

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

**CC:TEGE:EOEG:TEB/PLR-111104-00**

Date:

**September 15, 2000**

**LEGEND:**

Company =

Authority =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Bonds =

Lessor =

Vendor =

a =

b =

c =

Dear :

This letter is in reply to your request for rulings that (1) an allocation of bond proceeds may be disregarded, and (2) certain expenditures are not capital expenditures within the meaning of § 144(a)(4)(A) of the Internal Revenue Code.

### **Facts and Representations**

You make the following factual representations. The Company has a facility where it manufactures various steel products. Recently, the Company expanded that facility using the proceeds of the Bonds. The Bonds were issued by the Authority on Date 1 and the Authority elected to apply the \$10 million limitation for exempt small issues under § 144(a)(4)(A) to the Bonds.

Some of the Bond proceeds were to be used by the Authority to acquire equipment (the "Equipment") from the Vendor, which was to be leased to Company for the facility. To execute this plan, on Date 2, the Company issued a purchase order (the "Vendor Purchase Order") to the Vendor. That order specified that the price of the Equipment was \$a and required progress payments to be paid to the Vendor at various dates. As of Date 3, the Authority had the Trustee for the Bond issue pay \$b from the Bond proceeds in progress payments for the Equipment.

About Date 4, which was about the same time that the Authority had made the progress payments, the Company discovered that it had understated the aggregate amount of capital expenditures to be paid for the facility. When the error was corrected, the Company realized that the relevant capital expenditures, when aggregated with the Bond proceeds, would exceed the \$10 million limitation.

To correct the problem, the Company determined that it would need to make some of the capital expenditures from the Bond proceeds instead of from other sources of funds. As a result, there would not be enough Bond proceeds to pay these capital expenditures and to purchase the Equipment.

Accordingly, the Company planned to have an unrelated third party, the Lessor, purchase the Equipment and lease it, under an operating lease, to the Company. On or about Date 5, Lessor entered into a letter of understanding with the Company that provided that the Company would lease the Equipment from the Lessor under a previously executed master lease agreement.

On Date 6, the Company entered into a progress payment agreement (the "Progress Payment Agreement") with the Lessor, providing that 1) the Company assigned to the Lessor its right to purchase the Equipment from the Vendor and 2) the

Lessor agreed to make progress payments for the Equipment to the Vendor on behalf of the Company. The Progress Payment Agreement provided that these payments were loans from the Lessor to the Company. The Lessor paid \$c to the Vendor on behalf of the Company.

On Date 7, which was within 3 months of Date 3, Vendor returned to the Trustee the \$b that the Trustee had paid the Vendor from the Bond proceeds. The Trustee deposited this money into the construction fund.

On Date 8, the Authority, the Company and the Vendor entered into another agreement, which was intended to clarify and supercede any prior agreements to the extent that the Date 8 agreement was inconsistent with the prior agreements. Under the Date 8 agreement, the Vendor Purchase Order and the Progress Payment Agreement were canceled, the Vendor agreed to refund to Lessor the \$c that was paid under the Progress Payment Agreement, and the Lessor agreed to purchase the Equipment from the Vendor on its own behalf. Also on that date, the Vendor refunded \$c to Lessor.

As of the date of this ruling request, the Lessor had not fully paid the Vendor for the Equipment and the Equipment has not been delivered to the facility.

The Authority requests rulings that (1) the allocation of \$b of Bond proceeds to progress payments may be disregarded, and (2) the \$c that was paid by the Lessor on behalf of the Company under the Progress Payment Agreement, which was then later refunded to the Lessor, is not a capital expenditure within the meaning of §144(a)(4)(A).

## **Law**

Section 103(a) provides that gross income does not include interest on a State or local bond. Section 103(b) provides, in part, that § 103(a) does not apply to any private activity bond, unless it is a qualified bond under § 141. Section 141(e) provides, in part, that a qualified small issue bond is a qualified bond.

Section 144(a)(1) provides that the term “qualified small issue bond” means any bond issued as part of an issue the aggregate authorized face amount of which is \$1,000,000 or less and 95 percent or more of the net proceeds of which are to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or to redeem a prior issue that was used for those purposes.

Section 144(a)(4)(A) provides, in general, that at the election of the issuer with respect to any issue, § 144(a) shall be applied by substituting "\$10,000,000" for "\$1,000,000" and, in determining the aggregate face amount of such issue, by taking into account certain prior bond issues and the aggregate amount of capital expenditures with respect to certain facilities paid or incurred during the 6-year period beginning 3 years before the date of such issue and ending 3 years after such date.

