NATIONAL ASSOCIATION OF BOND LAWYERS

SUGGESTION FOR GUIDANCE ON MANUFACTURING FACILITIES

This report was prepared by a Task Force on Small Issue Bonds made up of members of the General Tax Matters Committee of the National Association of Bond Lawyers. Primary responsibility for drafting the report was taken by Jeannette M. Bond. Members of the Task Force who have contributed to these comments include Larry L. Carlile, David B. Ryan, Howard Eichenbaum, Bruce Polizotto, Kathleen McKinney, Daniel Waugh, Griffith F. Pitcher, Virginia D. Benjamin, Robert Price, Gary Duescher, Charles Katz, Walter Calvert, Charles C. Cardall, Chair of the General Tax Matters Committee, Mitch Rapaport, Vice Chair of the Committee and Jeffrey McHugh, Board Advisor to the Committee.

I. INTRODUCTION

The following are suggestions for guidance in the form of either regulations or a revenue ruling prepared by members of the General Tax Matters Committee (the "Committee" of the National Association of Bond Lawyers ("NABL"). These suggestions were prepared in accordance with NABL's purposes. While not all members of the Committee necessarily concur in these suggestions, the suggestions represent the consensus of the participants. Reference herein to the term "we" or "the Committee" is to the participants identified on the cover page. In addition, certain members of the Board of Directors of NABL have reviewed the suggestions. We would welcome the opportunity to discuss these suggestions with representatives of the Department of Treasury and the Internal Revenue Service ("IRS") and to answer any questions that the suggestions may raise.

NABL was incorporated as an Illinois nonprofit corporation on February 5, 1979, for the purpose of educating its members and others in the law relating to state and municipal bonds and other obligations, providing a forum for the exchange of ideas as to law and practice, improving the state of the art in the field, providing advice and comment at the federal, state and local levels with respect to legislation, regulations, rulings and other actions, or proposals therefor, affecting state and municipal obligations, and providing advice and comment with regard to state and municipal obligations in proceedings before courts and administrative bodies through briefs and memoranda as a friend of the court or agency. NABL currently has about 3000 members.

II. SUMMARY

In General

Tax exempt small issue private activity bond financing is permitted under sections 103 and 144(a) of the Internal Revenue Code of 1986, as amended (the "Code"), for any manufacturing facility. The term "manufacturing facility" is defined in Section 144(a)(12)(C) of the Code as any facility which is used in the manufacturing or production of tangible personal property (including the process resulting in a change in condition of such property.) In 1988, Section 144(a)(12)(C) was amended by Section 362 of the Technical and Miscellaneous Revenue Bond Act of 1988 ("TAMRA") by adding the last sentence of this paragraph, as follows:

> For purposes of the 1st sentence of this subparagraph, the term "manufacturing facility" includes facilities which are directly related and ancillary to a manufacturing facility (determined without regard to this sentence) if—
> (i) such facilities are located on the same site as the manufacturing facility, and
> (ii) not more than 25 percent of the net proceeds of the issue are used to provide such facilities.

No regulations have been promulgated yet under Section 144(a)(12)(C).

B. *Concerns*

As more fully discussed below, we believe that guidance is needed now on the scope of the manufacturing limitations and, particularly, on the meaning of the term "ancillary" in light of the legislative history of TAMRA. We also believe that clarification is needed regarding the treatment of related office space. We are concerned that the lack of guidance for participants in this area is resulting in uncertainty both for issuers and conduit borrowers who are trying to finance projects and for the IRS as it administers its enforcement efforts. We believe there are fundamental issues going to the very basic qualification of facility components that need to be resolved through the normal regulatory or ruling process and not in the context of bond audits. We also believe that many of the issues now being addressed in the audit process are arising as a result of a fundamental misunderstanding of the legislative history of TAMRA.

III. BACKGROUND

A. Clarification of Scope of a Manufacturing Facilitiy

In the Tax Reform Act of 1986, Congress imposed a sunset on the future issuance of small issue bonds after December 31, 1986, other than bonds issued before December 31, 1989 that were part of an issue 95 percent of the proceeds of which were used to provide a manufacturing facility. Participants in these financings were given little, if any, guidance as to fundamental questions such as whether a particular activity constituted manufacturing or whether particular components of activity known to be manufacturing were properly treated as part of the manufacturing facility. Because of the uncertainty as to the scope of the manufacturing exception certain issuers of small issue bonds sought additional guidance from Congress in 1987-1988 to clarify the intent of the exception as part of the legislative effort to have the sunset extended.

