.
- 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.
- 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.

Preview of Module H

Module H continues the text's discussion of qualified private activity bonds by discussing qualified student loan bonds and qualified scholarship funding bonds.

Exercises

Exercise 1

County B issues $8.4 million principal amount of bonds and loans the proceeds to Corporation X to acquire and construct a manufacturing facility. Corporation X agrees to purchase certain equipment from an unrelated party at a cost of $6 million. Corporation X makes a $3.1 million down payment on this equipment (from Corporation X's own funds). The equipment is being especially manufactured for Corporation X. When it discovers that the purchase would cause the $10 million capital expenditure limitation to be exceeded, Corporation X cancels the order. Corporation X then enters into a contract with Leasing Company, for Leasing Company to purchase the same equipment and to lease it to Corporation X. Leasing Company refunds the $3.1 million to Corporation X, purchases the equipment, and leases it to Corporation X.

Should the $3.1 million be included as capital expenditure in calculating the $10 million limitation?

Exercise 2

On May 15, 1995, County A issues $9 million principal amount of bonds and loans the proceeds to Corporation Y to acquire and construct a manufacturing facility. Prior to completion of construction of the new facility, Corporation Y has been leasing most of the space in an unrelated third party's building located in County Y. On August 17, 1995, while Corporation Y is still in the building, the owner installs a new air conditioning system at a cost of $1.5 million.

Is the cost of the air conditioning included in the $10 million capital expenditure limitation? **(See Rev. Rul. 85-145)**

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Exercises, Continued

Exercise 3

City B issues $6 million principal amount of small issue bonds on April 5, 1989, and loans the proceeds to Company Y. On January 26, 1989, Company Y incurred certain capital expenditures from moneys other than bond proceeds in an amount equal to $3.75 million. In October 1990, City B agrees to construct a parking garage adjacent to the facility financed with the bond proceeds solely for the use of the employees of Company Y. The cost of constructing the parking garage is $745,000.

Is the $745,000 properly chargeable to the capital account of Company Y for purposes of the $10 million capital expenditure limitation?

Exercise 4

On May 15, 1989, County X issues $4.5 million principal amount of small issue bonds and loans the proceeds to Partnership A for Facility 1 located in County X. On July 29, 1989, City Z issues $3.7 million principal amount of small issue bonds and loans the proceeds to Partnership A for Facility 2 located in City Z. The two Facilities are 10 miles apart. However, Facility 1 produces materials that are essential for use in Facility 2. On June 15, 1992, City Z issues $6.1 million principal amount of bonds for Partnership A for Facility 3 located in City Z. Partnership A had incurred $5.75 million principal amount of capital expenditures for Facility 1 between November 11, 1990 and on January 6, 1991.

Are the facilities integrated facilities?

Are any of the bond issues taxable due to exceeding the $10 million capital expenditure limitation?

Continued on next page

Exercise 5

Assume in Exercise 4 that Facilities 1 and 2 were less than half-a-mile from each other and Facility 3 is more than five miles from the Facility 1 and two miles from Facility 2 but produces raw materials essential to both Facilities.

Are any of the bond issues taxable due to exceeding the $10 million capital expenditure limitation?

Exercise 6

State X issues 40 separate issues at the principal amount of $1 million each and sells the issues using one offering document. Each bond issue has its own indenture but bears the same interest rate. All of the bonds are purchased by the same investor.

Are the 40 bond issues taxable?

Exercise 7

County Y issues 12 separate series of $1 million bonds. The proceeds are loaned to 12 separate corporations. Each corporation purchases a floor in a 12-story building. Corporations use the space to conduct manufacturing processes. No corporation will use the floor of the other corporation. Each bond issue is payable only from the revenues of the corporation that borrowed the proceeds of the issue. The corporations are not related persons.

Are the 12 bond issues taxable?

Continued on next page

Exercises, Continued

Exercise 8

County Y and County Z each issue $1 million face amount of bonds on the same date. The proceeds are loaned to unrelated corporations for financing manufacturing facilities. The bonds bear substantially the same interest rates and are marketed by the same offering document. Bank X has provided letters of credit for each issue and the letters of credit have the same terms.

Are the two issues of bonds taxable?

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