Section 1.148-6(a)(1) provides that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue. Section 1.148-6(d)(1)(iii) provides, in part, that an issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier.

In Rev. Rul. 79-248, 1979-2 C.B. 41, a corporation purchased equipment that is ordinarily leased, sold the equipment to an unrelated leasing company before it was installed or placed in service, and leased it back, under a operating lease, for use in its manufacturing plant, which had been financed with industrial development bonds. The ruling holds that for purposes of the exempt small issue limitation of § 103(b)(6)(D) of the Internal Revenue Code of 1954 (the predecessor to § 144(a)(4)), the cost of the equipment is a capital expenditure made on the date of purchase by the corporation.

In Rev. Rul. 80-162, 1980-1 C.B. 26, a corporation ordered custom-made equipment and paid a deposit and down payment for the equipment from its own funds. The corporation then discovered that its purchase of the equipment would cause the \$10,000,000 exempt small issue limit to be exceeded. The corporation immediately entered into an agreement with an unrelated corporation whereby the other corporation would purchase the custom-made equipment from the same vendors and lease it to the first corporation under a operating lease agreement. The vendors terminated their contracts and refunded the down payments and deposits to the first corporation. The ruling holds that the down payments and deposits are not capital expenditures because the corporation did not purchase the equipment. Rev. Rul. 79-248 is distinguished on the grounds that in Rev. Rul. 79-248, the purchase of the equipment was completed (the corporation had paid the full purchase price), whereas in this ruling the corporation did not actually complete the purchase of the equipment.

### **Analysis**

Neither the Code nor the regulations contain any rules under § 144(a)(1) for allocating bond proceeds to expenditures. Nevertheless, we consider the principles underlying the allocation rules of § 148 for guidance on the allocation rules for § 144(a)(1).

Under § 148, allocations of expenditures must occur within 18 months of the later of the date the expenditure is paid and the date the project is placed in service, but in no event later than 60 days after the earlier of the fifth anniversary of the issue date and the retirement date of the issue. By not requiring allocations to be determined when the expenditure is paid or incurred, the regulations acknowledge that day-to-day practicalities require some flexibility for when issuers must make allocations. We conclude that these practicalities also require flexibility for certain corrections to allocations, particularly if those corrections are made immediately after the error is discovered and soon after the allocation is made. For similar reasons, we conclude that some flexibility is necessary for allocations under § 144(a).

In the instant case, the Authority entered into the Vendor Purchase Order for the Equipment and allocated \$b of Bond proceeds to the progress payments it made to the Vendor. At about the same time, the Company discovered that it had erred in calculating the capital expenditures that would count toward the \$10 million limitation. Within 3 months of the date the progress payments were made and the error was discovered, the Authority received the \$b refund from the Vendor.

We conclude that the Authority is permitted to disregard its allocation of bond proceeds to the progress payments. The Authority took steps to correct the error immediately after it was discovered. Moreover, the Authority received the progress payments back within a short time of paying them.

We also conclude that, based on Rev. Rul. 80-162, the \$c that was paid by the Lessor on behalf of the Company under the Progress Payment Agreement, and that was later refunded to the Lessor, should not be treated as a capital expenditure for purposes of § 144(a)(4)(A). On Date 8, within a short period after the calculation error was discovered, the Company entered into an agreement under which the Lessor would purchase the Equipment and lease it to the Company. This agreement also terminated the Vendor Purchase Order. The \$c paid by the Lessor on behalf of the Company was refunded to the Lessor and the Progress Payment Agreement was terminated, eliminating any obligation the Company had to the Lessor under that agreement. As of Date 8 the Vendor had not been fully paid for the Equipment and the Equipment had not been delivered to the facility.

## **Conclusions**

Based on the foregoing analysis, we conclude that (1) the allocation of the \$b of proceeds of the Bonds to progress payments under the Vendor Purchase Order is disregarded, and (2) the \$c that was paid by the Lessor on behalf of the Company under the Progress Payment Agreement, which was then later refunded to the Lessor, is not a capital expenditure for purposes of § 144(a)(4)(A).

Except as specifically ruled above, no opinion is expressed concerning this transaction under any provision of the Code or regulations thereunder. Specifically, no opinion is expressed concerning whether interest on the Bonds is excludable from gross income under § 103(a). We do not address any issues under § 148, including any issues that may arise because the allocation of Bond proceeds to the progress payments is disregarded.

This ruling letter is addressed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Pursuant to a Power of Attorney on file with this office a copy of this letter is being sent to the Company's authorized representative.

Sincerely yours,

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

By: \_\_\_\_\_  
Rebecca L. Harrigal  
Chief, Tax Exempt Bond Branch