In TAMRA, Congress added the last sentence of the Section 144(a)(12)(C) at the same time as it granted a one year extension of the sunset for issuing small issue bonds for manufacturing. (After a series of short extensions, the sunset was repealed in 1993.) Although TAMRA was intended to clarify the scope of the manufacturing exception, it has resulted in yet more confusion as to what components of a manufacturing facility are eligible to be financed.

B. Technical Advice Memorandum 199904034

An example of the confusion that exists in determining what components are part of a manufacturing facility, and the basis for that confusion, can be seen in Technical Advice Memorandum 199904034 (the "TAM"). At issue in this TAM was the eligibility for small issue bond financing of equipment used in the operation of mining and crushing limestone. Without dwelling on whether a mining operation was manufacturing in the first place, the IRS concluded that the equipment in question, bulldozers were not part of

core manufacturing. It cited the legislative history to support its view that core manufacturing was to be narrowly defined. The TAM provides:

> The statute and legislative history indicate that core manufacturing should be narrowly defined. First, in the statute, Congress differentiated between core manufacturing and activities that are directly related and ancillary to that manufacturing. For example, a warehouse for short-term storage of raw materials is not part of the core manufacturing process. Likewise, forklifts or similar equipment used in the manufacturing or production process are not part of the core manufacturing process. See H.R. Rep. No. 795, 100th Cong. 2d Sess. 576-77 (1988). By making this distinction, Congress suggested a narrow definition should be used for core manufacturing.
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> Second, the legislative history to the 1988 Act provides that if a distinct and separate economic activity is performed at a single physical location where manufacturing takes place, that activity is not part of the manufacturing facility when the employment in such activity is significant even if that activity is integral and subordinate to the manufacturing facility. For example, a showroom staffed with full-time sales personnel is not part of a manufacturing facility. H.R. Rep. No. 795 at 576-77. By excluding from core manufacturing certain activities that are subordinate and integral to core manufacturing, the legislative history supports a narrow interpretation of core manufacturing facilities.

This interpretation of the TAMRA legislative history fails to take account of a fundamental distinction drawn in the legislative history.

C. The Legislative History of TAMRA

The relevant language of the House Report, H. Rep. No. 100-795. pp 576-577, provides as follows:

> The committee's amendment to the qualified small-issue bond manufacturing definition clarifies that the definition does not preclude the use of a portion of the proceeds of a qualified small-issue bonds to finance ancillary activities provided those activities meet several criteria and provided no more than 25 percent of the net proceeds of the issue are used other than to finance facilities other than the core manufacturing (i.e., production) facility itself. All ancillary activities must occur at the same site as the manufacturing activity, and manufacturing must constitute substantially all of the on-site economic activity. All ***other*** activities must be subordinate to and integral to the manufacturing process. [Emphasis added.]

What is being overlooked in this paragraph is a distinction being drawn between "ancillary" activities, which are subject to the 25% limitation, and activities that are "subordinate and integral" to the manufacturing process, which are not subject to this limitation. This interpretation is based on the use of the word "other" in the last sentence of this paragraph and the examples that follow. By using the word "other" and not the word "ancillary" in this last sentence, the House Report is establishing that there are three concepts to be considered in analyzing a financing for a manufacturing facility, (i) core manufacturing, *i.e.*, the facilities actually causing the transformation or processing of the manufactured product, (ii) subordinate and integral facilities and (iii) ancillary facilities. This framework and interpretation is consistent with the statutory language and supported by the balance of the House Report.

The legislative history continues in the next paragraph to give several examples of particular activities that are or may be considered *subordinate and integral* to the manufacturing process. The examples are as follows:

> For example, short-term warehousing of raw materials incidental to production, or the temporary warehousing of the finished product constitutes subordinate and integral activities. An on-site laboratory whose purpose is to test the manufactured product for quality or to experiment with different materials which might be used as raw materials for the product may be an integral and subordinate activity. Loading docks or rail spurs to unload raw materials or load finished products may be integral to the functioning of the manufacturing plant. Similarly, the committee believes that forklifts or similar equipment are integral to a manufacturing operation, but trucks or vans to deliver the final product are not integral to the manufacturing process.

These are all activities that under the facts and circumstances are or may be so integral to the manufacturing process that it could not go on without them. These are activities that are essential for the manufacturing process to operate. Furthermore, it is important to note that the term "ancillary" is not used once in describing these activities.

Ancillary activities are activities that are not integral to the process. They are activities that, as the statute provides, are directly related to manufacturing, but are, as the dictionary provides, secondary, supplementary, or extra. These are not activities that are so necessary to the actual manufacturing process that they would in all cases be located in the plant. In the next two paragraphs, the legislative history describes these separate activities that are not part of the manufacturing process but nonetheless are adjacent thereto:

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

> For example, an employee parking lot adjacent to the plant which does not cause the firm to hire parking attendants and does not generate revenue for the firm would not be a separate activity. Similarly, a separate room stocked with samples to show buyers can be integral to the successful operation of a manufacturing facility. However, a showroom staffed with full-time sales personnel is outside the scope of a manufacturing facility.

Because these activities can be separated from the actual manufacturing process and can, for example, be located at another site, it makes sense to permit their financing only if they are located at the site of the manufacturing facility. This is why the statute contains the location requirement for ancillary facilities.

When the House Report was released, the issuers and practitioners involved in the legislative process understood that the two distinct concepts of ancillary and subordinate and integral, were being illustrated. The confusion in the interpretation was caused by the second sentence of the Conference Report, Conf. Rep. No. 100-1104, p 203. (There was no Senate Bill provision on manufacturing.) The Conference Report stated that it was following the House Bill, but in describing what the House Report was saying, it mistakenly intermingled the concepts of subordinate and integral on one hand and ancillary on the other, that the House Report had spent four paragraphs illustrating:

> The House bill clarifies that up to 25 percent of the proceeds of a qualified small issue may be used to finance ancillary activities which are carried out at the manufacturing site. *All such ancillary activities must be subordinate and integral to the manufacturing process.* [Emphasis added.]

Because this sentence in the Conference Report is found in the paragraph that purports to be describing what the House of Representatives set forth, and not in the paragraph that describes what the Conferees are actually passing, it should not be viewed as a Conference amendment to the House Bill, eliminating the distinction between ancillary and subordinate and integral. Rather, it should be viewed as merely a misinterpretation of what the House was trying to say. In fact, equating the two concepts makes the House Report language nearly unintelligible, because ancillary does not mean integral.

It is by merging these two concepts that the IRS concludes that Congress intended a narrow interpretation of eligible manufacturing components. In fact, what Congress was trying to do was provide a reasonable and logical distinction that looked to the realities of a manufacturing operation and analyzed what components were really integrated with that operation and what components were secondary or supplemental to the operation. We believe there was no intention to subject these integral components to a 25 percent limitation. Congress was trying to respond to industry requests for

"clarification" of what was meant by manufacturing; it was not attempting to further restrict the meaning of manufacturing.

We believe many bond counsel firms currently apply a three step analysis similar to what is advocated here. The first step is to analyze what components of the facility are absolutely necessary to the manufacturing process. These components make up core manufacturing. The second step is to identify components that are directly related to the manufacturing process but not absolutely necessary. The third step analyzes the components in this second group to determine what components are spatially or temporally required to be near the manufacturing process, that must be close at hand in space and time to the manufacturing process, for it to operate efficiently. These components are the ones considered subordinate and integral to the manufacturing process and treated as part of core manufacturing. Those components that do not need to be close at hand to the manufacturing process are treated as ancillary facilities. Thus components such as short-term warehousing space for the raw materials necessary to support a product cycle would under this test be treated as subordinate and integral to the manufacturing process and not subject to a percentage limit.

This interpretation of the manufacturing provision makes the provision parallel the exempt facility provisions, which include functionally related and subordinate facilities, and, for example, in the transportation context, impose on storage and training facilities, a directly related standard and a location requirement.

It is also important to note that clarifying the confusion that currently exists and permitting the financing of subordinate and integral components as part of manufacturing without subjecting them to a percentage limit will not result in more tax-exempt bonds being issued since all of these bonds are subject to the state volume cap. It will merely affect the size of a given issue for a given borrower. How the volume cap gets allocated among issues is a determination that already must be made by each state and its issuers

D. Office Space Limitation.

In defining what is meant by the term "manufacturing facility," Section 144(a)(12)(C) of the Code specifies that, for such purpose, a "rule similar to the rule of section 142(b)(2) shall apply." Section 142(b)(2) contains a limitation on the financing of office space as part of an exempt facility. Under Section 142(b)(2), office space is generally not financeable as part of an exempt facility unless (A) the office is located on the premises of [an exempt facility] and (B) not more than a de minimis amount of the functions to be performed at such office is not directly related to the day-to-day operations at such facility." Such office space "test" was added by the Tax Reform Act of 1986 (the "1986 Act") and in the Conference Report for the 1986 Act (H.R. Rep. No. 841, 99th Cong., 2d Sess., Sept. 18, 1986), the conferees recognized that, although

> "office space generally is not treated as functionally related and subordinate to an exempt facility,… office space that is directly related to the day-to-day operations at an exempt facility and that is located at or within the facility may be financed

with exempt facility bonds and small issue IDBs for manufacturing." 1986 Conference Report at II-708-709.

Thus, from such statutory introduction in 1986, it was clear that office space was intended to be financeable as part of a small issue manufacturing facility, as long as the "directly related activities" and "located on premises" tests were satisfied, with no identified limit as to the amount of such space that may be so financed. We understand that there is concern, however, that the Internal Revenue Service may be interpreting the office space limitation standard as a "de minimis amount of space" standard, rather than a "directly related activities" standard. We believe that this is a misinterpretation based on language in the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the "1984 Blue Book") that was not supported by legislative history when written.

In the 1984 Blue Book, the drafters of the Blue Book asserted that the extension of the small issue termination date was intended by Congress to apply only to manufacturing facilities and not "nonmanufacturing facilities that are associated with manufacturing facilities," using by way of example the fact that "a de minimis amount (e.g., less than five percent) of the space in a manufacturing plant is devoted to offices directly related to the manufacturing process conducted in the plant may be disregarded." 1984 Blue Book at 942. The 1984 Blue Book explanation goes on to report that "a separate office building in a manufacturing complex or an office wing of a larger, mixed-use building" would not be financeable. Nothing in the actual legislative history of the Deficit Reduction Act of 1984 suggested a de minimis space limitation on office space.

Congress was no doubt aware of the language in the 1984 Blue Book because in describing the office space tests for purposes of Code Section 142(b)(2), the 1986 Conference Report cited "a separate office building, or an office wing of a mixed-use facility," as examples of office space that could not be financed, 1986 Conference Report at II-708, language that nearly mirrors the language contained in the 1984 Blue Book. The fact that the Congress chose to ignore the more restrictive "de minimis amount of space" requirement in favor of the "directly related activities" requirement must be given great weight and should be imposed as the standard by which office space that is part of a small issue manufacturing facility is measured.

Subject to the "directly related activities" standard, office space should be subject to the same analysis as the rest of the project under the three-part analysis we propose here. Generally, it will be treated as ancillary to core manufacturing. There may be an instance, however, depending on the facts and circumstances, when a portion of the office space may be integral to the manufacturing process and would not be taken into account in the application of the 25 percent limitation.

E. Suggested Guidance

We suggest that regulations be developed that recognize and clarify the distinction between ancillary facilities and those that are subordinate and integral to the

manufacturing process. These regulations should also address the confusion on office space. Suggested regulation language is attached hereto as Exhibit A.

Alternatively, we believe that clarification of the ancillary facility concept as suggested in this report could be undertaken through a revenue ruling. Suggested language for a revenue ruling is attached as Exhibit B

EXHIBIT A

SUGGESTED REGULATION LANGUAGE

Section 1.144(a)-12

(a) **Manufacturing Facilities** -- For purposes of section 144(a)(12)(B), the term "manufacturing facilities" includes:

(i) land, building and equipment used in the manufacturing or production process, including facilities that are subordinate and integral to such process, and

(ii) ancillary facilities that meet the requirements of subsection (b).

(b) **Ancillary facilities** – Ancillary facilities may be financed as part of a manufacturing facility only if –

(i) the facilities are directly related and supplementary or secondary to the manufacturing facility, (determined without regard to the inclusion of ancillary facilities);

(ii) the facilities are located at the same site as the manufacturing facility, and

(iii) not more than 25 percent of the net proceeds of the issue are used to provide such facilities.

(c) **Subordinate and integral facilities –** Facilities are considered subordinate and integral to the manufacturing process if they are not part of the manufacturing process, but their location at the manufacturing facility is essential or necessary for the operations to occur.

(d) The following examples illustrate the application of this section:

Example (1) Authority X issues bonds to finance a loan to be made to Company A to finance a new manufacturing plant. In addition to the manufacturing equipment and the building in which the manufacturing equipment will be located, Company A wishes to include as part of the bond-financed facility the following components: space for the short-term warehousing of raw materials incidental to production; space for the temporary and short-term warehousing of the finished product for a period of time not greater than the time necessary for a product cycle prior to its delivery to customers or a longer-term storage facility; an on-site laboratory whose purpose is to test the manufactured product for quality or to experiment with different materials which might be used as raw materials for the product and which must be located near the manufacturing process for the process to operate at peak efficiency; locker rooms and restroom facilities for employees and forklifts and similar equipment necessary to move raw material or product in the manufacturing process. All of these components are subordinate and integral to the manufacturing process and treated as part of the manufacturing facility without regard to a percentage limitation.

Example (2) The facts are the same as in Example 1, but in addition to the components described therein, Company A wishes to finance with the proceeds of the bonds the

following items: trucks and vans to deliver the final product that are based at the facility and a garage to house them at the facility; a showroom at the facility for the finished product staffed with full-time sales personnel; office space for accounting and other customary administrative functions and a warehouse at the facility for long-term storage of finished goods. All of these components are ancillary facilities in that they are secondary to the manufacturing process and are not integral to the operation of the manufacturing facility. Because all of these components are located at the same site as the manufacturing facility, they may be able to be financed with proceeds of the bonds so long as not more than 25% of the proceeds of the bonds are allocated to the cost of these components.

EXHIBIT B

SUGGESTED RULING LANGUAGE

Advice has been requested whether under the facts described below the facilities are eligible for financing with the proceeds of exempt small issue bonds under Section 144(a) of the Internal Revenue Code of 1986, as amended (the "Code"), without regard to the 25 percent limitation imposed on ancillary facilities of a manufacturing facility by Section 144(a).

FACTS

Situation 1. Authority X issues bonds to finance a loan to be made to Company A to finance a new manufacturing plant. In addition to the manufacturing equipment and the building in which the manufacturing equipment will be located, Company A wishes to include as part of the bond-financed facility the following components: space for the short-term warehousing of raw materials incidental to production; space for the temporary and short-term warehousing of the finished product for a period of time not greater than the time necessary for a product cycle prior to its delivery to customers or a longer-term storage facility; an on-site laboratory whose purpose is to test the manufactured product for quality or to experiment with different materials which might be used as raw materials for the product and which must be located near the manufacturing process for the process to operate at peak efficiency; locker rooms and restroom facilities for employees and forklifts and similar equipment necessary to move raw material or product in the manufacturing process.

Situation 2. The facts are the same as in Situation 1, but in addition to the components described therein, Company A wishes to finance with the proceeds of the bonds the following items: trucks and vans to deliver the final product that are based at the facility and a garage to house them at the facility; a showroom at the facility for the finished product staffed with full-time sales personnel; office space for accounting functions where not more than a de minimis amount of the accounting activity relates to activities unrelated to the plants operations, and a warehouse at the facility for long-term storage of finished goods.

LAW AND ANALYSIS

Section 141(e)(1) of the Code includes within the list of "qualified bonds" the interest on which is excluded from gross income under section 103 of the Code a qualified small issue bond. Section 144(a) defines qualified small issue bonds. Section 144(a)(12) provides a sunset for the issuance of qualified bonds other than for manufacturing facilities and certain farm property. Section 144(a)(12)(C) defines "manufacturing facility" as –

> any facility which is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of such property). A rule similar to the rule of Section 142(b)(2) shall apply for purposes of the preceding sentence. For purposes of the 1st sentence of this subparagraph, the term "manufacturing facility" includes facilities which are directly related and ancillary to a manufacturing facility (determined without regard to this sentence) if—
> (i) such facilities are located on the same site as the manufacturing facility, and
> (ii) not more than 25 percent of the net proceeds of the issue are used to provide such facilities.

Section 142(b)(2), referenced in this definition, permits the financing of office space in the exempt facility context only if the office space is located on the premises of the exempt facility and not more than a de minimis amount of the functions to be performed at the office is not directly related to the day-to-day operations at the facility.

Situation 1. A manufacturing facility by necessity includes components that are subordinate and integral to the manufacturing components. Facilities are considered subordinate and integral to the manufacturing process if they are not part of the actual manufacturing process, but their location at the manufacturing facility is essential or necessary for the operations to occur. These facilities are not treated as ancillary for purposes of the 25 percent limitation. In Situation 1 all of the listed facilities are subordinate and integral to the manufacturing process and may be financed with proceeds of the Bonds without regard to the 25 percent limitation on ancillary facilities.

Situation 2. The additional components listed in Situation 2 are all facilities that are directly related, but are supplementary or secondary to the manufacturing facilities. They are all components that by their nature and the nature of the manufacturing operation need not be located at the same site as the manufacturing facility. These facilities may be financed with the proceeds of the Bonds only if they are in fact located at the same site as the manufacturing facility and not more than 25 percent of the proceeds of the Bonds are used to provide such facilities.